“Mortgage Financing and Life Insurance Protection”

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The Mortgage

Introduction

The term mortgage is a generic term used to describe several different combinations of legal documents that allow a home buyer to get financing. The documents (note, bond, mortgage, deed of trust, open-end-mortgage, security deed, and riders) that are used depend on the state in which the property is located and the type of loan being applied for.

A mortgage is a financial claim against real estate. A mortgage is given to a lending institution, along with a bond or a note, which is a personal promise to repay. In return, the lender provides the money or cash needed to complete the transaction**. The person who takes on the mortgage debt is called the "mortgagor" because he is technically the party who is accepting the mortgaging.** The lender takes and holds the mortgage until repayment has been made and is called the "mortgagee."

Loans secured by properties located in deed of trust states are secured by a document called a deed of trust. When deed of trust is signed, ownership of the property is actually transferred to a trustee. The trustee holds the deed to the property in trust until the loan is paid off. If a dispute arises between lender and borrower, the trustee must to follow state law in resolving the dispute. When a borrower stops making loan payments then it becomes necessary for the trustee to conduct a foreclosure sale for the purpose of paying off the lender. The procedure for a foreclosure is detailed in the deed of trust and controlled by state law. In most states, a court hearing is not required to accomplish foreclosure. In most states allowing mortgages, however, the lender must go to court, argue the case before a judge and obtain the judge's approval before a foreclosure sale can be held. Lenders prefer to have loans secured by deed of trust because foreclosing on a deed of trust is cheaper and quicker than on a mortgage. As a borrower, you can consider mortgages and deeds of trust as generally interchangeable terms.

Reality of Home Buying

Affordable housing programs were greatly expanded since the late1990's. People have become more knowledgeable about real estate buying while lenders have come to realize that it is not a perfect world when it comes to credit history. However, some of the loose availability of mortgages to people who could not repay them has lead to the recent banking crisis which nearly brought down the American and world economies. Since rules have become tighter to qualify for a mortgage since the near financial meltdown of 2008-2009, it will likely be harder for Americans to achieve the dream of home ownership than it was just a few years earlier.

Tax Advantages

● Mortgage interest is deductible.
● Property taxes are deductible

This means that taxing authorities help you buy your home with years of indirect tax subsidization. Although you may be paying one thousand dollars a month in total interest and real estate tax charges, you do not have to pay income taxes on some the money that is used for this payment. The higher your tax bracket, the more of the payment that is not taxable.

Pre-payment Advantages

● Saves thousands of dollars in interest payments by paying off mortgage early.
● No additional mortgage payments.

● Safety and security in case of income reduction.

● Home equity provides a source of cash for retirement, investments, emergencies or education funding.

When a mortgagor pays a little extra principal with every payment it can have a powerful effect on the amortization of a mortgage and reduce the repayment period by many years. By paying off a mortgage term early, the mortgagor enjoys all of the advantages listed above. The basic idea is to achieve greater financial stability and flexibility in the future by creating a plan today to reduce the term of a mortgage period. Owning a home free and clear helps provide more economic freedom and security, frees up cash for other investments, provides a greater credit line for the owner and most importantly offers the peace of mind that only freedom from debt allows.

Loan Amortization

Amortization is an impressive sounding word that lenders use to describe the tedious process of liquidating a debt by making periodic installment payments throughout the loan's term. Loans are amortized (repaid) with **monthly payments** consisting **primarily of interest** during the early years of the loan term **and reduction of principle**, which the lender uses to replace the loan's balance. If the loan is fully amortized (meaning the mortgagor pays exactly what is owed each and every month of the term of the loan), it will be repaid in full by the time the final loan payment is made.

The reason that mortgage loans have long terms (often 25 to 30 years) is to stretch out the time and therefore reduce the monthly payment amount. However, a main drawback of a long-term loan is that the interest paid over the life of the loan may be some three or more times the amount actually borrowed, depending upon the percentage rate applied.

There are a number of types of loans that provide "rapid" amortization. The easiest to arrange is a 15-year mortgage. This will significantly increase each and every principle and interest (P&I) payment, typically by 20%. Since a higher amount is paid monthly and more of that higher payment is being used to reduce the total amount of principal still owed, the term of the loan is significantly reduced. In other words, by increasing the monthly payment by only 20% the mortgagor cuts 50% off the mortgage repayment time (from 30 years down to 15 years)

A **bi-weekly mortgage** is another approach to accomplish the same objective of reducing significantly the repayment time. The payment required is one half of a monthly payment for a standard mortgage. This amount is paid every two weeks. Because there are twenty-six periods of two week in a year (52 divided by 2 =26), it is similar to making thirteen payments in a year instead of just twelve. However, making such payments will significantly shorten the amortization period, although it may adversely affect affordability, especially if borrower is stretching the budget to buy the home. It is especially useful, though, for people who are paid every week or even two weeks, but not for those paid monthly or even twice a month (which is not quite the same as every two weeks).

An alternative is to arrange a 30-year loan to keep the payments at an affordable level. Then, the borrower can pay more each month or in a lump sum when they have some extra cash. Note, that if the borrower encounters hardship after making extra payments on a shorter term mortgage, the lender may not be amenable to reducing or skipping future payments. When the borrower takes a longer term to repay they create their own flexibility to repay faster if they choose or take the full term if cash flow is long term problem.

Most lenders will cooperate by applying the extra payment to the current principle balance. Some lenders apply prepayments to the escrow account or to the last required payments, an unfavorable procedure for a borrower. Some lenders make it easy to apply advance payments to the principle by providing a space on the coupon book so the borrower can indicate the application of an extra payment. It works like this: the principle and interest (P&I) portion of the payment (don't count taxes and interest) has been financially engineered to pay off the loan over a certain period, with interest due on the unpaid balance. In a long-term mortgage loan, most of the payments in the early years are for interest, with a small amount for principle reduction (amortization).

As the loan is reduced, less of the total P&I payment is interest and more is used to reduce the principal remaining. Suppose you make an extra payment to reduce the principle. Thereafter, future interest will be less because you do not owe as much as you would if, so more of the payment will reduce the principle. This cycle will repeat every month and will compound for each additional principal payment made. The grand effect is to hasten the reduction of the debt. Any advance payment effectively earns compound interest at the same rate as the mortgage bears, and the advance payment, plus earnings based on it, will shorten the loan term. **Mortgage acceleration, as it sometimes called, can be a powerful financial tool for creating wealth and financial stability for any home buyer.**

Types of Mortgage Lenders – Primary Market

It used to be fairly easy to put a term to a lender that accurately described them and the types of mortgages they originated. Time, past savings and loan institutional problems and a maturing marketplace have served to "blend" or blur those differences. Some old adjectives barely apply now and are rarely used**. Direct issuers of mortgage loans are referred to as “primary market” lenders.**

Mortgage Bankers

A true Mortgage Banker is a lender that is large enough to originate loans and create pools of loans which they sell directly to Fannie Mae, Freddie Mac, Ginnie Mae, jumbo loan investors, and others. Any company that does this is considered to be a mortgage banker. They can very greatly in size. Some may service the loans they originate, but not all of them will. Most true mortgage bankers have wholesale lending divisions.

Examples of two of the largest mortgage bankers are Countrywide Home Loans and Wells Fargo Mortgage. One is associated with a bank and the other is not, but both are most correctly classified as mortgage bankers. A lot of companies call themselves mortgage bankers and some deserve the title. For others, it is mostly a marketing concept.

Mortgage Brokers

Mortgage Brokers are companies that originate loans with the intention of brokering them to wholesale lending institutions. A broker has established relationships with these companies. Underwriting and funding takes place at the wholesale lender level. Many mortgage brokers are also correspondents, which is why many of them also claim to be mortgage bankers. However, they are essentially a middle-man. Mortgage brokers deal with lending institutions that have a “wholesale” loan department.

Wholesale Lenders

Most mortgage bankers and portfolio lenders also act as wholesale lenders, catering to mortgage brokers for loan origination. **Some wholesale lenders do not even have their own retail branches, relying solely on mortgage brokers for their loans**. A good analogy is the wholesale lender is the factory, producing the product and making it available at a discount price to a retailer who is the mortgage broker. The mortgage broker then finds the borrower.

These wholesale divisions offer loans to mortgage brokers at a lower cost than their own retail branches offer them to the general public. The mortgage broker then adds on his fee. The result for the borrower is that the loan costs about the same whether he obtains the mortgage directly from a retail branch of the wholesale lender or from a mortgage broker.

Portfolio Lenders

Portfolio lenders are institutions which lend their own money and originate loans own their own behalf. They are lending for their own portfolio of loans and not worried about being able to immediately sell them on the secondary market (secondary mortgage markets are discussed in a section that follows this discussion of primary market lenders). Because they are not reselling their loans, portfolio lenders don't have to obey Fannie/Freddie guidelines and can create their own rules for determining credit worthiness. Usually these institutions are larger banks and savings & loans.

Usually often only a portion of their loan programs are "portfolio" product. If they are offering fixed rate loans or government loans, they are certainly engaging in mortgage banking as well as portfolio lending. This market diversification will allow the portfolio lender to service more markets than just the loans they originate and wish to keep.

Once a borrower has made the payments on a portfolio loan for over a year without any late payments, the loan is considered to be "seasoned." This seasoning creates a positive history of timely payments it makes the loan marketable (capable of being sold to another party), even if it does not meet Freddie/Fannie guidelines.

Selling these "seasoned" loans frees up more money for the "portfolio" lender to make even more loans, which is another way that portfolio lenders engage in mortgage banking. When loans are sold, they are packaged into pools, or groups, and sold in these batches on the secondary market. A mortgagor will probably not even realize his loan has been sold because, quite likely, loan payments will continue to be made to the same lender, which has now become the "servicer."

Direct Lenders

Lenders are considered to be direct lenders if they fund their own loans. A "direct lender" can range anywhere from the biggest lender to a very tiny one. Banks and savings & loans obviously have deposits they can use to fund loans with, but they usually use "warehouse lines of credit" from which they draw the money to fund the loans. Smaller institutions also have warehouse lines of credit from which they draw money to fund loans. Direct lenders usually fit into the category of mortgage bankers or portfolio lenders, but not always.

One way you used to be able to distinguish a direct lender was from the fact that the loan documents were drawn up in their name, but this is no longer the case. Even the tiniest mortgage broker can make arrangements to fund loans in their own name.

Correspondents

Correspondent is usually a term that refers to a company which originates and closes home loans in their own name. After the closing, they sell the loans individually to a larger lender, called a sponsor instead of grouping them together in a pool. The sponsor acts as the mortgage banker, re-selling the loan to Ginnie Mae, Fannie Mae, or Freddie Mac as part of a pool.

The correspondent may fund the loans themselves or funding may take place from the larger company. Either way, the loan is usually underwritten by the sponsor. The correspondent is almost like being a mortgage broker, except that there is usually a very strong relationship between the correspondent and their sponsor.

Banks and Savings & Loans

Banks and savings & loans usually operate as portfolio lenders, mortgage bankers, or some combination of both.

Credit Unions

Credit Unions usually seem to operate as correspondents, although a large union could act as a portfolio lender or a mortgage banker.

Choosing a Mortgage Lender

What kind of lender is "best?" If you talk to a loan officer, he or she will probably say the lender they work for is "the best" and give you a list of reasons why. If you meet the same loan officer years later and he works for a different kind of lender, he will give you a list of reasons why his new lender is better.

Realtors have differing opinions and, as a group, their opinions have changed over time. In the past, most would often recommend portfolio lenders - because they almost always closed the deal. As time passed, mortgage bankers and mortgage brokers became more important, and agents switched along with the changing times.

Most often a Realtor will direct you to a specific loan officer who has demonstrated a track record of service and reliability -- or a loan officer who works for a lender affiliated with their real estate office.

It is often more important to choose a good loan officer and not the institution. Loan officers have two jobs. One is to be your advocate in getting the loan approved. The other is to deliver quality loans. The best method is to obtain referrals from real estate professionals who have witnessed dependable and ethical behavior in the past from lenders they have come to trust.

As for lending institutions, each type of lender has strengths and weaknesses. Quality within each branch or office can vary, depending on the loan officer, the support staff, and a variety of other factors.

Should you select a portfolio lender who is usually a Savings & Loan institution and sometimes a bank?. Recall they are called "portfolio" lenders because they tend to originate loans for their own portfolio (usually adjustable rate loans), not for resale in the secondary market. The distinction gets blurred because most portfolio lenders also engage in mortgage banking. They will often pay more compensation to their loan officers for originating a portfolio product than for originating a fixed rate loan. You may also find that they are not as competitive as mortgage bankers and brokers in the fixed rate loan market, though this is no longer a hard and fast rule.

It is often easier to qualify for a portfolio loan, so they are often a lender of "second resort" for those who cannot qualify for a fixed rate loan. If a loan officer is steering you towards "sub-prime" loans, it might be wise to check out a portfolio lender first, especially if your credit history is strong. **The use of lenders who specialize in less than perfect credit histories should usually be used only when the borrower has little choice due to poor credit.**

However, portfolio lenders also can serve as "niche" lenders because certain things are more important to them than meeting the more standardized underwriting guidelines of a mortgage banker. An example would be a savings & loan which is more concerned with an individual's savings history than being able to fully document income. Getting a break from a lender who does not require perfect income documentation can be of great benefit to certain classes of buyers, especially the self-employed or those who derive a sizable percent of income from cash sources.

If you apply for a loan with a portfolio lender and you are declined, then it is very likely that you will be unable to secure financing. If you still think you should be able to qualify for a loan, you have to start over somewhere else.

For many potential borrowers the major strength of dealing with banks and savings and loans is that consumers will recognize their name. Banks and Savings & Loans often operate as portfolio lenders, but as the lending world has changed, most also operate as mortgage bankers and sometimes brokers.

Mortgage bankers, usually considered a larger source for loans, can be counted upon to have several strengths. For the biggest ones, like Countrywide or Wells Fargo, you will recognize the "brand name." Usually, larger mortgage bankers are much better at promoting special first time buyer programs like those offered in cooperation with state and local governments. These programs will have slightly lower interest rates and costs than the current market rate. To qualify for these programs, your income must usually fall below a median average for the area and you must not have owned your residence for the last three years.

On the other hand a drawback can be that mortgage bankers may have problems just because they are "too big" or they may operate like well oiled, but impersonal machines. A lot depends on the branch or office that the consumer will work with.

When applying for an FHA or VA loan, sometimes mortgage bankers are more adept at some of the intricacies involved while the mortgage broker will be unable to operate in this area as well. For example, the tract being considered for purchase may not be "approved" by FHA or VA. Mortgage bankers often have more clout in getting it approval than would a small mortgage broker.

If a home loan is declined for some reason, many mortgage bankers allow their loan officers to broker the loan to another institution. However, because your loan officer is so used to promoting his own company's product, he often loses track of the "niches" offered by certain wholesale lenders.

Recall that wholesale lenders use mortgage brokers as their loan officers. They offer a lower rate to the broker, the broker adds on his compensation, and the rate is usually about the same as you would get using a mortgage banker. Sometimes the rate is lower, sometimes higher, depending on how much compensation the broker adds on.
Mortgage brokers also learn the "hot points" of various wholesale lenders and can handpick the lender for a borrower which may be unique in some way. He will be able to submit your loan to either a portfolio lender or a mortgage banker. Another advantage is that, if a loan gets declined for some reason, they can simply repackage the loan and submit it to another wholesale lender.

One additional advantage is that mortgage brokers tend to attract a high number of the most qualified loan officers. This is not universal, because mortgage brokers also serve as the training ground for those just entering the business. If you have a new loan officer and there is something unique about you or the property you are buying, there could be a problem on the horizon that an experienced loan officer would have anticipated.

A disadvantage is that mortgage brokers sometimes attract the greediest loan officers, too. They may charge you more on your loan which would then nullify the ability of the mortgage broker being able to "shop" for the lowest rate.

Borrowers cannot get direct access to the wholesale divisions of mortgage bankers and portfolio lenders without going through a broker. Therefore the wholesale market in off limits to the consumer.

Secondary Mortgage Market

Fannie Mae

The Federal National Mortgage Association (FNMA) is known as "Fannie Mae." In 1938, the Federal government established Fannie Mae to expand the flow of mortgage money in the US economy by creating a secondary market. Fannie Mae was authorized to buy Federal Housing Administration (FHA)-insured mortgages, thereby replenishing the supply of the money which could then be used again by new borrowers seeking a mortgage. Fannie Mae was one of many solutions enacted by the government in response to the collapse of the banking system in 1929 at the start of the Great Depression.

In 1968, Fannie Mae became a private company operating with private capital and in a manner which made them self-sufficient. Its role was expanded to include the purchase of mortgages beyond traditional government loan limits, thus reaching out to a broader cross-section of Americans.

Today, Fannie Mae operates under a congressional charter that directs them to concentrate efforts into increasing the availability and affordability of homeownership for low, moderate, and middle-income Americans. Fannie Mae operates in this manner despite the fact it currently receives no government funding or backing.

Fannie Mae is a private, shareholder-owned company that works to make sure mortgage money is available for people. They do not lend money directly to home buyers. Instead, they work with lenders to make sure that primary lenders do not run out of mortgage funds to offer to consumers seeking mortgages. Fannie Mae stock (FNM) is actively traded on the New York Stock Exchange and other exchanges and is part of the Standard & Poor's 500 Composite Stock Price Index.

(PLEASE NOTE: On September 7, 2008, the Federal Housing Finance Agency (FHFA) announced, pursuant to the financial analysis after the mortgage market meltdown and according to staturtory authority granted to the FHFA, that both Fannie Mae and Freddie Mac were placed under the conservatorship of the FHFA. The FHFA has stated that there are no plans to liquidate the company. This action was taken due to the fact that share value of Fannie Mae and Freddie Mac plummeted and confidence had been lost.)

Ginnie Mae

The Government National Mortgage Association (GNMA) is known as Ginnie Mae. In 1934, during the depths of the Great Depression, Congress passed the National Housing Act to strengthen a housing market that was in deep trouble. A hallmark of this legislation was to make mortgage funds available to more Americans by protecting lenders from the risk of default by the borrower.

In 1938, Congress amended the act to create the Federal National Mortgage Association (Fannie Mae as discussed in the previous section), an entity designed to help mortgage lenders gain access to capital for mortgage loans.

The provisions of the act changed gradually over the years until, in 1968, Congress established the Government National Mortgage Association, commonly known as Ginnie Mae, as a government-owned corporation within the Department of Housing and Urban Development (HUD). Today, Ginnie Mae securities are the only mortgage-backed securities that offer the full faith and credit guaranty of the United States government.

In its earliest days, financing for the home buying market was quite scattered across the country and this made it quite inefficient and illiquid. This resulted in mortgage rates varying considerably from region to region while and some areas would have virtually no funds available to lend to home buyers. This illiquidity was a direct result of the near impossibility lenders faced of being able to sell individual mortgages on the secondary market. Lending institutions would issue a mortgage, collect payments, and file the mortgage away until the principal was paid off up to thirty years later. Since these funds were tied up for so long this resulted in a virtual limit on the number of new mortgages that could be issued. Such an ongoing situation would have resulted in long term disaster in the American economy but limiting economic growth. Ginnie Mae solved this problem and revolutionized the American housing industry in 1970 by pioneering the issuance of mortgage-backed securities.

Today, lenders pool packages of qualifying FHA, VA, RHS or PIH mortgages and convert them into securities. Ginnie Mae guarantees investors the timely payment of principal and interest on these securities. By drawing money to purchase these securities from investors, the funds can be used to issue more mortgages and keep the entire market liquid with ready money available to loan.

In a single step, the issuance of Ginnie Mae mortgage-backed securities converts individual mortgages into safe, liquid securities for investors around the world. Ginnie Mae thus helps channel global capital into American housing markets, helping making even more mortgages available.

Freddie Mac

The Federal Home Loan Mortgage Corporation (FHLMC) is known as Freddie Mac. An Act of Congress created Freddie Mac's charter in 1970, with the goal of stabilizing the nation's mortgage markets. The second goal of this law was to expand opportunities for homeownership and affordable rental housing to low- to middle-income homeowners and renters with lower housing costs and better access to home financing.

Freddie Mac is a stockholder-owned corporation chartered to keep money flowing to mortgage lenders in support of homeownership and rental housing. Freddie Mac purchases single-family and multifamily residential mortgages and mortgage-related securities. This creates financing mostly by issuing mortgage pass through securities and debt instruments in the capital markets.

Not all the loans they purchase are packaged into securities and some are kept in their own portfolios. Funding is made available by selling bonds to investors throughout the world. By offering investors a way purchase mortgages on homes within the United States, the ability to increase the purchase of mortgages from lenders is created. This in turn helps maintain a continuous flow of mortgage loan funds that then provides families with even more affordable mortgage financing.

The Private Mortgage Insurance Market (PMI)

The biggest challenge for most first-time homebuyers is accumulating money for the down payment of a new home purchase. A cash down payment of at least 20% of the home's value is required or an arrangement for Private Mortgage Insurance (PMI) must be made. Do not confuse PMI with life insurance because it is a coverage that guarantees payment of mortgages will be made to the mortgagee. There are two basic choices to the consumer, either purchase PMI through the government (FHA) or a private company. The latter is commonly referred to as PMI and is similar to, yet different from, if the insurance is obtained through the FHA.

With either FHA or PMI, the consumer does not need to go out and shop for insurance. Merely inform the lender as to which loan is preferred: an FHA loan or a "conventional" loan. A conventional loan will be insured by a PMI company if the lender so requires. The lender applies for the insurance when the loan is applied for. **The mortgage loan will not be provided if the insurance is not approved.** The insurance will compensate the lender for losses incurred should borrower default on the loan occur and the lenders are forced to foreclose. There is an insurance premium charged as part of the loan and this allows the borrower to secure a mortgage with less than a 20 % down payment.

In looking at this equation form the other perspective, the borrower who does have at least the 20 % down payment required will enjoy a substantial savings by not being required to pay this PMI premium.

A number of factors affect the amount of premium that must be paid pay for PMI and some are within the control of the mortgagor (borrower). Other factors are determined by the lender and the type of loan selected. Therefore, it makes sense to ask about PMI premiums when comparing loan terms. Some lenders may require more coverage, and that will drive up the cost. Premiums are usually higher for adjustable-rate mortgages (ARMs0) than they are for fixed-rate loans. They may be higher for long-term loans. Premiums also increase substantially as the loan-to-value (LTV) ratio increases (this means the less money down you have the more PMI will cost you).

There are different ways to pay the premium, and even that choice will affect the premium amount. Paying one lump sum at closing will usually give you the lowest premium because it incorporates the time value of money. However, if you want the right to a partial refund in case you prepay the loan early (a highly likely possibility especially if you change residences in a few years), it will cost extra. You can also pay the premium on an annual basis, with or without the option of a refund for the part of the year after you prepay the loan. Alternatively, you can pay as you go in a series of monthly payments. The monthly payment method is probably the best choice if it is likely the home buyer may move or pay off the loan within a few years of purchase.

Unlike FHA insurance, PMI can be canceled when the balance of the loan amount outstanding becomes less than 80% of the value of the home. Two conditions make this possible. First, the loan is being paid back, so the principal balance declines slightly with each payment. Second, in ideal situations, the value of the home is increasing. The balance of the loan can be determined at any time by consulting an amortization table for the loan. But, because the value of the home can be documented only through a professional appraisal it will cost money for an appraisal to verify that the home increased in value. A recent tax assessment obtained for free from the local tax assessor can be used but usually such assessments are often below the true market value of the home, so the assessed value may not support the case for PMI cancellation. Another way to eliminate PMI is to argue that the value of the home has at least remained constant and therefore the insurance should be canceled based purely on amortization.

In 1999, the Homeowner's Protection Act was passed by Congress in an effort to make it easier to cancel PMI. The law requires lenders to notify borrowers of their right to cancel and the procedure required to do so. Further, if the mortgage balance is less than 78% of the current value of the house (based on amortization), the insurance is automatically canceled. The law applies to loans closed after July of 1999, so check to see if you are eligible. Some lenders are extending these benefits to borrowers with loans made before the effective date.

There are ways to avoid PMI altogether. One is by securing an FHA loan. The main constraint is the cap placed on FHA loan amounts, although that maximum has expanded greatly in recent years. However, FHA loans have their own insurance premium, which may be as high as or higher than PMI payments. If you qualify for a VA loan, they require very little down payment and there are no premiums for the guarantee.

If the lender agrees, you can use another loan to make part of the down payment. This second mortgage that supplies cash to substitute for the bulk of the down payment will carry a higher interest rate than the first mortgage. But there is no requirement for insurance on the second loan and, if the first loan is no more than 80% of value, there should be no insurance requirement for that loan as well. Such a combination of loans may be arranged from a lending institution or through a mortgage broker. These are often referred to "80-10-10" loans or some other combination of numbers. The first number indicated the percentage of value represented by the first mortgage, the second number is the percentage for the second mortgage, and the last number is the percentage of cash down payment. Thus, an "80-15-5" loan requires a 5% down payment. Note that the combined payment for the two loans may be more than the payment for an insured loan including the premium. However, interest paid on the second mortgage can be deducted from taxable income if you itemize, while FHA or PMI premiums cannot be deducted. Also, when the second loan is retired, typically after 5 to 10 years, you will have a lower loan balance than if you had taken out one large loan.

PMI cost will vary from insurer to insurer, as well as from plan to plan. For example, a highly leveraged (very little down payment) adjustable-rate mortgage would require the borrower to pay a higher premium to obtain coverage. Buyers with a 5 percent down payment on a conventional fixed-rate loan can expect to pay a premium of approximately 0.49 percent of the annual loan amount ($61.25 monthly for a $150,000 purchase price). But the PMI premium would drop to around 0.34 percent of the annual loan amount (or $42.50 monthly) if a 10 percent down payment was made on the loan.

Types of Mortgages

Conventional Mortgage

A conventional loan means that a mortgage is obtained without any insurance or guarantee by the government. Conventional loans were the first traditional loans made by local lenders. Loans were held in the lender's investment portfolio until they were paid in full or foreclosed on when required. Today some lenders still keep loans in portfolio but most sell their loans to a secondary market.

There are both advantages and disadvantages to the borrower in a conventional loan. ***The advantages are:***

●The interest rate is set for the life of the loan. This prevents escalating interest and payments.

●Lenders may be willing to keep the loan in their own lending portfolio, thus allowing more underwriting flexibility.

●Lenders may negotiate or eliminate certain loan fees.

●Lenders may allow co-mortgagors.

●A lender may allow collateral other than or in addition to the real property being mortgaged.

●A lender may be willing to finance personal property with the real estate loan, i.e.., appliances and/or furniture. Such "package loans" may be made when a newly constructed property is sold furnished by the builder.

●Appraisals need to meet only the lender's guidelines (if the loan is held in portfolio) or the secondary market's (if applicable), instead of the strict appraisal standards of FHA and VA.

●If PMI is required, its premiums are usually less expensive than with ARM programs or FHA mortgage insurance.

●For a borrower who may have difficulty obtaining PMI, the lender may self-insure the loan, increasing the interest rate to compensate for any potential loss.

●The lender can fund a portion of the closing costs in exchange for a higher interest rate.

"Home affordability programs" allow buyers to purchase real estate with as little as 3 percent down. Under some programs, the down payment can be borrowed on the buyer's credit card! And yet other conventional programs require no down payment, just 3% minimum towards the borrower's closing cost.

What are the disadvantages to the borrower of the conventional fixed-rate loan? ***The disadvantages are:***

●The interest rate is set for the life of the loan. If interest rates fall, the purchaser's rate does not.

●Interest rates are set by each lender and can exceed those of FHA and VA.

●Origination fees and other loan costs are determined by each lender and can therefore be higher than similar programs.

●Because mortgage documents for fixed-rate loans can vary depending on state and lender, a lender could specify certain clauses to be included in a mortgage document. These include the alienation (or due-on-sale) clause, prepayment penalty, and acceleration clause.

●Most loans with greater than an 80 percent loan-to-value ratio will require the borrower to purchase PMI.

●Conventional loans may require larger down payments than those of government programs.

●Some lenders may require nonrefundable application and processing fees at the time of loan application.

●Lenders may not allow some creative financing options for the buyer.

There are rules regarding what a lender can and can't do in conventional mortgage lending. For instance, a lender who wants to sell loans into the secondary mortgage market has one set of rules. Furthermore, if those borrower's require PMI, then there is yet another set of rules. Also the local lender's boards of directors might even be more restrictive.

Because of a majority of all conventional loans are sold to the secondary market, those guidelines often apply and become the benchmark for conventional mortgages.

Different types of borrowers will project varying profiles as to who could best benefit by using a conventional fixed-rate loan. In general, a conventional-loan buyer will has these characteristics:

■ has at least a 3 to 5 percent down payment, or is making the purchase with a gift of 20 percent or more from a third party; or has strong enough credit to offset the down payment requirement.

■ has money for closing costs, and reserves.

■ has good to excellent credit.

■ can qualify for a loan using a standard ratio and market-rate interest.

■ doesn't usually need a lot of special loan underwriting considerations.

■ desires a fixed-rate mortgage (for financial and/or emotional stability).

■ has fairly light debts in proportion to his or her income.

■ might ask the lender to keep the loan in portfolio (particularly if he or she has been a longtime customer, or is using a large down payment).

■ can wait the standard 30 to 45 days it takes to close the loan.

■ may have a job where income increases are either rare or nonexistent.

■ has room in his or her qualifying and loan payments for PMI insurance.

Adjustable-Rate Mortgage (ARM)

Adjustable-rate mortgages (ARM) were created of necessity in the 1980's following a hyper-inflationary period witnessing fixed rate mortgage loans in excess of eighteen percent interest Today ARMs are offered by virtually all mortgage lenders and are an important part of the market. There is one major difference between ARMs and fix-rate mortgages. The interest rate on a fixed-rate mortgage does not change over the entire life of the loan. This means that the monthly payment of principal and interest is never changed (your monthly payment may vary due to changes in the escrow payment for real estate taxes and property insurance , which changes independent from interest rates). By contrast, the interest rate on an ARM may be adjusted from time to time; meaning that your principle and interest payment may vary from one year to the next.

The interest rate on an ARM is related to an index specified by the lender. This index tends to rise and fall as interest rates change in the economy. Most ARMs are set up to be adjusted once a year on the anniversary date of the origination of the loan. If the time comes to adjust the rate and the index has gone up then the lender may raise the interest rate applied to the loan. The effect is similar to refinancing, at no cost, the loan balance at each anniversary date. Selecting an ARM is more complex than negotiating fix-rate loans and introduces a new type of risk for the borrower. However, these mortgages offer the opportunity to save money on interest payments if interest rates do not increase substantially.

An important factor in selecting an ARM or a fixed rate loan is the volatility of interest rates. Generally, in a period of high volatility, you want the predictability of a fixed rate. Also important is something called the slope of the yield curve. A slope (which is the normal situation) means that the rate on short-term borrowings is less than for long-term borrowings. When this is the case, the ARM will provide reduced payments compared to the fixed rate loan-until there is a general increase in interest rates. As interest rates increase the ARM rate may exceed at some point the rate which would have been charged had a fixed rate mortgage originally been purchased.

As with conventional loans, there are advantages and disadvantages to ARMs? ***The advantages are***:

● Lower interest rates than for fixed rate mortgages means the buyer can qualify more easily for a loan or even leverage what they can afford into a more expensive property than would otherwise be affordable.

● Rates adjust based on increases and decreases in the particular index used, which is a reflection of inflation in the economy. This creates an fair situation for both the lender and borrower because the lender's costs are covered, while the borrower's wage increases can pay for the rise in payment amounts.

●Various indexes are available on which to base the ARM.

● Various rate adjustment periods are available to the borrower, (i.e., six months, one year, three years, five years, or ten years).

● Some ARMs can be converted to fixed-rate mortgages during a specific time frame in the loan.

● Initial lower-than-market "teaser rates" can drastically reduce the borrower's monthly payment in the first year of the loan.

● Many lenders keep ARMs in portfolio, allowing the buyer to request special concessions of the lender, such as no PMI or no reserve (escrow) account for taxes and insurance.

● ARMs are more frequently assumable than are other types of mortgages.

●Adjustable-rate mortgages are good to use in times of low inflation, as well as for short-term ownership.

The disadvantages of ARMs are

●There are no interest rate guarantees because indices fluctuate with the economy.

●The buyer's financial situation may change after the loan is made thereby making payment increases financially out-of-reach for the borrower.

●The buyer may over leverage, using an unrealistically low initial teaser rate to get into the loan without being able to make the higher payments that come later.

●The loan may contain a negative amortization clause, which means that any shortfall of interest not paid monthly will be added back on to the principal balance, actually increasing the total amount owed. (This could cause a resale nightmare should the buyer have to move while the loan is showing negative amortization. It may also create an property that no one will want to purchase because the loan balance is greater than the market value.)

●The buyer may not fully understand ARMs and not be aware that the lender's program is using a particular index as a base that is unfavorable to him.

●The lender may be charging an unusually high margin which includes the lender's cost of doing business plus profit which is then added to the index to create the interest rate. This margin is set at loan origination and remains constant for the life of the loan.

●Convertible ARMs may have high interest rates or margins as a bonus to the lender. If the buyer chooses not to convert to a fixed-rate mortgage, this premium may defeat any cost savings with the ARM or perhaps make the program less cost-effective than a fixed-rate program might have been.

●Convertible ARMs have conversion fees for changing the interest to a fixed rate. The new fixed rate is not determined by the cost of the lender's current fixed-rate program but is usually based on the note rate for that particular investor (i.e.., FNMA securities) plus an additional 5/8 percent interest.

It is important to understand the manner in which an ARM works.
Understanding is accomplished by learning the components of an ARM. These components include:

Index: is a financial indicator that rises and falls based primarily on economic fluctuations. It is usually an indicator of inflation and is the basis of all future interest adjustments on the loan. Mortgage lenders currently use a variety of indexes.

Margin: equals a lender's loan cost plus profit. The margin is added to the index to determine the interest rate because the index is the cost of funds and the margin is the lender's cost of doing business plus the profit the lender desires to earn.

Initial interest: This is the rate during the initial period of the loan, which is sometimes lower than the note rate. This initial interest may be a teaser rate or an unusually low rate used to entice buyers and allow them to more readily qualify for the loan.

Note rate: The actual interest rate charged for a particular loan program.

Adjustment period: The interval at which the interest is scheduled to change during the life of the loan (i.e., annually).

Interest rate caps: Limit placed on the up-and-down movement of the interest rate, specified per period adjustment and lifetime adjustment, (i.e., a cap of 2 and 6 means 2 percent interest increase maximum per adjustment with a 6 percent interest increase maximum over the life of the loan).

Negative amortization: Occurs when a payment made is not enough to pay the interest due on the loan amount. This shortfall amount is added back onto the principal balance and this results in a higher principal amount than before the payment was made.

Convertibility: The option to change from an ARM to a fixed-rate loan. A conversion fee may be charged.

Carryover: Interest rate increases in excess of the amount allowed by the caps that can be applied at later interest rate adjustments (a component that most recent ARMs are deleting).

Minimum Payout ARM's

The ARM market even offers a One-Month Option Adjustable Rate Mortgage. A 1-month option adjustable rate mortgage has a fixed interest rate for an initial 1-month period; thereafter the interest rate may change monthly according to the index and the margin on the loan. It has a minimum payment amount that adjusts on an annual basis subject to a change cap limit. This cap limits how much the minimum monthly mortgage payment can increase or decrease from the previous minimum payment, except on the fifth year of the mortgage loan and every five years thereafter. It also has a lifetime interest rate cap.

The benefits of a one month ARM is that it offers up to four payment options from which the borrower may choose depending on their overall financial picture from one month to the next. If rates increase, the borrower can pay the minimum amount (option 1), in which case some of the interest would be deferred. Deferred interest, also known as negative amortization, occurs when the monthly payment is not sufficient to cover the interest accrued during the prior month. The unpaid interest is added to the balance of the loan, rather than increasing the current monthly payment.

The borrower can avoid deferred interest and take advantage of the maximum tax benefit in the current year by paying option 2 or 3. Rate decreases may result in accelerated amortization, reducing principle or any unpaid interest more rapidly. There are four options.

Option 1 is a minimum payment that keeps monthly payments manageable. The payment changes annually and is calculated using the initial interest rate for the first 12 months. The minimum monthly payment is usually recalculated annually thereafter; and is based on the outstanding principal balance, remaining loan term and prevailing interest rate. The payment change cap limits how much this option payment can increase or decrease each year. The disadvantage is that during the initial interest rate period, it represents a full principle and interest payment; therefore, options 2 and 3 are not applicable.

Option 2 is an interest only payment. At times when the minimum monthly payment is not enough to pay the monthly interest due, the borrower can avoid deferred interest by paying the minimum monthly payment plus any additional interest accrued during the month. Payments remain manageable, with no change in the principal balance for the month. The disadvantage with this option is that it will not be offered if the interest only payment is less than the minimum payment due.

Option 3 is a 30-year full principal and interest payment. It is a fully amortized payment based on a 30-year loan. The payment is calculated each month based on the prior month's interest rate, loan balance and remaining loan term. It pays all of the interest due and reduces the principal to help the borrower pay off the loan on schedule. The disadvantage is that it will not be offered if the full principle and interest payment is less than the minimum payment due.

Option 4 is a 15-year full principal and interest payment. With this the mortgage is calculated to amortize the loan based on a 15-year term from the first payment due. It is the largest monthly payment option, but equity build-up is faster, substantial interest savings and quicker payoff. With this option the disadvantage is that it will be offered only on the 30 or 40-year terms and will cease to be an option when the loan has been paid down to its 16th year.

The most common purchaser of the one month ARM is likely to be an individual owning a businesses or a person who works on a commission. This type of mortgage allows for future cash flow for the business owner, and the opportunity for a commissioned individual to make smaller or larger payments as their income permits.

Federal Housing Administration (FHA)

The FHA was established in 1934 under the National Housing Act. It is part of the federal Department of Housing and Urban Development (HUD). Its birth paved the way to mortgage affordability for many Americans who had previously been locked out of home ownership due to a combination of high interest rates and short-term loans, making payments costly. Programs of the FHA expanded loan terms to 30 years at interest rates typically below those offered in conventional loans.

FHA was also instrumental in calculating the first set of construction and appraisal standards for inspecting property prior to loan approval. Many of the quality and safety standards that the housing industry uses today are the indirect result of early FHA guidelines.

Before 1983, FHA retained the right to control rate ceiling maximums on FHA loans. It's interesting to note, however, that though interest rates are no longer capped, FHA loan rates have remained generally lower than conventional rates. This is the result of supply and demand, default protection to the lender, and discount points, for three reasons. First, low down payments on FHA loans, as well as fairly liberal underwriting guidelines, make FHA loans attractive, thus creating demand. Second, the lender is insured against borrower default for the life of the loan. Finally, the lender can offset the lower interest received for the security of loan repayment in case of default.
Discount points charged by the lender help sweeten the pot financially, increasing the desired yield to the lender.

As with other mortgage forms, there are pros and cons to using FHA financing? The many advantages FHA loans afford borrowers include:

●There is a low down payment requirement. On the standard Section 203(b) homeowner's program, the down payment is 3 percent, up to the maximum loan amount allowable in the particular region.

●The entire down payment can be gifted or borrowed from a relative.

●Unlike conventional loans, there are no reserve requirements of two months' PITI payments at closing.

●Loan rates are typically lower than for market-rate conventional fixed-rate loans.
●A seller or other third party is allowed to participate in paying the buyer's closing costs.

●Loans originated prior to December 1, 1986, are simply assumable, meaning that the purchaser does not need to formally qualify. Other

●FHA loans are assumable with qualifying.

●Loans are assumed at the note rate under which they were originated, with the exception of FHA ARMs, which are assumed at the loan's current rate of interest.

●FHA loans have no prepayment penalty when the loan is retired (if FHA is given a 30 -day notice to prepay).

●Because a new FHA loan pays off existing encumbrances, the seller receives all of his or her equity, less costs of sale.

●Qualifying guidelines assist the average buyer in the marketplace; some underwriting guidelines are less restrictive than those of conventional fixed-rate loans.

●The lender is insured against loss for the life of the FHA loan.

●It is possible to place subsequent mortgages after an FHA first mortgage. New financing could even be placed around an FHA mortgage originated before December 1, 1986.

●A second mortgage can be initiated simultaneous with a new FHA first mortgage.

The possible drawbacks of using an FHA mortgage to finance a home purchase are:

●loans originated after December 1, 1986, are no longer assumable without qualifying.

●On loans originated before December 1, 1986, purchasers who do not receive a release of liability when selling may be secondarily liable should the loan default.

●Buyers and sellers may object to paying discount points or other closing costs attributed to FHA financing.

●Because a seller may be requested to pay fairly heavy costs to assist a buyer, the seller may want to sell only if full price is received.

●A mortgage insurance premium (MIP) is required up front, or can be financed into the loan, and an annual renewal premium is charged, payable in the monthly payment.

● A one percent loan origination fee is charged on FHA loans.

●Appraisal guidelines for FHA loans may be more stringent than those of conventional mortgage appraisals.

●Loan processing for FHA loans may take longer than for conventional loans.

●Generally, borrowers are allowed only one FHA loan at a time.

Veterans Administration (VA)

In 1944, Congress passed the Serviceman's Readjustment Act. This legislation, more commonly known as the GI Bill of Rights, was developed to assist veterans in readjusting to civilian life by providing them with medical benefits, bonuses, and low-interest loans. Title III, one of six sections of the bill, guaranteed home loans to eligible veterans. Although loans were to be a type of bonus for those who had served their country, credit standards and underwriting guidelines were strictly enforced so that veterans would not be able to undertake a mortgage obligation they could not fulfill.

Under a VA mortgage a local lender makes a loan for up to 100 percent of the appraised value of the property, with the Department of Veterans Affairs indemnifying the lender against loss on a portion of the loan. Originally, the guarantee was for 50 percent of the mortgage balance, not to exceed $2,000. Today's guarantee is still a maximum of 50 percent of the loan balance, but the dollar amount over the years has increased to a maximum of $50,750. As of January 1, 2006, the maximum VA loan amount with no down payment is $417,000 and can be as high as $625,500 in certain high cost areas. VA also allows the seller to pay all of the veteran's closing cost as long as the cost do not exceed 4% of the sales price of the home.

The advantages of using VA financing, if the home buyer is qualified to use this method include:

●There is no down payment requirement unless the purchase price of the property is greater than the VA appraisal called the Certificate of Reasonable Value (CRV); or if, based on the borrower's qualifications, the lender requires a down payment to make the loan.

●There is no VA limitation on the size of the mortgage. However, the lender or the requirements of the secondary mortgage market may set one.

●Loan rates are typically below market rate when compared to conventional fixed-rate loans.

●A seller can assist a buyer in paying closing costs.

●A veteran can own more than one property secured by VA loans.

●Loans originated prior to March 1, 1988, are simply assumable (assumable without qualification of the new purchaser). All VA loans are assumable (even by non-veterans) at the note rate under which they were originated (with the exception of VA ARMs, which are assumed at their current rate of interest).

●The veteran can pay discount points, making VA loans rate-competitive.

●VA loans have no prepayment penalty.

●Because a new VA loan pays off existing encumbrances, the seller receives all his or her equity, less costs of sale.

●Qualifying guidelines are designed to assist the veteran in financing a home; therefore, some guidelines may be more liberal than found in conventional financing.
●Although the VA doesn't lend money, it acts to guarantee the lender against default on a portion of the loan.

●No mortgage insurance is charged on VA loans (unlike FHA and some conventional mortgages).

The disadvantages of financing with a VA loan are:

●Loans originated on or after March 1, 1988, are no longer assumable under simple assumption guidelines. The VA must approve the new purchase, and an assumption fee must be paid.

●For loans originated prior to March 1, 1988, veterans who sell property with assumptions of the mortgage may not be relieved of liability should the subsequent purchaser default.

●In case of default, the veteran may be held liable for repaying the VA any guaranteed amount paid to the lender.

●Sellers and veterans may object to paying discount points or other closing costs.

●Loan-processing time is typically longer than conventional loans.

●Because the seller's costs of sale are higher than those attributable to conventional loans; the seller may accept only his or her full asking price.

●A funding fee based on the amount financed must be paid at closing.

Growing Equity Mortgage (GEM)

The growing equity mortgage, or GEM, is a fixed-rate, 20-year or 30-year amortizing loan, with annual payment increases of 3 percent, 5 percent or 7.5 percent annually, depending on the lender's individual plan. These characteristics alone may not sound unique; the difference, however, is that the monthly payment increases are applied directly to reduce the principal. This will cause most 30-year loans to be paid in full between years 13 and 15. In other words the GEM is structured so that it begins as a thirty year mortgage and then automatically converts, over time, to a significantly shortened payment schedule.

Most lenders will qualify GEM borrowers at the initial payment amount and ask for a minimum of 10 percent down. A bonus GEM program even allows the borrower to qualify at a discounted introductory rate, sometimes as low as 2 to 3 percent below the standard rate. This is done by using an up-front temporary buy-down of the interest rate.

A type of buyer that can benefit from the GEM is one who needs up-front leverage today, but will be able to meet the payment increases of the future: young professionals, M&M's (married and mortgaged), and first-time buyers who need qualifying.

Both the VA and the FHA allow GEM mortgages. The qualifying guide lines are the same as those for the standard FHS 203 (b) program. Because there is no negative amortization with the GEMs and since all payment increases are applied directly to reduce the principal balance, the FHA does not see this as a high-risk loan.

Graduated Payment Mortgage (GPM)

A graduated payment mortgage (GPM) is a loan where the payment graduates (increases) annually for a predetermined period (i.e., five or ten years), and then becomes fixed for the duration of the loan. During times of high-rate interest, borrowers used them as leverage to be able to more readily qualify (because the initial payment was less). But the downside is that even though the initial payment is less, the interest owed is not – and the payment shortfall in the early years is added back onto the loan, which can result in negative amortization.

FHA offers plans that vary in annual payment increases and number of years over which the payments can increase. The greater the rate of increase or the longer the period of increase, the lower the mortgage payments are in the early years. After a period of five or ten years, depending on which plan is selected, the mortgage payments level off and stay at that level for the remainder of the loan.

GPMs can be good for borrowers if:

■They have predictable income increases.

■The property value is expected to rise or at least keep pace with the payment increases.

■Ownership of the property is not short term (requiring that they sell quickly, especially if negative amortization has caused the loan to exceed the home's value).

■They have the ability to refinance eventually into another type of loan.

■They require jumbo loans (those over the secondary market limit). Example: initial payment on a $250,000 mortgage would be approximately $500 per month less using a graduated payment mortgage.

Reverse Annuity Mortgage (RAM)

As the name hints, reverse annuity mortgages allow persons over the age of 62 to release equity in their primary residences without having to sell and move from their homes. Instead, of making payments immediately after taking out the mortgage, the flow of payments is reversed to the borrower in flat sum amounts, a credit line account, monthly cash advance, or any combination thereof.

The RAM was designed to help house-rich and cash-poor seniors tap equity from their homes without having to move or repay mortgages while they lived in their homes.

The mortgagors must occupy the home as a principal residence (where they spend the majority of the year). All programs lend on single-family one-unit dwellings, and some programs also include 2 to 4 unit owner-occupied dwellings, condominiums, and manufactured homes.

Because the borrower makes no monthly payment, the loan amount grows larger over time (thus your equity decreases). But federal guidelines on reverse annuity mortgages will not permit the loan value to ever exceed the value of your home at the time the loan is repaid.

The loan size depends on several factors including the borrower's age, the value of the home, its location, and the cost of the loan (many of the fees can be financed into the loan to limit the out-of-pocket cash required). The maximum-size loan also depends on the loan program chosen. (The most well-known in the marketplace are the FHA-insured program Home Equity Conversion Mortgage and Fannie Mae's Home-Keeper mortgage.) Additionally, you can obtain a personalized quote as to the size RAM you could qualify for at the Web site of the National Center for Home Equity Conversion at www.reverse.org.

The RAM loan doesn't have to be paid back as long as the borrower lives in the home. But it must be repaid in full (including all interest and any other charges) when the last living borrower dies, sells the home, or permanently moves away.

Most RAMs are adjustable rate mortgages that adjust monthly and have maximum lifetime caps (i.e., loans that can't increase more than a predetermined percent over their lifetime). The lender is at risk because the total amount of interest accrued would be capped (should the borrower outlive the estimated life of the loan), so rates are considerably higher for the RAM that they are for the standard ARM programs.

Home Equity Lines Of Credit

The home equity line of credit is like a second mortgage loan, but the borrower does not have to take possession of all the money at one time. This type of loan is well suited for borrowers who anticipate that they will need more money in the near future, but do not need it immediately.

Setting up a home equity line can be like applying for a credit card. However, because a second mortgage is involved, there is processing, including an appraisal of the property. The application fee may be up to 2 percent of the line of credit, though some lenders may reduce or even waive this fee. Some plans also charge an annual fee to encourage the borrower to use the line once it has been granted. In addition, many plans require the borrower to take out a minimum amount when the loan is granted.

Home equity lines of credit offer a flexible way to access home equity, thereby financing periodic needs with tax-deductible interest. Borrowers may tailor the plan to the way they want to handle payments and can draw upon the line with checks (good for infrequent, large withdrawals) or credit cards (for frequent, smaller withdrawals).

First and Junior Mortgages

Mortgages may be recorded at county courthouses to give notice of their existence. The mortgage loan that is recorded first at the county level is always called a first mortgage until it is fully paid off. In the event of default and foreclosure, the lender who holds the first mortgage receives payment in full before other mortgage lenders receive anything.

Any mortgage recorded after the first mortgage is called a junior mortgage. Junior mortgages are further described as second, third, fourth, and so on, depending upon the time they were recorded in relation to other mortgage loans on the same property. The earlier a mortgage is recorded, the earlier the mortgagee's claim in a foreclosure action.

Flexible Payment Mortgage

In the ARM, the adjusted payment directly follows the change in interest rates, whereas in a flexible payment loan, changes in the interest rate may not be directly felt in the payment; instead there may be payment caps that limit the change in payments. Instead of the payment rising to pay for the higher interest requirement, the principle balance increases. Increases in the principal amount will obviously result in either higher payments in the future or an extended repayment period.

Balloon Mortgage

Balloons are short-term mortgages that have some features of a fixed-rate mortgage. First, they provide level monthly payments that amortize over a stated period of time (i.e., 30 years), but provide for a balloon (one time, large) payment that is due at the end of an earlier specified term (i.e., five, seven, ten, or fifteen years). Depending on the program chosen, at the end of the balloon term (i.e., five years), the borrower can convert the loan into a fully amortizing market–rate loan (i.e., for 25 years) in either fixed-rate or adjustable rate formats.

Because balloon mortgages are considered short-term mortgages, interest rates are generally lower than traditional 30-year fixed mortgages. Most of the mortgage loans due when the Great Depression struck the nation were of a balloon variety. Since there was no liquidity with the Depression, large numbers of homeowners were forced into foreclosure. These terrible situations lead to many of the mortgage reforms instituted by government in the 1930's.

Fixed-Rate Mortgage (FRM)

A fixed-rate mortgage is a conventional loan with a single interest rate for the life of the loan. As you may have surmised from the name, fixed rate mortgages have an interest rate that does not change for the entire life of the loan, which are typically 15 or 30 years.

Therefore you have no surprises, no uncertainty, and no anxiety over possible changes in monthly payments that would encountered with an adjustable-rate mortgage. In addition to paying a premium interest rate when you originally get a fixed rate loan, the disadvantage can be if interest rates fall significantly after you have your mortgage, you face the risk of being stranded with your costly mortgage.

Biweekly Mortgages

Biweekly mortgage means making mortgage payments every two weeks. With a 30-year loan, instead of making twelve payments per year, the borrower makes 26 payments that are half the size of one of the 12 monthly payment amounts. This translates into one additional monthly payment being made each year.

By paying on the principle balance every two weeks, the principal is reduced more quickly, more often and the borrower saves significantly on interest because the loan's duration is reduced by approximately twelve or more years, depending on the rate of interest.

The **advantages of biweekly payment** include:

●Payments are made every 14 days instead of once a month (using a 365-calandar day year), so each payment amount is half the monthly payment for a comparable fixed-rate mortgage.

● Payments will be applied to interest, principle and other charges when received, resulting in a lower overall interest payment.
Payments can be timed to coincide with payroll deposits for easier budgeting.

The **disadvantages of biweekly payment** include

●A homeowner who misses just one payment in a two-week period would be considered in default.

●Most lenders require that payments be automatically withdrawn from the borrower's checking accounts (and often charges a fee for doing so). This means that the borrower loses the use and the float of the money with less likelihood of it generating interest. If borrowers convert their existing monthly mortgage loans into a biweekly loan, they must pay a conversion fee (often hundreds of dollars).

Buy to Let Mortgage

A buy to let mortgage is a special type of mortgage designed for people who buy a property/house with an intention of giving it away. A buy to let mortgage is similar to other mortgages except for the fact that it requires a larger deposit or down payment and will have a lower LTV (Loan-to-Value).

There may be other terms and conditions associated with a buy to let mortgage such as minimum letting out terms, rental income details, etc. In such loans the rental income plays an important role in deciding how much money the lender is going to give you.

The borrower may opt or a buy to let mortgage rather than normal mortgages because generally, when a homeowner is buying a house to rent out to someone else or sell off, the risk associated with the deal increases and the mortgage lender who is at the receiving side will automatically need to have security in the form of an increased down payment or deposit. This is the precise reason why lenders differentiate between the two types of mortgages as "buy to let" mortgages versus a "buy to live in" mortgage. But with the competition increasing and more and more players entering into the market the deposit rate for a buy to let mortgage has decreased and is much lower than it used to be.

Construction Loan-to-Permanent Mortgage

A construction loan is a loan that funds construction by advancing money incrementally as the project is developed. Generally, it is considered to be a high risk and is accompanied by a high interest rate, discount points, and fees. Underwriting is more difficult for a proposed project than for a home that is already built. The construction lender does not want to advance more than is put in the project, so the loan is made in increments; when the land is purchased, streets and utilities installed, foundations, framing, and so on. Before providing a construction loan, a lender generally requires a commitment to convert the loan to a long-term traditional mortgage upon completion of the construction.

For a subdivision loan, release provisions allow parcels to be removed as collateral so the lots may be sold. To release a lot requires a payment against the loan.

Bridge Loans (also known as Swing Loans)

A bridge loan is really an equity loan used to bridge the cash-flow gap from selling one property to purchase another. This loan type is used for a brief period of time until the mortgage borrower can put up the permanent financing by selling current real estate. It is equivalent to using the existing real estate as collateral.

Bridge loans can be structured to completely payoff the old property or simply to add the financial obligation of the new property to current debt depending on the amount of equity available. The new property is bought with the loan, and the amount raised by selling the existing property is used to pay off the bridge loan.

The general amortization period is structured between 6 to 36 months with hefty prepaid interest (perhaps six month's worth). If after this time the old property has not sold, the borrower begins making interest-only payments on the loan. If the property sells within the first six months, any unearned interest payments will be credited.

Bridge loans are used not only for home buying but also for buy-outs, foreclosures, restructuring, cash out, construction purposes and business mergers. The most commonly used are for business mergers, investments and buy-outs.

The advantages of the bridge loan are:

●Swift funding of the loan

●Large amounts of $250,000 to a million (some institutions will provide even larger amounts)

●No prepayment penalties

●Negotiable interest rates

●Using your property as collateral to acquire the new loan, you have a much stronger negotiating position

●The sale of the current property guarantee's the pay back of the loan

The disadvantages:

●They must be secured with real estate (your existing property as collateral)

●Often a premium has to be paid upon repayment
●Repayment usually within the short-frame of six to thirty six months

●Rates and fees can be high

Budget Mortgages

Budget mortgages require a homeowner to pay, in addition to monthly interest and principle payments, one-twelfth of the estimated taxes and insurance into an escrow account. These mortgages reduce a lender's risk; for the lender is thus assured that adequate cash will be available when an annual tax or insurance bill comes due.

Wraparound Loan

A wraparound is really a second mortgage. It is a combination of an existing assumable loan and a new mortgage loan that results in an interest rate set between the old rate and the current market rate.

Chattel Mortgage

A chattel mortgage is a mortgage on personal property to help secure the mortgage. The property may be a car, boat, furniture, or the like. It can not be affixed to the land or building. A lien is then put on these assets for backing the loan.

They are used when additional security is needed for a loan or when it's important to identify certain personal property assets.

Package Mortgage

This mortgage is most often used when building or buying a new home whereby, not only is the cost of the home included in the mortgage but, major essential furnishings to be purchased are also included. The lender tends to exercise more control over a borrower's monthly obligations, and the borrower is able to spread the payment for such items over a lengthy period.

Bad Credit Mortgage

Bad credit mortgage is no different from an ordinary mortgage except for the fact that it's given to people having a bad credit history. A bad credit mortgage helps buyers with a bad credit history caused by non payment of debts, bankruptcy, black marks from any credit agency, court cases etc. Bad credit mortgage is also referred to as adverse credit mortgage, sub prime mortgage, non standard mortgage, poor credit mortgage or credit impaired mortgage.

Lenders generally shy away from people having a bad credit. But the situation has changed rapidly and many home mortgage lenders and bad credit mortgage companies have sprung up that offer bad credit home mortgages to people having a bad credit history, with almost the same interest rates (just a marginal difference) and terms as in a normal mortgage loan.

Sometimes a self employed borrower does not have enough of a credit track history and they fall into the non status category and can go for a non status mortgage which is equal to a normal mortgage. Bad credit mortgages are no longer what they used to be.

The interest rates for home equity loans with bad credit have drastically decreased making them almost similar to a normal mortgage. People get bad credit histories because they don't have proper understandings of their financial capabilities and end up taking more loans than they can actually pay off.

Blanket Mortgage

A blanket mortgage is a mortgage creating a lien against two or more tracts of real property. Developers us blanket mortgages to develop large tracts of land into many residential or commercial properties.

A single blanket mortgage can be used to finance all of the properties without taking out separate mortgages on each individual property. Release provisions are usually included to allow individual parcels to be released from the mortgage upon payment of part of the mortgage principle.

Open-End Mortgage

This mortgage comes with a provision that permits borrowing additional money in the future from the principal that has been paid on the mortgage without refinancing the loan or paying additional finance charges. Open-end provisions often limit such borrowing to no more than the original loan amount.

Refinancing Mortgages

Most mortgage loans are originated for a term of 25 to 30 years. In many cases, mortgages are paid off when the home is sold. However, many homeowners refinance their loans due to many reasons. A key advantage of being a mortgage borrower is the ability to change financing as conditions change.

Some homeowners refinance when they need to raise money for some purpose. Over time, they accumulate equity in their home. Equity is the difference between the value of the home and how much they owe on the mortgage. Essentially, their home equity is a form of personal wealth, just like stocks and bonds. Equity increases as the value of the home rises. It also increases as they gradually pay off the principle of the mortgage loan.

Until the home is sold, this equity is locked in. With refinancing they can access equity by refinancing the old loan for one with a higher principle or by getting an additional mortgage on the home. A loan secured by their home equity is less expensive than other types of consumer loans. Both the interest rate and the repayment term are more favorable than other types of borrowing. There are also tax advantages to using a home loan as compared to other types of borrowing.

Homeowners needing to make major improvements on the home may refinance to pay for the work. The improvements should increase the value of the home and allow them to get a larger loan. Even though they can finance improvements in other ways, a new loan covering the entire home might be the least expensive alternative.

Another reason people refinance a loan is to take advantage of lower interest rates. For example, suppose the homeowner has a fixed-rate loan that they obtained when interest rates were high. They may find that they can get a new loan at a lower rate of interest. A home owner can significantly reduce monthly payments using this tactic.

Often the buyer has a loan provided by the seller at the time the home was purchased. Most of these loans have terms that “balloon”, or expire in a few years. By refinancing, they can assure themselves of long-term financing for their home.

In other cases, homeowners with adjustable-rate mortgages (ARMs) may want to refinance with fixed-rate loans while interest rates are relatively low. In this way, the borrower can lock in the interest rate and avoid the risk of rates rising in the future.

Refinancing may be helpful before the sale of a home. When rates are low, they may obtain a loan that can be assumed by the buyer. If rates increase before they sell, or if the mortgage loans become hard to get, an assumable loan can add the resale value of the home.

There are certain costs associated with refinancing. The existing loan may have prepayment penalties that must be paid if the loan is repaid early. The new loan will require application fees, various charges, and discount points. These costs must be considered in the decision to refinance. Any savings from the refinancing must outweigh the costs. These saving will be realized over the period of the loan; so they must stay in the home long enough to make refinancing worthwhile and cost effective.

There is also personal income tax to consider when refinancing. With a lower interest rate on their home loan, they will have less interest to deduct on their income tax return. That, of course, may increase their tax payments and decrease the total savings they might obtain from a new, lower-interest mortgage.

Homeowners should also be aware of an Internal Revenue Service (IRS) ruling with respect to points paid solely from refinancing a home mortgage. IRS regulations require that interest (point) paid up front for refinancing must be deducted over the life of the loan, not in the year they refinance, unless the loan is for home improvements. This means that if they paid a certain number of points, they would have to spread the tax deduction for those points over the life of the loan. If, however, the loan or a portion of the loan is for home improvements, they might be able to deduct the points or a portion of the points. Check with the IRS regarding the current rulings on refinancing, particularly if they are using the new loan to make home improvements.

Property Appraisal

An appraisal, or valuing of the property, is necessary to ensure that a lender does not lend more on a property than its value. Most lenders hire an outside appraiser who inspects the property and then compares it to nearby comparable properties that have sold recently. A value is then determined according to the sale prices of those comparable properties. A report is then submitted to the lender who uses it in deciding how much of a mortgage can be made available for the specific property.

National standards govern the content, format and valuation methodology of residential appraisals. Government-insured mortgages or a conventional mortgage your appraisal format will be based on requirements developed jointly by the Federal Housing Administration (FHA), the Department of Veterans Affairs (VA), Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac).

The FHA and the VA do require certain additional information for their appraisals in the form of extra information included with the appraisal report. Although some small local lenders may have their own special requirements, most lenders follow the national requirements.

The national standards govern not only the format for appraisals; they also specify the appraiser's qualifications and credentials. Also, most states have enacted appraiser licensing requirements and apply them to appraisers evaluating properties located within those states. Appraisers are required to have a certain amount of training and experience before their valuations are acceptable to mortgage lenders and investors. Appraisers use three different valuation methods to value residential properties including market value approach, cost approach and the income approach (mostly for investment properties)

Market value is the most important valuation method in appraisal because a property is worth only what a buyer is willing to pay and a seller is willing to accept. The result is an indication of value based on recent sales of similar properties in the local market. The market approach assumes the typical buyer views the property as an alternative to buying similar property.

The market approach indicator is most reliable when market activity is normal and there are many close substitutes for the property in the market. When activity is slow, it is difficult to obtain enough good comparison sales to derive a reliable indication of value. Also, if the subject property is unusual, there may be no good substitute properties in the market.

To make a market approach value estimate, you must collect information on recent sales of properties similar to your subject property. These sales are called comparables or "comps." The more comparables there are, the better the analysis, but there should be at least three. The sales prices of the comparables are adjusted to account for any differences between the comparable property and the subject property.

Adjustments are commonly made for such features as size, physical attributes, condition and quality, date of sale, location, and financing. If special financing was used in the sale, a portion of the sales price may reflect the benefits of the loan to the buyer. In most cases, it is best to avoid use of these comparables. If this is not possible, the price increase due to financing must be purged through a process called cash equivalence.

Each adjustment is based on the appraiser's judgment of how much the market is paying for a feature. Adjustments are used to set the price of the comparable at what it would have been if the property had the same features as the subject property. If the comparable is better than the subject, its sales price is adjusted down. If inferior, the comparable's price is adjusted up. After all comparables are adjusted, the appraiser estimates values from among the adjusted sales prices.

The market approach is often the most useful indication when you are interested in what the property will likely sell for in the current market. By looking at the way comparables are adjusted, you may learn how certain features are valued in the market. This may be helpful if you plan to add a feature to or expand the property. The selection of comparables also may indicate how active the market is for properties like yours. If the market is very active, the comparables will be recent. If not, some of them may be six or more months old. The comparables may indicate what features are standard in the market.

Cost approach is another way of calculating an estimated value for property. The approach is based on the cost to reproduce the subject property and assumes the typical buyer considers the option of new construction when viewing the property. The cost approach is often used in support of another appraisal method. However, it may be the primary indication when the property is new, unique, or when market conditions are abnormal.

The cost method generally starts with an estimate of the cost to reproduce an exact replica of the subject property at current rates. This estimate is reduced by the total use of the subject property which is also called depreciation. This adjustment is necessary because the property is not brand new. The result is an indication of the value of the building alone.

Another method begins with the cost to replace the property, but using modern materials, design and current construction techniques. Depreciation then is subtracted to derive a value estimate. The site is valued by using a market approach, as mentioned above. These are sales of vacant sites having a use similar to the subject property. The value of the site is added to the building value to obtain an indication of property value.

The cost approach might also calculate the value of the building and real estate separately. It may be useful to estimate how much value is added by the building when a change in use is contemplated. When renovation or modernization is considered, the cost approach may indicate how much value would be added. An analysis may indicate that building features do not contribute as much to the value as they actually cost. In appraisal terms, these are called deficiencies when they are inadequate or obsolete.

The cost approach is far more appropriate for a new building or proposed new construction than it is for an older property or one with functional or external depreciation. It is best not to rely on the cost approach alone. Remember, cost and value are not the same idea.

The income approach is another one of the standard methods used to derive value indications. The method is based on the value of the income produced by property and assumes the typical buyer views the property as an investment. The emphasis is on the financial returns from the property rather than on the physical characteristics.

The income approach is most reliable when the property produces current income and is similar to other income-producing properties in the market. The method is not useful to appraise properties held mainly for appreciation or development potential, such as raw land. It is also not used for owner-occupied properties. However, a variation on the technique, called the gross rent multiplier can be substituted.

Comparable sales are taken from the market for rental properties similar to the subject. Gross rent multipliers is the sales price divided by monthly gross rent and these are calculated for each comparable. A single multiplier is selected to represent the market. It is then applied to the subject property by estimating what the house would rent for and then applies the multiplier. The results are an indication of the property's value.

For income properties, the income approach starts with an estimate of market net operating income (NOI). This figure is the income the property would produce if leased or rented and also incorporates vacancy rates and operating expenses typical to the market. The NOI is converted into an indication of value by applying a capitalization rate. Capitalization, or cap, rates are taken from recent sales of comparable income properties by dividing their NOI by the sales price.

This process is similar to the market approach used to derive adjusted sales prices of whole properties or sites. In the absence of good comparables, cap rates may be estimated using various formulas and market data on interest rates and investment returns. Generally, the cap rate is 1 to 2% above the mortgage interest rate for the property, although much of it depends on the prospects for value appreciation or expected external depreciation.

Sometime properties are offered for sale based on a historical cost or replacement cost amount whereas the income approach would indicate a higher appraised value. These could prove to be excellent buys. The income approach provides an indication of value in financial investment terms. It can be used to compare the value of the property with that of other types of assets, as well as with other real estate. By using different estimates of NOI, you can see how value might be affected by boosting rents, reducing vacancies, or lowering operating expenses.

Chapter 2:Real Estate Ownership

(2 Exam Questions)

The Land Estate

Property is described as being either "real" or "personal". These terms **are mutually exclusive:** if something is real property it cannot be personal property and vice versa. Real property is land and anything permanently affixed to the land. Personal property is best defined as any property other than real property.

Personal property can be further segmented to include property which **is either tangible or intangible.** If you can feel, touch and see an object, such as an automobile, it is regarded as being tangible. The value of an auto is in its functional use as a method of transportation. Intangible property has value because of what it represents not because of what it does. For instance, **ownership of a life insurance contract is an intangible.** It has no functional use but value exists in the financial rights it provides to a beneficiary upon the death of an insured.

The term **"estate"** may conjure up the serene pastoral setting of a fox hunt taking place against the backdrop of a mansion in the rolling English countryside, but from a modern legal sense it simply **refers to ownership as a possessory right** to either personal or real property. Ownership can be absolute and unlimited or subject to use and/or time restrictions. The notion of possessory interest can include both present and potential future rights.

Fee Simple Absolute

The broadest possible ownership available in real estate is referred to as "fee simple" or "estate in fee simple absolute". Such ownership in real estate is absolute in the sense that it belongs to the individual with no strings attached and can be owner for an infinite length of and passed to anyone the owner selects upon death. The only limits of use imposed upon the owner are those restrictions enforced by society as to zoning or other legal conditions. Furthermore, through the use of "eminent domain", the government can take privately owned property by providing just compensation.

Lesser ownership interests include life estates, estates for a term of years and estates with reversionary and remainder interests. A **life estate** provides a right to possess property in an absolute fashion but only during the life span of a specified individual (or individuals). There is no right to pass ownership accorded to a person enjoying a life estate.

The party to whom property reverts upon the passing of the measuring life is referred to as the **"remainderperson".** To protect the remainderperson's right in the property, the life estate holder must not "waste" the property. Therefore the life estate holder owes the following duties: pay property taxes in a timely fashion, insure the property against loss and protect any income producing source of the property. Any breach of these duties by the life estate holder can enable the remainderperson to institute a legal cause of action against them.

Leasehold Interests

An **estate for a term of years** specifies the exact time of possession for the estate holder and is sometimes referred to as a leasehold since it is not permanent ownership. The same restrictions found in a life estate apply to the leasehold property holder. If the individual enjoying the property for a term of years dies prior to the term period, the remaining time can be passed to someone else by the original holder of the term.

Other Real Property Concepts

The concepts of **remainder and reversionary** interests must be explained. A remainder interest refers to the current right of a party to enjoy property in the future after a currently held estate right expires. Remainders can be vested or contingent. Vested interests are absolute and current and future enjoyment of property can never be removed. The **broadest possible remainder** interest in which the entire property shall be received in an absolute fashion is referred to as an **"indefeasibly vested remainder."** Contingent interests create an uncertainty that a possessory interest may never become available. If a stated contingency is not realized, the possessory interest at stake will not occur.

Reversionary interests, which are always vested, enable the owner (referred to as the grantor) to have some or all of the original property rights which were transferred returned at some future point in time. A reversion exists when less than the estate owned by the grantor has been transferred.

Legal and Equitable Title

Another property **ownership concept is the difference between legal and equitable ownership.** The person holding title to property is considered to be the legal owner. The equitable (also known as beneficial) owner is the party who uses, possess and enjoys the property. Legal ownership is most commonly split between a legal and equitable owner when property is held in trust. The trustee is bound as a fiduciary to the terms of the trust and holds the legal title to the property while the beneficiary who is benefiting from the trust holds the equitable title. Upon the termination of the trust the legal and equitable distinctions are merged back to one complete title of ownership held by the beneficiary of the original trust arrangement.

Situs and Domicile

Under the terms of law, the **physical location of property,** or **"situs",** is a crucial point to proper estate planning. Since state and local governments have the authority to tax real property located within their boundaries, the residence state of the real property owner is not relevant when different from the location of the property. Any real and tangible personal property owned within a state is subject to the laws of the situs state and local jurisdiction prevails.

The place a person considers to be his permanent residence is deemed to be that person's "domicile". However, people sometimes live and own property in more that one state. Can a person have more than one domicile state? The U. S. Supreme Court has ruled in the affirmative on this point and has created the possibility of multiple taxations. Once a person dies, their property is taxed and distributed according to the laws of the domicile state.

Since laws regarding distribution and taxation of estates vary, **the issue of domicile is crucial to the estate planning process.** Real property is only taxed by the state in which the property is located. However, personal property, both tangible and intangible, may be subjected to taxation by both an owner's domicile and property situs state simultaneously.

Domicile state can be established in a variety of ways according to activity. Included are voter registration, bank account locations, auto registrations and the state in which property and income taxes are paid.

Concurrent Ownership Forms

There are three basic ways one individual can own the same property at the same time with one or more other individuals:

Tenancy in Common

Two or more people have an undivided ownership interest which may or may not include an equal ownership share. Each co-owner has the right to dispose of his or her ownership interest by gift, sale or will without being in any way accountable to any other person have a concurrent ownership share. There are no survivorship rights. At death, a co-owner in a tenancy in common has their interest pass through the estate to legal heirs and not to other property co-owners when those co-owners are not among the legal heirs entitled to ownership through the estate.

Joint Tenancy with the Right of Survivorship

In this form, each of two or more property owners owns equal obligations and rights and there can be no disproportionate ownership. The key to this form is that, upon death, the co-owners interest passes to the surviving co-owner(s), outside of a will. This right of survivor means that ultimately, the property will be owned by the last surviving owner. Joint tenancy does not prevent one co-owner from selling their interest in the property to someone other than another co-owner. However, to do so, destroys the joint tenancy and creates another form of ownership, usually tenancy in common.

Tenancy by the Entirety

This form of ownership can only exists between a husband and wife during the time of a marriage and it is unlike joint tenancy because during marriage, the property cannot be conveyed to anyone else unless both husband and wife agree. If two owners are not married and do not want joint tenancy, only Tenancy in Common is available as a form of ownership. This form of ownership has proven useful to individuals who have formed business partnerships. Since the partnership form of ownership can subject an individual partner to personal liability, this form of ownership protects real property because the spouse who is not party to the partnership can not have his or her rights taken away to satisfy the legal obligations of the partner spouse.

The above forms of ownership are associated with common law states. However, nine states are called **community property states** including Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington and, most recently, Wisconsin. Community property deals with co-ownership of property held between spouses and is an important consideration in the estate planning process.

Chapter 3: Term Life Insurance

(4 exam questions)

Definition

Term Life Insurance means insurance death benefit protection only and there is no cash value accumulation. ***Term is temporary life insurance protection for a specified time period or "term" of time.*** The death benefit is only paid if the insured dies during the contract period and all premium has been paid in a timely fashion. TERM plans do not develop any cash surrender AND therefore DO NOT provide nonforfeiture values.

The purchaser is ONLY exchanging premium dollars for death benefit coverage and policy expense, NOTHING ELSE. Term is low cost life insurance when compared with Whole Life because in a term policy, the owner is not paying extra for a cash value building element.

Rising Popularity

Term life insurance became very popular in the late 1970's as unusually high interest rates exposed a basic weakness of cash value building life insurance: long term, low rates of return on equity. After the next section explains the whole life contract, an historical summary explaining the prevalent role of term life in the modern era will follow.

The cost of coverage per thousand dollars of insurance is quite low for young purchasers but can become very costly for older insureds (generally 65 years of age and older). **The cost increases upon contract renewal as the insured grows older simply because the risk of death increases with each passing year of life.**

Cost is based upon actuarial assumptions made about death rates in a given population. For instance, if we expect that of 1,000 males aged 30, only 2 are likely to die within the next year, we know the insurance company will keep collecting premiums on 998 remaining customers.

Mortality constructs such as those cited above allow consumers to enjoy great amounts of coverage at tremendously low premium costs. As of January 1, 2009 all life insurance companies are required to use the 2001 CSO Mortality Table to calculate life insurance premiums, the lowest cost ever. **Industry statistics indicate that of all term policies purchased only about 1% are paid as proceeds on death claims.**

Types of Term Policies

Level Term

The **death benefit is level** during the term of coverage, not necessarily the premium cost. There is a level and specified amount of death benefit during the contract period. Level term commonly is issued for periods of years like one, five, ten or twenty years. ***The longer the period of years selected, the higher will be the premium charged per year***.

INSURED'S AGE	COST PER $1,000	ART/YRT	5YR	10YR	20YR
30	$1.00	$1.00	$1.20	$1.50	$2.00
31	$1.10	$1.10	$1.20	$1.50	$2.00
32	$1.20	$1.20	$1.20	$1.50	$2.00
33	$1.30	$1.30	$1.20	$1.50	$2.00
34	$1.40	$1.40	$1.20	$1.50	$2.00

In the above chart, the cost of or insurance for ART (annual renewable term) or YRT (yearly renewable term) will increase each year based on the increasing risk of death caused by growing older. This type of small incremental increase will continue year after year.

The five-year term, on the other hand, will average the cost of the five year period and charge the same amount each year. Thus the insured pays more per thousand for the first couple of years but less per thousand for the last couple of years. At the beginning of the sixth year of coverage the policy cost will be adjusted to incorporate the average cost for the next five year period.

In the ten-year term column we see that the average cost per year over 10 years is expected to be $1.50 per thousand dollars of coverage for each year of coverage. In the eleventh year of coverage the policy cost will be adjusted to incorporate the average cost for the next ten year period.

Finally, the twenty year term begins at the highest cost level of all, $2.00 per thousand – double that of the ART/YRT product's initial cost. The cost of this product (per thousand dollars of insurance) will not likely rise again until the twenty-first year of coverage.

Which Level Term Product is the Cheapest?

If you put this question to a random group of ten people you will likely have most people indicating that the ten to twenty year term cost is perceived by them to be the better value. The remaining minority will select the ART/YRT or five year categories. Indeed, insurance industry figure bear out that most consumers prefer the comfort of longer term constant premium pricing.

Americans seem to love the concept of fixed rate, “I always know what I am getting” payment structures. However, paying $1.00 per thousand dollars of coverage is less than paying $2.00. Therefore, ART/YRT is decidedly cheaper but most consumers will still prefer the ten and twenty year higher cost level term product models.

What is the Role of the Insurance Professional?

Do you bring the majority of consumers to their senses and try to reverse the beliefs of a lifetime? Even if you tried all you would do in most cases is alienate a person that likely would have become a terrific long term customer. The very reason the insurance industry offers such broad term product choices is to specifically address the need and comfort levels of the insurance buying public.

In other words, **it is not the role of the insurance agent to educate consumers unless they specifically indicate they would appreciate your knowledge and input.** Instead, the agent should help them to understand their needs and show them products that, to them, comfortably satisfy such needs. Those clients who understand the investment concept known as the time value of money will likely choose ART/YRT because they understand that one dollar of value today will diminish over time. At the end of the analysis of term life insurance products, a review of this fundamental relationship between money values versus time is provided.

Decreasing Term

The **death benefit decreases** over the term, but the premium charge remains constant from year to year over the entire coverage period). The face amount of insurance decreases from year to year until it reaches zero at the end of the contract period. Although the **premium charge is the same year after year,** the cost "per thousand" dollars of coverage is actually increasing each year since the same amount is paid annually for less and less death benefit.

Uniformly Decreasing Term

<u>Example:</u> A 20 year decreasing term plan is purchased at an annual cost of $500 for $100,000 of initial death benefit. If this is a "uniformly decreasing" term plan, then in 10 years the insured will still be paying $300 annually but for only $25,000 of benefit because annually the face amount of coverage would decrease by $5,000 ($100,000 divided by 20). In this example, the cost per thousand would double in 10 years. This concept of decreasing coverage for level premium is consistent with the cost of term insurance increasing with age. With this variety of term insurance, the death benefit decreases by the exact same number of dollars each and every year. The table below illustrates another way to view this concept:

BEGINNING TIME PERIOD	***Term Coverage Amount – 20 year Policy***
YEAR 1	$100,000
YEAR 5	$ 75,000
YEAR 10	$ 50,000
YEAR 15	$ 25,000
YEAR 20	$ 5,000

In the table above, since it is a twenty year coverage period the term coverage amount is reducing by $5,000 each and every year. When the full 20 year period ends, the coverage reduces to zero. This particular type of decreasing term insurance would be a particularly poor choice to cover the principal balance of a long term loan like a mortgage. Since the principal balance of a mortgage declines in very small increments, especially in the early years of repayment, the uniformly decreasing term contract would leave a gap in coverage in all but the first and last coverage years.

$100,000 Original Mortgage @ 6% interest

Year	Principal	Interest	Balance
2005	$2,669.80	$5,927.37	$97,330.20
2006	$2,834.47	$5,762.71	$94,495.74
2007	$3,009.29	$5,587.88	$91,486.45
2008	$3,194.90	$5,402.28	$88,291.55
2009	$3,391.95	$5,205.22	$84,899.60
2010	$3,601.16	$4,996.01	$81,298.44
2011	$3,823.27	$4,773.90	$77,475.17
2012	$4,059.08	$4,538.09	$73,416.09
2013	$4,309.44	$4,287.74	$69,106.65
2014	**$4,575.23**	**$4,021.94**	**$64,531.42**
2015	$4,857.42	$3,739.75	$59,674.00
2016	$5,157.02	$3,440.15	$54,516.98
2017	$5,475.09	$3,122.08	$49,041.89
2018	$5,812.78	$2,784.39	$43,229.10
2019	$6,171.30	$2,425.87	$37,057.80
2020	$6,551.94	$2,045.24	$30,505.86
2021	$6,956.05	$1,641.13	$23,549.82
2022	$7,385.08	$1,212.09	$16,164.74
2023	$7,840.57	$756.60	$8,324.16
2024	$8,324.16	$273.01	$0.00

The mortgage chart above is used to illustrate the following concept: If the mortgage holder died during the tenth year of a twenty year mortgage the principal balance still due would equal about $65,000. The death benefit payable from the comparably begun uniformly decreasing term plan would be only $50,000 or $15,000 short of paying off the remainder of the debt. However, if the product explained below, Mortgage Decreasing Term, had been used, this gap would not exist.

Mortgage Decreasing Term

The coverage amount also declines until reaching zero but remains proportionately higher in the early policy years and then quickly drops during the last years of coverage. In this manner it **operates like a typical "AMORTIZED" LOAN:** the principal owed on a home mortgage is higher in the early repayment years and later, when mostly principal is being repaid, the amount owed decreases rapidly.

Using "mortgage term" coverage would eliminate the gap that uniformly decreasing coverage would create because mortgage term coverage would precisely follow the declining principal balance of the mortgage. But is this the best coverage for a mortgage?

Which is better coverage: Level or Decreasing Term?

The answer to this question will depend upon the goal of the insured in obtaining the coverage. Decreasing term has been taking a smaller and smaller share of all term insurance sales with each passing year. Most decreasing term is now sold on a group, rather than individual basis, by lenders to consumers of a wide range of products for which most or the entire purchase price is paid with borrowed funds. Many times the purchase of group decreasing term is not of much benefit to the consumer due to its higher cost.

Take credit card group term coverage as an example. The offer sounds enticing: coverage is "only" ten cents per one hundred dollars of coverage per month. This sounds wonderful until you do the math. Ten cents times 10 "hundreds" gives us the cost per one thousand dollars of coverage (the customary manner in which insurance pricing is quoted industry wide) per month of $1.00. Now we must multiply this $1 cost times the twelve months of a year and we find the cost is $12 per thousand per year! For term insurance, depending on age, this could be quite a hefty and unnecessary expense. A healthy consumer in his or her late twenties would expect to pay less than $2 per thousand for many individual term contracts.

This expensive decreasing term pattern can be found repeated in other consumer purchases area like automobiles, durable good items and even group mortgage coverage. Find a person who recently financed an auto purchase who also took the group decreasing term coverage (recent industry statistics indicate about one-third of unassuming such consumers take a bite from this particular apple) and you have found an excellent prospect for an individual term policy. Depending on variables like age and health, the same premium paid for the group plan could buy upwards of five times the coverage amount under an individual term contract!

State laws prohibit a lender from making the purchase of life insurance mandatory for loan issuance. If an unscrupulous lender hints or bullies such a condition, simply ask them to put that in writing so you can forward it to the Division of Insurance for review. As you might suspect, such a request on your part will end this charade in the majority of cases. Once a consumer has purchased group term, it can be easily canceled or replaced with a more economical policy by the consumer without affecting the loan.

In view of this information, does decreasing term insurance have legitimate use in the marketplace? From a consumer's viewpoint it would seem that level term would have insurmountable advantages as the product of first choice. Level Term has a lower starting cost per thousand of coverage and since the insurance amount stays constant, a consumer remains better protected if future insurability diminishes. Furthermore, since virtually all decreasing term is sold on a group rather than individual basis the consumer needs to be aware of the following drawbacks:

Disadvantages of Relying on Group Term

● ***Mandatory early retirement*** – imagine the middle-aged to older worker being forced out. Unless he or she is in very good health, obtaining low cost life insurance to replace the lost group coverage can be a problem. If the worker has ownership of individual coverage and is forced into early retirement, coverage will not be threatened.

● ***Downsizing*** – large companies are eliminating jobs daily in our economy and the group coverage that goes with employment is eliminated

● ***Employer bankruptcy*** – when the employer goes broke, even if the business can be re-organized, there are fewer employees and benefits available to those employees.

● ***Shifting payment to employees*** – as employers look to save money or increase profitability, "perks" like free or shared life insurance cost are being offered to a lesser degree every year.

● ***Change of career*** – when employees leave one group for another, the new career may not offer coverage that was as generous as the job left behind.

● ***Chronic health impairment –*** when the employee's health deteriorates so does his or her ability to obtain quality life coverage at the cheapest cost. By taking charge of your personal life insurance needs on an individual basis you can control of your income replacement destiny.

● ***Discontinued group term*** – employers can decide to end a group life contract at anytime and leave employees in a position of fending for themselves while simultaneously exposing them to temporary coverage shortages (or permanent if the employee's health is poor and they are unable to replace the insurance).

● ***Lowering available group term coverage*** – the employer may not eliminate coverage completely but will reduce it instead. This leaves the employee in the same position as a discontinued plan, just to a lesser extent.

Term Life Uses

Term insurance is most suitable when

- The need for protection is purely temporary, such as for loans

- The need for protection is permanent, but the insured temporarily cannot afford the premiums for permanent insurance

- The greatest coverage at the lowest cost is most desirable, such as the need for extra life insurance while children are growing up

Traditional Riders

All three term riders discussed below: waiver of premium, renewability and convertibility may be purchased as "riders" and added to most term life insurance contracts. **A rider is an additional, but optional, coverage for which the policy owner will pay additional premium.** Life riders are requested and added at the point a policy is issued and they generally are not available at a later point in time after a policy has already been issued.

Although the **three riders** listed **are sold with MOST term** policies, they are not **sold with all such contracts.** The "nonrenewable and nonconvertible term" life policy expiring in five years or less can be purchased without waiver of premium by a consumer who demands the absolute lowest cost product without regard or concern for their future insurability condition.

Waiver of Premium

In the event the insured becomes totally and permanently disabled, the company **"waives"** premium due for as long as the insured is disabled. **Waiver means premium is not paid but the coverage continues.** This is actually a health or disability insurance concept and the premium cost is the best a consumer can do given age, health and occupation considerations. If an insured becomes disabled and funds become scarce, food purchases will likely come before an insurance premium payment. This rider relieves the insured of the need to make such a drastic choice.

Renewable

The insured has **the contractual right to renew the term policy for a similar term of time without being required to provide proof of insurability** (good health). Normally this renewal feature is restricted by age (available only to age 65, for example) or number of times renewed. The insurance company must charge no more than the **standard rate which is the amount the insured would pay if deemed to be in very or standard health**. This rider enables the insured to control coverage during the greatest need years no matter what health changes may occur.

Convertible

With this rider the insured, under a term life contract, owns the **right to convert or change that term policy to any Whole Life policy offered** for sale by the company. This option must be exercised by some specified future time (usually by age 60 or 65). The conversion must be allowed, without proof of insurability, by the insurance company at standard rates. In the event an aging insured still wishes coverage to continue into old age but is alarmed at the rapidly increasing term insurance cost, a switch to whole life can average the cost lower over a ten to twenty year future coverage point.

NOTE: ► Policy conversions take place at **"attained"** age of the insured (this **means** the **current age** of the insured at the point conversion is elected).

Disability Income Rider

This rider provides monthly benefits for the insured if total disability occurs. The amount of monthly payout is usually up to $1,500 per month, payable for 2 years. It is a very good rider, especially to add to a mortgage term life insurance policy. Since the amount of this rider can be sufficient to pay for a monthly mortgage plus real estate tax payment, it is ideal to add to the death benefit coverage amount.

Return of Premium Rider (ROP)

This rider guarantees that all of the premiums you pay will be refunded to you at the end of the coverage period. If the policyowner cancels before the original termination date, they may receive back part of the premiums paid. This allows the buyer to only pay for the actual coverage time they need. This rider is extremely popular on term policies and mortgage insurance. Purchasing it with mortgage term insurance, if available, can allows the policyowner to prepay mortgage principal and significantly reduce both

● the number of years are required to make payments and

● the principal and interest that would have otherwise been payable.

Protecting Insurability With Term Life

The safest way for the individual to maintain adequate life insurance protection is to **purchase an individual policy** while he or she is still employed and insurable. Since life contracts are **"unilateral" agreements,** the insured is entitled to coverage for as long as premiums continue to be paid in a timely fashion. The insurance company will always be bound to coverage and only the insured can elect to terminate the agreement.

With a level term contract issued in the proper face amount, the insured is secure in the knowledge of the exact number of dollars which would be available in the event on an untimely death. If the income needs of the insured are on track to increase moderately to significantly over the next few years it can also be a wise idea to purchase more term coverage in the present when health and employment are strong. If health issues later arise and adding coverage would be at issue, then at least the previously purchased level amount is in place safely and securely.

Because modern level term insurance is so inexpensive, especially for the young and healthy, it can be a wise investment of a few dollars today that purchases what appears to be unneeded coverage. Life circumstances can change swiftly and take the unprepared by surprise. By "over-insuring" your life today you can make certain that future requirements will be met even if your health deteriorates.

The single greatest asset any individual owns is the ability to produce current and future income. To protect this asset to the greatest extent possible at the lowest conceivable cost is simply common sense. Not so surprisingly individuals are apt to spend more in premiums to protect a home or automobile, apparently unconcerned that ownership of such possessions are possible only because of the stream of money created by the ability to earn continued income. Stop that steady income due to premature death and awareness of the meager costs of what it would have taken to preserve it through term life insurance seems painfully obvious in hindsight. A good slogan for this proactive approach to term life insurance purchase concept may well be:

Group Life Concepts

Historical Significance

Group life insurance dates back hundreds of years when slave traders insured ship loads of slaves being transported from Africa to America. Slave traders made themselves contract beneficiaries. Later contracts would involve insuring the lives of Chinese laborers who were being transported from China to North, South and Central America to work on various projects such as railroads and the Panama Canal. **The first group life insurance plans, as we know them, were established around 1911** and today's group life contracts bear a strong resemblance to this ancestor. There are more than one half million master policies now in force in the United States.

Modern group life insurance began with the efforts of Montgomery Ward and Company in negotiating with the Equitable Life Insurance Society of the United States to issue a group policy to nearly three thousand employees of Montgomery Wards. Just a few years later other major life insurance companies also began to issue group life insurance.

Role of the NAIC

In 1917 the National Association of Insurance Commissioners (NAIC) developed standards by which group life insurance could be purchased and sold. This NAIC model has been changed and amended several times since 1970 leading to the current Act. The earliest 1917 NAIC model group life insurance was a policy that covered not less then fifty employees, with or without medical examination. It defined ***contributory plans*** **where the employer and employee split the cost of the coverage and that 75% of all eligible employees must participate in the coverage.** It also described **a *non contributory plan* in which the employer paid all the premiums and each eligible employee had to participate.** The law was later revised to lower the group number to 25 and again, later, to 10. The modern version specifies no minimum number to constitute a group.

Current group life insurance policies recognize the following basic categories as eligible groups; employees and employers, debtors or creditors, members of labor unions, members of associations, members of credit unions and groups which are deemed to be discretionary.

Almost all group life insurance master policies issued in America are the employer-employee group type. Under the modern version there is no requirement that the employer contribute part of the premium or that at least only 75% of eligible employees are covered in a contributory policy. However the rules on 100% participation in a noncontributory plan are still followed and only those employees who reject the coverage in writing are not covered, since the employer pays the entire cost.

STANDARD GROUP LIFE POLICY PROVISIONS

There are twelve standard provisions in model group life insurance. These include the following:

1) Grace period provision - there must be a grace period of 31 days for payment of premiums from the time it is due, except for the first premium.

2) The incontestable clause - makes a master policy incontestable, except for non payment of premiums, after the policy has been in force for at least two years.

3) Application provision - closely related to the incontestable clause, it has three parts:

a) The group life policy must provide a copy of the application to the policyholder and attach it to the master policy when issued,

b) The group life policy has to provide all statements made by the policyholder or people insured and all statements are representations and not warranties and

c) The group life policy has to provide that no statement made by an insured will be used in a contest of the policy unless a copy of the instrument containing the statement is or has been furnished to the insured or to the beneficiary or administrator of the insured's estate.

4) Evidence of insurability provision - group life policies are required to have a provision setting forth the conditions under which the insurance company has the right to require an eligible person to furnish evidence of individual insurability.

5) Misstatement of age - an equitable adjustment of premiums or benefits, or both, will be made in the event the age of a person insured has been misstated and such provision must contain a clear statement of a method of adjustment.

6) Settlement provision - requires group life policies to include a provision that death benefits are payable to the person the insured has designated as a beneficiary. **The insured under the group master policy has the right to name the beneficiary, not the master contract holder or employer.**

7) Certificate provision - the group life master policy has to be provided by the insurance company with certificates to the policyholder for delivery to each of the insured persons.

8) Conversion privileges - employees must have a certain amount of time to convert their group coverage to individual policies without being required to prove evidence of insurability if their employment is terminated. The conversion period begins at termination of employment and lasts 31 days.

(**NOTE:** although this provision seems generous, bear in mind that the conversion is to an individual whole life plan only and a term contract is not being offered. The theory is that those who are most likely to convert are not in the best health. Therefore if the law dictates that the insurer must provide coverage without regard to heath considerations then at least they can charge the considerably higher whole life premium amount).

9) Extension of death benefit - the highest coverage amount for which the employee was eligible under the group life contract must be paid under an individual contract if the insured dies during the 31-day conversion period, even if the employee did not apply for individual coverage.

10) Continuation of coverage during disability - this late addition to the model act requires a continuation of coverage under group policies during periods of total disability only under an employer - employee contracts. The continuation is to be for six months unless the insurance company approves continuation under another policy provision or the policy terminates. Coverage continues as long as the employee pays the premium cost for his share of cost for coverage as if no disability existed.

11) Creditor group life insurance certificates - insurance companies issuing creditor group life are required to issue certificates of insurance to creditor policyholders.

12) Nonforfeiture provisions - although the vast majority of group life is usually yearly renewable term without cash valves, some group life does build cash values. Where there is cash value the policy must contain nonforfeiture options.

GROUP MASTER POLICY

When an insurance company provides group insurance, it must issue a master policy to the policyholder (normally an employer, union, association, etc.). The master policy, together with the applications of the policyholder and all insureds, constitutes the basic contract of insurance. The insurance company then issues certificates to the policyholder for distribution to insured individuals and these certificates explain the insurance to the people receiving the coverage.

Although certificates contain all of the provisions found in the master policy, it is not the actual contract of insurance but, together with the master policy, constitutes the provisions of the entire agreement. Any ambiguities or conflicts between the master policy and certificates are interpreted to give the insured the best coverage possible.

Group polices relating to employment usually stipulate that employees must be actively working otherwise the employees will not be covered. This **"actively at work requirement"** prevents people who are too sickly or ill from being insured and receiving coverage under the group policy. The policy seeks to insure people who are reasonably able bodied. This is an important underwriting concern from the insurance company's point of view. Some group policies require the employee be a **full time worker which customarily means 30 or more hours per week.**

Since individuals can only be insured by group policies if they are a member of a group, insurance coverage ends when the employee ceases to be a member of that group. **If an insured employee dies before the date employment terminates, the employee is considered to be insured and the death benefit will be payable.** What constitutes termination can sometimes be unclear, but when employees resign, retire or are fired by employers they are regarded as having been terminated from employment.

Mere absence from work or a leave of absence **does not terminate employment** as a general rule. Although the date of an employee termination may sometimes not be easy to determine, many group policies contain a provision stating that when temporary leaves or layoffs continue for a period of two, or sometimes three months, employment will be considered terminated unless the employer elects to consider it as otherwise.

Typically premiums are paid to the insurance company by the policyholder and the premium is payable before the period of coverage will begin. Under non contributory plans, **enrollment cards are completed by each eligible employee** and this serves as a record of coverage and indicates a beneficiary designation. Under group insurance contributory plans employees must sign an application authorizing deduction of premium contribution from salary. **Legal problems stemming from premium payment are more apt to occur when plans are contributory rather then non contributory.** Sometimes group policies provide for dividends or return of part of premiums. Premium refunds in a group situation are usually paid to the policyholder and not to insured individuals.

Chapter 4: Whole Life Insurance

(4 exam questions)

In contrast with term insurance paying benefits only if the insured dies during a specified period of years, ***whole life insurance provides for the payment of the policy face amount upon the death of the insured, regardless of when death occurs.*** Whole Life can accomplish such a feat because of the higher premiums charged which are in turn used to build an equity feature that essentially transfers the risk from the insurer to the insured over his or her lifetime.

An analysis of many different types of life contracts is crucial to understanding the importance that the role of level term life plays when used to protect incomes and to secure the long term payment of debt when income disappears due to premature death. This section reviews in detail the workings and traditional uses of permanent insurance.

Traditional Whole Life Products

Ordinary (Straight) Life

All Whole Life is also known as **"permanent"** insurance. You can never outlive the coverage. Mortality tables calculate the rate of death in a given population. While the death age changes from time to time, it is currently pegged at age 100 (but is due to increase in the near future to as high as 115 years of age). This means that no matter when you purchase whole life coverage, as long as you pay on time the coverage will last until your "death" age of 100. This age is the age at which everyone is dead for insurance purposes.

Any person who actually lives to this death age is paid the full policy proceeds just as if he or she had died. Technically the cash value of the contract, which has been building all along since purchase, equals the full death benefit upon attainment of age 100. This is known as the "endowment" point of the policy or the point at which the cash values ripens into full maturity. All permanent life contracts share this age 100 endowment point.

Two other characteristics shared by all whole life contracts in addition to the death age concept are level guaranteed death benefit and level cost. Once whole life is purchased the death benefit is certain to never be less than the amount originally purchased. Furthermore, whatever premium amount that was paid in the first year is the same amount that will be paid annually in the future. Simply put you always know what your coverage amount is and you will always know that the cost will remain fixed and level.

EXAMPLE:

A healthy 30 year -old man is issued a whole (straight) life contract with a face amount (death benefit) of $100,000 at the annual premium cost of $1,000. Each year for seventy years the insured will be required to pay $1,000 unless he first dies, stops paying or cash surrenders the policy. If the insured dies at any time, $100,000 will be paid to a named beneficiary or to the insured's estate if no qualified beneficiary is named.

Should the insured live to age 100, the entire death benefit would be paid to the insured because the policy technically "endows." The insured who receives his own death benefit (which are called "proceeds" upon the actual payment as a death benefit) also has created an income tax liability. Since he only paid $70,000 in total premium but is receiving $100,000 at age 100, he will have to report $30,000 as income in the year in which it was received.

Other Types of Whole Life

Limited Pay Policies

Insurance coverage is provided for the insured's entire life but **premium payments are condensed and are paid in a shorter time frame than over the entire lifetime of the insured.** Therefore, the **regular annual premium installments paid are higher than for straight life.** Compared to straight whole life a fewer number of installments are made over time.

There are many varieties of limited pay life. The fewest number of payments possible is called **Single Premium Whole life (SPWL).** This is the purchase of whole life coverage in a lump sum, all at once with just **one premium** payment made. The disadvantage to the consumer is that it requires a large cash outlay all at the initial purchase point. The death benefit protection continues during the insured's lifetime and the **endowment point remains age 100** (which is the endowment point for all WL contracts).

Other variations on this limited pay theme are

➔ **10 Pay life** - pay for ten years, covered for entire life, endows at age 100.

➔ **20 Pay life** - pay for twenty years, covered for entire life, endows at age 100.

➔ **Life Paid @ Age 65** - pay until insured attains age 65, covered for entire life, endows at age 100.

The use of limited payment whole life plans of years past was dedicated to the concept of building higher cash value sooner rather than later. While death benefit protection was a key priority of purchasing such plans, the buyer was favoring cash value buildup over coverage. These were selected by people eager to participate in the "forced savings" concept that was heavily marketed by life insurance companies.

The disadvantage to such plans is paying a lot of premium for a relatively small death benefit. While straight whole life itself charges significantly more than mortality and policy cost to insure a life, the limited pay plans took the idea much further. The owner of this policy was not making a very efficient insurance purchase.

To appeal to the younger insurance buyer who had great health but limited funds available for premium, the insurance industry introduced the several ideas which follow:

Modified Life

This whole life is characterized by a **lower premium payment in the early years of policy protection (usually the first 3, 5 or 10 years),** followed by a one time premium increase at the end of the reduced cost period. There is little or no cash accumulation during the modified lower premium cost period. Take for example a variation of this policy called "Ten Year Mod Life." The premium cost annually for the first ten years would be fixed at a sum that is lower than the same amount of whole life (straight) coverage would cost. After the ten year period concludes, the Mod Life policy hikes and fixes the premium for the rest of the insured's life for an annual cost that is greater than the straight whole life policy could have been purchased ten years earlier.

Graded Premium Whole Life

Similar to Modified Life except that during the initial premium cost phase, Graded Premium Whole Life premium cost increases each year (usually for the first 10 years or so) until the cost levels off and remains constant. It also has minimal cash accumulation in the early years.

In both cases, **the modified life and graded premium contracts offer the younger purchaser reduced cost now followed by a higher fixed cost later with no or minimal cash value provided during the lower premium cost phase.** They were popular during the 1960's and 1970's and helped nurture young insurance buyers to develop a taste for whole life rather than term insurance. They were plans that the traditional life insurance industry introduced to cultivate future permanent insurance buyers. Until the late 1970's the industry was accustomed to achieving over eighty percent of sales in the permanent (as opposed to term) life sales area.

Adjustable Life

This form was **i**ntroduced in 1971. This policy allows the owner to change the plan of insurance by increasing or decreasing face amounts and premiums**,** within certain limits. The protection period can also be lengthened or shortened by the owner. Depending upon the insured's face amount and premium payment amount selected, **the contract could resemble** and perform **like a term, straight WL or a limited pay life** policy.

The owner can make this policy anything he would like it to be contingent on certain underwriting restrictions. In theory the younger buyer can start out with a low cost term premium and later, when he is older and enjoys a higher income, can increase the premiums in a manner which creates a cash value building permanent plan maturing at age one hundred. All this is done with the single contract originally purchased by the younger buyer.

Uses of Whole Life

Advantages

Because it builds cash value whole life equity can be borrowed for emergencies or other purposes. As the insured ages and pays premium year after year, the equity (cash value) in the contract grows. In times of financial emergency, such as lost employment or disability, a policy loan can be arranged to smooth over a temporary rough patch. The amount borrowed will accumulate interest charges as specified in the contract. There is no requirement to repay any of the loan or interest amount during the lifetime of the insured, however the indebted amount will be deducted from the death benefit when the proceeds are paid to the beneficiary.

A major misconception of the public is that such cash values belong to the policyowner. However, since the company guarantees cost and benefit to be level for the entire lifetime of the insured, all cash values belong to the company. The policyowner can at anytime stop paying premium or surrender the policy or even elect to take a reduced paid up amount. For this reason all policy loans require an interest factor to be assessed against the loan amount disbursed.

Cash values can also be used later in life to help fund retirement, especially if the need for the death benefit has evaporated over time. The cash value of the policy could be surrendered at age 65 or older when two-thirds or more or the death benefit has matured and then the money invested or spent by the owner. The insurance company is always available for a single premium immediate or deferred annuity purchase if the policyowner simple wants additional guaranteed income for life without the headaches of money management.

Since cash values are available they can also be used as collateral for a loan at the bank in the event a policyholder wishes to establish credit or a better relationship with a particular institution. In the alternative, merely listing the cash values as an asset can help strengthen the personal balance sheet of the individual owner.

Another possible use of the permanent life contract is to make an “absolute assignment” of the policy. This means giving up all right as owner to another party. Since a life insurance contract is a unilateral agreement and an intangible personal property right an owner can sell or give away his rights under the policy to any other party. An older policyowner gifting his contract to a child or grandchild is not an uncommon practice.

Disadvantages

Whole life has distinct cost disadvantages when compared with term insurance. While permanent insurance cash value is a nice feature to own, it comes with a hefty cost. Since the first year premium of whole life is used to pay costs of the policy including all commission, there is customarily no cash value creation until a little begins in the second policy year. It normally takes ten years or longer for the typical whole life contract to accumulate a cash value that equals the total of premiums paid by the policyowner.

This focus on cash accumulation and the higher cost associated with acquiring it means the insured must settle for more limited protection. This is the trade off of permanent coverage: greater cash value is achieved only at the expense of being able to purchase a smaller death benefit. If a prospective purchaser has limited premium dollars available he runs the risk of under insuring based on actual need level when buying whole life instead of term insurance. If the whole life proceeds left behind is not sufficient to satisfy the monetary needs of the people it was meant to benefit then cash value accumulation will seem like a poor thing to emphasize when total insurance coverage required remains unsatisfied.

Using Term as a Rider

These typically combine term coverage and whole life insurance into a single policy. They were primarily used for family coverage situations, and most were issued in the 1950's through 1970's. **The term coverage is added to the permanent contract as a "rider" and is not issued as a separate contract.** The normal reasoning for its use was to provide larger amounts of coverage at a small cost (term) when the protection is needed most (family rearing years). The permanent (WL) coverage would always be there and cash value accumulation was available for financial emergencies. The central concept was to combine permanent and term coverage together to yield a higher death benefit at an overall lower cost than if only permanent coverage had been used.

The Family Policy

All family members are issued coverage under one policy. A **Whole Life policy is bought on the life of the family wage earner while term rider coverage is placed upon the lives of all other dependents in the same family unit (spouse and children)**. Premium cost is based on the life of the primary individual who is insured by the WL contract.

The "perk" of this contract: if the named **insured dies** during the family policy coverage period, then the **dependent term coverage is fully paid until it expires** (age 65 for the spouse and adulthood for the children). Dependents **may also convert** the term to individual permanent insurance without proof of insurability prior to coverage expiration. **Any children born are NOT covered IMMEDIATELY, but only after 15 or 30 days of life**. Children born after the insured dies are also covered (as long as they are born within 9 months, or so, of dad's death).

Family Plans

These were also very popular plans in the 1950's, 60's, and 70's. Again the wage earner (usually dad) bought a whole life policy and selected a term rider (the choice was between either level or decreasing term). **Upon** his premature **death,** the **whole life proceeds were paid in full to the beneficiary** (the widow, hopefully) but the **proceeds from the term rider were invested by the insurance company (at the instruction of dad when he bought the policy) and a monthly income was paid to the family** for either a pre-selected time or for a pre-selected amount. The design was to have the term rider help make up for the income lost due to dad's premature death.

The Family Plan variations, depending upon the type of term selected include:

"Family Income Policy" (FIP) uses ***Decreasing term*** as the rider to the Whole life plan. This rider has a serious disadvantage to the insured if death occurs near the end of the term time because there will be less death benefit to invest to supple an income to the family.

"Family Maintenance Plan" (FMP) is the name of a Family Plan where ***level term*** insurance is the rider. Obviously with a lever term rider, the exact amount of death benefit will be the same no matter when the insured dies during the term coverage period

Of these two, all other factors being equal," Which is a cheaper rider, FIP or FMP? FIP is because the coverage decreases over time.

Other Whole Life Riders

Waiver of Premium

Although today agents are familiar with the disability income benefit as a stand alone health policy, the concept dates back almost 100 years when disability was only offered as a rider to a life insurance policy. **If the insured became disabled and could not work, the company waived the premiums** which would have to otherwise be paid, to continue the life insurance policy.

The disability rider on the life insurance policy states that if the insured becomes disabled, according to the life insurance policy definition of disability, the insurance company waives the premiums due during and for as long as the disability will continue. Disability which begins after a specified age of 60 or 65 would not be covered. There is **a waiting period of six months** prior to the time disability benefit waiver will kick in thus relieving the insured from having the burden of paying premiums. **This 6-month threshold is included so the insurance company does not have to be bothered with premature claims** or short term disabilities or disabilities which would not continue for at least six months. The insurance company is concerned only with very serious and long term disabilities. Causes of disability which would not be included for a payment waiver include war, declared or undeclared, and intentional and self inflicted injuries.

Definitions are crucial to the application of the disability benefit being activated for the benefit of the policy owner. The term **"total disability" means a disability which prevents the insured from working at a customary occupation or at any other occupation for which the insured is suited by training and education.** "Permanent disability" means the disability will last for an indefinite and continuous period of time. Before the benefit will be paid, most policy riders stipulate an insured must be totally and permanently disabled in order to receive the disability benefit.

Although most policy riders for disability define disability with respect to the inability to engage in any occupation or business for which the insured is trained by education or experience, there are some more generous policies offering an occupational disability clause (meaning the disability would stop the insured from working at their own specific occupation rather then the more general total disability definition). The insured needs to check their policy to see which language is used within the contract.

Accidental Death

For an extra premium an insured can elect to add the accidental death benefit by rider to the application for life insurance. The **accidental death benefit typically will match or equal the amount paid on the base policy if the cause of death results from an accident.** From this concept emerged the phrase **"double indemnity"** as it applies to the Accidental Death Benefit rider. For example, if a $100,000.00 death benefit is purchased with the accidental death rider and the cause of the death is an accident, the policy will pay $100,000.00 on the base policy and match it with another $100,000.00 for a total of $200,000.00. On the other hand, if the death is not by accident then only $100,000.00 will be paid. In certain types of accidents (death as a result of using the services of a common carrier, i.e., as a passenger on a train, plane, bus or other public conveyance) sometimes the accidental death benefit will triple or even quadruple the original face amount.

There is a long historical evolution of accidental death occurring as either a result of **"accidental means"** or an **"accidental result."** When accidental death is defined in terms of accidental means, both the cause and effect of the death must be unexpected and unforeseeable. Accidental result language means only looking at the cause of death as having been an accident. An accidental result dismisses the idea that both cause and effect must be involved in the accident. An accidental result is a much broader and more generous term to the insured than is accidental means. Courts throughout the 20th century have, for the most part, defined accidental death in terms of accidental result even if there is accidental means language used in the contract.

Courts generally interpret "accident" and "accidental" according to their ordinary definitions in society, unless a state statute or a contract provision requires some other interpretation. Customarily, an accident is an unusual event which is not foreseen by an insured whereas accidental events happen suddenly, all at once, unexpectedly. Elements of violence, force or attack may be involved in an accident. The word accidental simply means death occurs by accident. An accident must be the proximate cause of a death in order for an accidental death benefit to be paid. In legal terminology, **proximate cause simply means that a cause is either directly responsible for the death or that the death began as a result of an unbroken chain of events which brought about the death.**

Also important in the accidental death benefit provision is certain risks or causes of death are not covered by exclusions specifically incorporated into the provision itself. It is possible for the insurance company to exclude up to about 100 risks which may not be covered. However, most insurance companies limit risks not covered to only a handful, usually a dozen or less.

The most common ADB exclusions include:

- Suicide of the insured whether they were sane or insane,
- Intentional or self-inflicted injury whether sane or insane,
- Participating in a felony or an assault which leads to the insured's death,
- Flight on an aircraft other than as a fare paying passenger on a regularly scheduled airline flight or if the insured is a pilot, officer or member of a crew or has duties aboard a plane,
- Any infection or disease existing before or after the accident,
- Any drug or medication taken voluntarily which was not administered by a licensed physician or taken as prescription medicine,
- The use of alcohol in combination with any drug, medication or sedative,
- Any poison or gas fumes voluntarily taken in, absorbed or inhaled, and
- By war or any act of war declared or undeclared.

It is also **critical,** according to the accidental death benefit, **for death to occur within 90 days of an injury** otherwise payment will not be made. Ninety days from the date of the accident is the deadline by which the insured must die to qualify the death as a result of an accident.

If a policy owner or beneficiary must sue an insurance company when there is a discrepancy or dispute involving payment of the accidental death benefit, the burden of proof is on the plaintiff (a policy owner). The burden on the insurance company is to prove that the loss or death resulted from a risk which was not covered or specifically excluded in the accidental death benefit provision.

Guaranteed Insurability Option

This rider offers an insured the future ability to buy insurance even when they become uninsurable. **The GIO offers the insured the ability to purchase insurance at specified future dates without providing evidence of insurability.** The maximum amount of insurance which can be purchased in this manner is stated in the guaranteed option provision.

The standard industry GIO typically allows the insured to buy additional amounts of coverage every three years up to the age of 40. Beside age triggers, these options can also be used when certain specified occurrences happen in an insured's life such as getting married or having or adopting children.

The New York Rule as it pertains to the general guaranteed insurability option is important. **The New York Rule stipulates every new policy issued under this option automatically provides an incontestable and suicide period which runs from the date of the original policy which was issued with the rider.** Under the New York Rule the insured could buy the original life insurance policy in 2000, **pick up an option in 2005 and the incontestable and suicide period runs from 2000 for this option conversion.**

In modern insurance contracts term insurance has become so cost effective as to render this option essentially useless. Why should a healthy young insured purchase this "option" to buy when he could use the same funds as premium and actually get a death benefit as opposed to the right to buy a death benefit in the future?

Payor Benefit

This rider is added to juvenile policies (policies purchased on the life of minor's) and is another form of **premium waiver.** The Payor Benefit rider is added to a juvenile policy and the cost is based on the age and health of the parent or guardian who is the policy applicant. The rider states that premiums **will be waived until the insured (a child) reaches a certain age** (usually 21 to 25) **in the event** the premium **"payor"** (parent/applicant) **dies or becomes disabled** before the insured reaches the specified adult age.

The **"Jumping Juvenile" policy is a related concept.** Many juvenile policies are written with a face amount of coverage which remains fixed at one amount while the insured is a child and then, **upon attaining adult age,** the **face amount** of the policy **"jumps" to a higher amount (usually 5 times the original face amount).** At this time the insured can either reject the policy or he must pay premiums on the increased amount based on attained age. This provides children with the option of greater coverage later, without proof of insurability required

Joint and Survivorship Life

Joint Life is a life insurance contract which promises to pay the face amount of the policy based on the **death of the FIRST of two or more insureds covered** by one contract. Often the contract is used to insure both a husband and wife, each being the beneficiary of the others benefit.

THE POLICY ONLY PAYS ON THE DEATH OF THE FIRST COVERED INSURED WHO DIES, AND THEN THE CONTRACT IS OVER.

The survivor(s) then loses the coverage unless they **exercise the** contract's right to buy permanent insurance without having to prove insurability. However, if both insureds **die in a common disaster**, the insurer will pay the face amount for each insured. Legally this is required under the contract because it cannot be determined which insured died first if they die within 31 days of each other after the accident occurs.

The advantage of joint life is that the premium cost for a given face amount **is smaller** than the total premiums would be for the same two people had they bought separate policies individually. Joint life coverage is normally available under both term and universal life plans, in addition to permanent plans.

SURVIVORSHIP LIFE (SL)

These are known as **"last-to-die" or "second to die" contracts.** Two or more lives are insured under a single policy and the death benefit is **paid upon the death of the second or last insured.** Nothing is paid when the first insured (who is also covered) dies. Most SL contracts are issued as permanent insurance but some are term or universal. SL differs from joint life because SL pays on a life **OTHER THAN THE FIRST TO DIE.**

SL is an attractive policy type for the **estate planning** process when the unlimited marital deduction is used. More than two lives can be insured with death benefit paid either upon the second, third, fourth or greater life.

Chapter 5):Interest Sensitive Insurance Products
(9 exam questions)

Introduction: Interest -Sensitive Life Products: Universal, ISWL and Variable Life

All of the products described in this category have one thing in common: they all pay a rate of return on cash values that fluctuates rather than a fixed, never changing percentage. Two of the products, Universal Life and Interest-Sensitive Whole Life (ISWL), guarantee cash value to the policy owner but the insurance company reserves the right to make all investment decisions. The other two contracts, Variable Life and Variable Universal Life, allow the policy owner to make investment choices but some of the choices could result in the loss of principal (the investor bears the risk of loss and the insurance company makes no guarantees as to return of, or return on, principal sums, unless a guaranteed account has been offered by the company and selected by the policy owner).

A buyer would select a select a product without guarantees for a potential higher rate of return on cash value principal. The variable contract owner is seeking to earn a return that keeps pace with, or even out paces, the inflation rate. The downside is risk to principal but the upside is possibly significant earnings and greater death benefit coverage amounts which enhance the value of money invested. **Term life and all forms of permanent insurance, except for ISWL, are not interest sensitive life insurance contracts.**

An Historical Review

Although life insurance has been in existence in America since the 1800's, it was not until very recently that the consumer had such a banquet of choice and opportunity available to meet virtually every financial need. The economics and tax law of the 1930's through the mid 1970's dictated the manner in which insurance products were available to consumers just as they play the key role in product offerings today.

The early forms of maritime risk transfer in Europe during the 16th century allowed ship and cargo owners to be indemnified in the event they lost their assets due to the hazards of ocean travel. This would give way to applying such concepts to human life. In the mid-1700's a European mathematician conceived the first mortality table, a device through which predicting the span of human life became a more definite and measurable science.

As the Industrial Revolution spread from Europe to America in the early 19th century, with it came the concept of Industrial Life insurance. Small face amount policies, typically from $50 to a few hundred dollars, were marketed to hard-working factory laborers whose life spans were not particularly generous. A 'debit' agent would come to the worker's home every week to collect meager premiums amounting to only few pennies. This premium collection would help to fund and build multi-national corporations which today boast tens and hundreds of billions of asset dollars. Familiar companies like, Prudential, Metropolitan, New York Life, etc., shared these somewhat humble beginnings.

As America grew, so did her appetite for inexpensive immigrant labor. Millions of hard working new citizens looked for the streets that were fabled to be paved with gold. During this period, the nation's insurance companies prospered. Tens of millions in premium dollars were placed with insurance companies who, in turn, needed places to invest the money. Investment enabled them to meet their obligations to pay death benefits, overhead expenses and, of course, reap profits.

Obtaining premium dollars from the citizenry meant competing with other 'intermediaries' in society, chief among them the banking and savings and loan industry and the secondary (stock markets) marketplaces. **Intermediaries are institutions in society soliciting funds from individuals and business in exchange for paying a return for the use of the money over time.** The goal of the intermediary is to earn more money than they are required to pay for using it. The next section examines the economic recent past of America and the effect it had on **three main intermediaries: insurance companies, banks and savings and loans and the stock and bond marketplaces.**

The 1920's in America were whimsically called "The Roaring Twenties" for a reason. Exciting new inventions, fresh investment opportunities, Prohibition and the rise of organized criminal activity combined at the same point in time to create an atmosphere of economic invincibility. A member of the general public could buy $1 worth of ownership in a major corporation with a scant ten cent investment while the rest was furnished the friendly brokerage house that was eagerly willing to finance the purchase. People became obsessed with the euphoria created by enormous paper profits as they witnessed the almost miraculous rise of their investment portfolio.

Then that famous day in October 1929 forced everyone back into the real world: the stock market signaled an economic collapse felt around the world. On a simplistic basis, the stock market crashed because everyone was willing to sell stock but buyers were as scarce as dollars. At the time, the federal government decided to strangle the nation's money supply in a futile attempt to quell the financial panic.

Brokerage houses were placed in a perilous position: they had lent most of the money to the public for the purchase of securities and now the value of those investments had shrunk to the point where it was the brokerage house, and not the stockholder, who was actually losing the money. The brokerage house contacted clients and told them that they must bring in more dollars to cover the mounting losses. But from where could these clients get the funds? Many would visit their bank or savings and loan.
The long lines found near banks and savings and loans told the story. Everyone had the same idea of withdrawing their savings as the solution to floating through tough times. The only problem: the savings institutions had very little money on hand. Then, as now, depositor money is lent to customers who borrow at a higher rate. Deposited money is not placed in a vault where it mysteriously multiplies as it waits to be claimed by its owner.

The insurance industry was able to handle the financial crises in a much more successful manner. Since their main function is to satisfy death benefits as they are legitimately claimed, short term cash reserves were readily available to meet this purpose. Since the vast majority of the industry's assets were invested in long term and illiquid vehicles, insurance companies experienced the same severe cash shortages felt by their financial counterparts. Policyholders requesting cash surrenders or policy loans were refused even though their contract said they could borrow. Although policyholders found their normal rights suspended, the end result justified the means: policyholders cash values turned out to be 99.71% safe!

As the entire world struggled through the deep depression of the 1930's, the next decade would bring turmoil of a different nature. World War II helped to end the economic hard times but at a tremendous cost to human life. America was forced to utilize all of her resources for mere survival. All healthy adult males were expected to bear arms against enemies. Factories and industry had to cease production of goods for a peacetime population and retool to produce the weapons of war.

The resource of money was much sought after by the government. Everyone from Mickey Mouse to Cary Grant urged Americans to buy War Bonds and underwrite the expense. If you were not investing your money patriotically in War Bonds, your options were quite limited. An example of a safe corporate bond offering was 2 1/2% for 40 years! Invest $1,000 and receive $25 per year and, in only 40 years, your $1,000 is returned. By the standards of today this sounds completely inadequate, but in 1942 it seemed like a wise investment.

As the war concluded in 1945, GI's returned home to hero's welcomes and life returned to a more normal state. However, there was one huge problem. It would take a year or two for business and industry to adjust operationally back to serving peacetime needs. Auto plants that had been producing jeeps and tanks now had to resume the manufacture of family vehicles. Other durable goods like refrigerators and washing machines were in short supply but in great demand. Prices rose dramatically as inflation was fueled by too much money chasing too few goods. The rate of inflation for 1946 and 1947 were a staggering 10% and 12%, respectively.

The basic insurance contracts available in post World War II America were offerings of endowment, whole life and (somewhat grudgingly) term insurance. While endowment contracts were the darlings of the fifties and sixties, whole life began building in popularity in the 1960's and term insurance gained favor by the late 1970's. To properly understand this product evolution that lead to today's product revolution, a discussion of these contracts and their popularity is necessary.

The boom times following World War II found Americans with a new prosperity but still burdened with the pessimism of the recent past. **Endowment Life insurance was tailor made for success in this time period for several reasons.** The main competitions for endowment life in the 1950’s were bank and savings and loan passbook accounts. Stock purchases for the individual were not a highly sought after alternative in view of the fact that adults of the day had been children of the depression era stock market crash.

Endowment Plans provide a level death benefit, but their **main focus is on cash accumulation**. The premium charge is significantly higher than for comparable amounts of protection under a whole life plan, but the policy matures (pays the full face amount) at a specified future point in time. Because they provided guaranteed future amounts of cash, endowments were primarily marketed as either retirement enhancements or fund builders for educational purposes. A 1984 tax law changed redefined insurance and, although grandfathering previously purchased endowment contracts, endowment insurance no longer meet the new definition because of the emphasis on cash value accumulation relative to death benefit.

The main reasons for their popularity were **rate of return, tax advantages and the fact that the Americans of that era were hearty savers.** Imagine yourself as head of a 1950's family. You are concerned about saving money for your children's education or your own retirement. Your basic choices are a bank account or an endowment policy. The bank is paying 3.25% interest which is income taxable. On the other hand, an **endowment is** paying 3.25% with **tax deferred cash accumulation until maturity. If you die** prematurely as the insured in an endowment contract **your family receives a guaranteed amount that is free from income taxation.** Furthermore, if you become totally and permanently disabled the insurance company will continue to pay your premiums on your behalf and complete the plan on schedule. On the other hand, your bank account value stops when you die and if you are disabled, your ability to continue making deposits will stop as well. Which method of saving would you choose?

The 1960's saw interest rates and unemployment rise over levels of the Fifties. Also making itself felt was inflationary pressure unknown since the end of the WW II. Although endowment plans would still be popular into the 1970's, whole life insurance was being purchased in record amounts.

Whole life products have traditionally been distinguished from other insurance products because **of fixed premium, level face or death benefit and coverage that lasts for an insured's entire life.** Premium cost is fixed due to mortality rates, returns on invested premiums and overhead costs.

Whole life products place much greater emphasis on the protection element and less on savings when compared to an endowment. However, the savings feature, or "cash value" of whole life, was still a very important consideration. Being able to borrow against cash values at low guaranteed rates in an emergency was a strong selling point.

Whole life is a long range product. It should not be purchased with the idea of retention for only five or ten years. Over a very long time period (20, 30 or more years) it will serve well and predictably. **The drawback: a comparatively low and conservative rate of return.** Most whole life plans written in the 1950's to 1970's provided a modest built-in return of between 3% to 4%. Again, they were geared for protection and not accumulation. Most people owned a whole life plan and not much fuss was raised until the hyper-inflation of the late 1970's and early 1980's. When taken in context, whole life was a highly competitive financial product until the day interest rates went haywire.

As America began to switch from a manufacturing to a service based economy the inflation, unemployment and interest rates increased dramatically. Short term returns on certificate of deposits hit 11, 12, 14 and even 16%! The built-in whole life insurance cash value returns of around 4% looked embarrassingly meager. A new battle cry could be heard throughout the land: **"BUY TERM AND INVEST THE DIFFERENCE".** Although the economic factors leading to this volatile period are varied and complex, their effect would profoundly change the way the insurance companies did business.

The replacement of whole life with term insurance began to take root. Those who were not cashing in whole life were taking out maximum cash loans against value. **The strategy was simple: borrow cash value at 5% or 6%, invest it in a 15% CD and pay the interest on the loan while walking away with a handsome profit after paying income taxes on the CD income**. Major insurance companies became uneasy as they found it necessary to sell bonds and stocks in order to have adequate cash flow. Not since the great depression had such cash crisis faced these corporate giants.

In more steady economic periods it is usual for about 2%-3% of the asset base of a company to be requested by policyowners in the form of loans and surrenders. By the early 1980's, from 12%-15% was demanded. Although this was a staggering percentage, perhaps even more remarkable was the fact that is was not significantly higher.

Insurance giants could have invoked the "delay clause", a state insurance law allowing companies to make policyholder wait up to six months for cash surrenders or loans in times of financial uncertainty. The Insurance industry chose not to invoke the delay clause. Why? Their concern with future reputation outweighed current short term losses. Insurance company officials probably voiced more than one plea to a Higher Power for interest rate relief.

In the meantime, the only other option available was to create and introduce new insurance products capable of competing in widely fluctuating interest rate markets. These new products would have to be designed in such a manner that policyowners would not have any incentive to remove cash values and place them elsewhere on either a temporary or permanent basis when interest rates rise quickly.

Term insurance became the protection of choice. Term life is **very low cost insurance.** The premium increases with age, the death benefit can be level, decreasing or temporarily increasing and coverage is considered temporary and not for an entire life. **There is no cash value or savings element, therefore the purchase is one of insurance only.** Again, there is no mystery about the strategy suggested and employed:

- *A MALE AGE 30 COULD BUY $100,000 WHOLE LIFE FOR $1200 ANNUALLY. THE SAME AMOUNT OF TERM PROTECTION WOULD COST $200 PER YEAR. THE STRATEGY WAS TO BUY THE TERM AT $200 AND PUT THE $1000 OF SAVED PREMIUMS IN A HIGH INTEREST RATE CD.*

IN JUST A FEW YEARS, THE INTEREST FROM THE CD WILL PAY THE COST FOR TERM INSURANCE. WHEN YOU ARE 60 OR 65 YOUR CD WILL BE WORTH SO MUCH MONEY, YOU WON'T NEED ANY MORE LIFE INSURANCE AND INCREASED INSURANCE COST AT AN OLDER AGE IS NO LONGER A CONCERN.

Taken at face value in 1979-1983, who could argue? But things were about to change dramatically. First, inflation was being brought under control. Second, double digit rates of return were no longer achievable on a steady and conservative basis. Third, insurance companies were about to fight back strongly with competitive products that were interest sensitive.

Guaranteed Products - Overview

In an interest sensitive insurance contract that is guaranteed, the insurance company assumes all investment risk. Any cash value accumulation receives a fluctuating rate of return but the return paid has a "floor" rate under which the rate paid can never pay. Many such contracts use a floor rate of between four and five percent interest.

■ **Universal Life** (also known as *"Flexible Premium Whole Life"*) - This contract combines the best features of low cost term insurance with a tax-deferred policy account feature which allows cash values to build (tax-deferred) at competitive (fixed rates which can change periodically to match increases or decreases based on shorter term market interest rates). The term insurance cost can be paid either by regular premium and/or from the policy account itself. The policy owner can even choose to skip some payments completely, as long as there is sufficient cash value upon which the company can draw to cover term cost expenses.

The interest that accumulates in the savings fund is taxable only when the insured receives it to the extent it exceeds the entire amount of cumulative premiums. However, cash values may be withdrawn up to the total amount of premiums paid, without causing a taxable event. Such a withdrawal is just that - it is not a policy loan and no interest is charged. Since the policy owner is paying at all times for the term cost of the product, all cash values and interest payments that are in excess of insurance cost belong to the policy owner and not to the insurance company. Cash values, or policy accounts, are guaranteed by the insurance company to achieve some minimal return (usually 4 or 5%). The advantage of universal life, over traditional cash value policies, is the greater flexibility the owner enjoys along with higher yields.

■ **Interest Sensitive Whole Life** (ISWL) - behaves exactly like a traditional whole life contract (review earlier part in this section for WL details) except that the rate of return paid on cash values can fluctuate with fixed market conditions. This fluctuation is not available on all other whole life products. This will mean ISWL will provide a higher yield during increased interest rate markets than will traditional whole life contract.

Products Without Guaranteed Return - Overview

In variable life insurance contracts, the return on cash value accumulation is not guaranteed by the insurance company and the contract buyer assumes all investment risk. The typical variable life contract offer the policyowner the ability to invest cash values through a "family of funds" concept as discussed below. One of the most common selections, mutual funds, offer the investor immediate diversification into carefully selected and managed securities. Automatic reinvesting of capital gains and dividends will speed up the growth of the investment.

FAMILY OF FUNDS - Many Mutual Funds have a broad spectrum of funds to meet the needs and temperaments of various investors. Since Fund names may be subject to marketing influences, you should always read the Fund's prospectus to determine its precise objective. A typical Family of Funds might include the following:

MONEY MARKET FUNDS

- Invest in short-term money instruments. Usually very little risk and relatively low rates of return are offered.

BOND FUNDS

- Invest in debt-type instruments
- Relatively high yield.
- Market value fluctuates inversely to interest

INCOME FUNDS

- Seek maximum income.

SECTOR FUNDS

- Concentrate on a particular area of the economy.

AGGRESSIVE GROWTH FUNDS

- Very Volatile, invest is high-performing stocks. The policyowner can get very rich or go broke in a relatively short period of time depending upon market forces and fluctuations.

GROWTH FUNDS

- Invest mainly for capital growth.

GROWTH & INCOME FUNDS

- seek a balance of stocks & bonds

GUARANTEED ACCOUNTS

- Participation will place return risk on the insurance company and defeats the purpose of the ability to enjoy greater returns over many years compared with mutual funds and stock accounts. However, guaranteed funds are available to variable contract holders through which to invest and accumulate policy cash values.

■ **Variable Life** - requires a fixed and level premium payment. Cash values (amounts invested which are more than the policy cost) can be invested in a wide range of accounts, i.e. bond funds, money market funds, mutual funds, balanced funds, aggressive growth funds and even a guaranteed fund (which pays a fixed and usually lower return). In the guaranteed fund, the loss to principal cannot occur to any funds placed therein.

This relative newcomer is a plan that is not considered to be a traditional form of life insurance. Although the CONSUMER BEARS ALL INVESTMENT RISK, the "upside" is not only a higher investment yield, but also an increasing face amount of insurance which will also keep pace with (or out pace) inflation. The death benefit originally purchased is guaranteed to be paid upon the death of the insured regardless of investment return.

■ **Variable Universal Life** - has the identical contract features of variable life but offers the same flexible premium payment options of universal life. It is subject to same the Securities and Exchange Commission & state rules as is variable Life.

NOTE: The attraction consumers would have to a variable product is based on the POTENTIAL return of the variable product and its ability to keep pace with or even exceed the rate of inflation, over time, in our economy. The "downside" of such a product is the notion that the consumer is on his own and any financial losses suffered are his problem. A prospectus must be supplied to any prospect for a variable life insurance product. In addition to requiring that a soliciting agent possess a state insurance producer license the selling agent must also have a securities license which is regulated through the Securities and Exchange Commission.

Variable versus Fixed Return Rates

The nature of risk is closely linked to whether a rate of return is fixed or variable. In the world of investment the general rule is: **"the higher the return, the greater the risk; lower the return, and lessen the risk."** Any investment decision primarily rests upon the extent to which the investor is willing to accept the potential loss of (original) capital.

For example, the most conservative yet liquid investment is the United States T-Bill. Correspondingly, the return is fixed at rates considered conservative for the investment environment in which they are offered. The central idea is safety of capital - you will not lose your investment; therefore your return is average (and taxable) to reflect the virtual absence of risk. This is a **fixed (known)** rate of return investment.

An important question needs to be asked: **"How safe is safe?"** An investor can not get safer than government securities, true enough. However, **is the government's promise to pay absolutely failsafe?** You decide. The government backs its promise to pay with what is termed "the full faith and credit of the United States Government." Simply put this means two things. First, the government can increase taxes to raise revenues and second, as long as people believe in their government, its currency has value.

But **what if the unthinkable happened?** Suppose one fine morning a substantial number of Americans no longer had confidence in either the government or the money it prints. Would you accept dollar bills in exchange for goods and services or would you prefer something more substantial or useful (like food or clothing)?

Although the United States government establishes fiscal and monetary policy for the fifty states and several territories comprising our great nation, other powerful world economies profoundly affect the values of our own goods and services. The United States, although still a major economic force on the world stage, no longer is able to exert the control and will it once could.

In addition to government securities, many Americans select banks and savings and loans as the institution of choice for their money. The public feels secure with this choice because of FDIC and FSLIC insurance on deposits up to $100,000. This enormous confidence stems from consumer faith in the government which backs the deposits. **With what does the government back these trillions of dollars?** With full faith and credit, of course.

Therefore the same important questions posed earlier needs reiteration: "How safe is safe?" Recall the Savings and Loan fiasco of the late 1980's, through which approximately 200 to 300 billion (depending upon whom you believe) dollars were lost. These billions are now part of the national debt, a legacy which shall make the next several tax paying generations liable for repayment. Could the entire banking system again collapse? It has several times before and likely will again someday.

If we cross the street from fixed and walk over to the variable side, investments such as buying and selling the stock of publicly traded corporations is considered somewhat risky and unpredictable. A stock can both appreciate in value and pay a rate of return via a dividend. This opportunity for high return must be tempered with a considerable vulnerability for loss of capital.

While income may be paid on the invested capital, the value of the stock may decrease markedly or even cease to exist. Such risk and unpredictability illustrates the concept of **variable (unknown)** rates of return.

Whether or not a person will put their hard earned dollars in fixed or variable return opportunities is dependent upon the investment philosophy of the individual. The very conservative person will seek to preserve existing capital at all cost; therefore rate of return is not the main consideration. Conversely, the risk taker is very willing to accept the potential loss of some or all capital in exchange for a potentially dynamic return.

A good question to ask any prospect is: "Are you more concerned with the return on your capital or the **return of your capital?**

Think of your accumulated savings as a pile of money. The rate at which this pile grows depends upon the capital you invested and rate of return paid to you on that capital amount. Alter either the amount of capital or interest payment rate, or the total size of the pile of money accumulated changes to reflect the alteration. We know that rates of returns can be variable or fixed, but what about our principal amount? What can occur to reduce the principal amount before or during investment? The smaller our pile, the less is our chance to accumulate a comfortable amount of money for the future.

There are four basic threats to principal:

- *A risky investment that turns sour and reduces the amount we have to invest. (Have you ever made an investment you later regretted? If you are over forty years old your answer is probably a resounding "yes!".)*

- *Our friendly federal and state partners who tax significant portions of most of the good fortune we may enjoy.*

- *Inflation in even modest amounts seriously erodes the purchasing power of our pile of money over time.*

- *Finally, dipping into our principal savings in the event of individual economic emergency will erode accumulated principal amounts.*

If an individual makes a poor investment, common sense dictates that the younger the age at which it occurs, the better. Making a serious error in investment judgment at age 50, 55 60 will result in "golden years" turned to the rust of economic disaster.

Paying taxes is a necessary evil for most people but a sizeable majority pay more than is required of them. By placing significant portions of principal in safe and highly accessible (also called “liquid”) investments, income taxes become due and payable each year. Tax-free and tax-deferred savings vehicles are often avoided because most of them require long term dedication to saving without easy or painless access to funds.

Even pressures resulting from 2 to 4 percent, a relatively low range for the inflation rate, will take a heavy toll on the future purchasing power of any investment. By placing money in a lower and safe return investment in which after tax returns are then offset by the current inflation rate, the investor has historically finished with less purchasing power than he had at the time the investment was made.

Combine all three considerations above with the fact that America has not been a nation of dedicated long term savers for the past couple of decades and you have a recipe for future financial instability. People will save money for short periods of time only to yield to the temptation to spend. The "saving to spend" syndrome, as it has been called, establishes a hard to break habit which results in current consumption of goods at the expense of long range financial security. Furthermore it is suggested that an individual's investment program should have the strong foundation of a pyramid with riskier investments comprising lesser percentages as risk increases, as shown below.

The Traditional Investment Pyramid

● Arts
Metals, Gems,
<u>Options, Venture Capital</u>

Δ Growth Mutual Funds
<u>Investments in Real Estate Projects</u>

■ Balanced Funds, Conservative Equities
<u>Municipal Bond Funds, Utilities, U.S. Bonds</u>

❖ <u>Life insurance, CD Savings, T-Bills, Money Market</u>

● = Speculative (Very High Risk)
Δ= Growth (Moderate Risk)
■=Secure (Low Risk)
❖=Liquid (Very Low Risk)

The insurance industry today offers interest sensitive products compared with traditional life products of the past. Current plans enable consumers to achieve rates of return on policy cash values which fluctuate with the actual economic environment. In addition, these cash values are allowed to accumulate on a tax-deferred basis. Since life insurance contracts which are guaranteed by insurance companies are considered very safe, the consumer is able to match the returns offered by bank accounts and government securities without the burden of current income taxation. Reduced current taxation on unearned income means a better chance to keep pace with, or even defeat, inflation. This enables the consumer to have greater purchasing power.

This leads to the last discussion point prior to a review of individual products. Achieving an understanding of the future and present value of money is essential for anyone associated with insurance or any financial services related field.

Universal Life

No insurance product has ever had more publicity (both good and bad), discussion and fast market growth (and decline) than has universal life (UL). Never before in the history of the insurance industry had one product caused such analysis, debate and economic impact. Since its market debut in 1979 by a single small insurance company, universal life became the product market share leader among new policies sold in the mid 1980's. Most life insurance companies now offer a universal contract. Industry market studies indicate that from a peak market share of more than 40% in 1985, universal life's popularity has decreased to the 20%-25% range in sales. Many companies that had been initially enthralled with UL began cutting back on its sale as it became viewed by some firms as a severe threat to future profitability.

When it was first introduced, universal life was designed as a low commission (40-50%) contract which promised high volume sales because of its consumer oriented design. As competition increased, so did the commissions offered by insurance companies to attract a sales force. Some product providers cannibalized the concept to such an extent that they began to lose money, forcing them to downplay the marketing and sale of universal life insurance.

It was not until 1984 that the United States Congress redefined life insurance and the universal life policy fully qualified. For that reason, many insurance companies held back from offering a universal type product until 1984 even though the concept had been launched five years earlier. In general, universal life resembles a permanent insurance product that allows the policy owner an opportunity for making flexible (varying) premium payments. Universal life is also known as "Flexible or Adjustable Premium Whole Life".

Confusion does exist as to the precise nature of universal life. Although it is considered by insurance insiders as whole life because it allows for the accumulation of cash value to equal an identified endowment point (age 95), the IRS recognizes UL as term insurance by definition. As we shall see, UL exhibits signs of being both term and permanent. The cost of UL, however, is decidedly based on the term insurance concept.

The most important distinction of universal life from traditional life insurance is the flexible nature of its premium payments compared to the definite fixed amounts required by traditional whole life. As long as the policy owner pays enough premium to take care of all policy cost, the UL contract will not lapse. To the extent more premium is paid than is necessary for cost, excess money goes to the policy account where it earns a fluctuating (interest sensitive) rate of return. The maximum premium which can be paid is dictated by current IRS insurance definitions. If the policy owner chooses to skip normal premium payments, the insurance company simply deducts required charges from the existing funds in the policy account.

Another major difference between whole life and UL is that the UL policy account is the insured's money, while the cash value of whole life belongs to the insurance company until the insured's death, endowment of the policy or cash surrender occurs. This means the UL policyholder may access cash values by simply requesting the money and no interest will be assessed by the company on any funds which are withdrawn, or partially surrendered. Furthermore, the charges inherent within the UL policy are supposed to be "transparent" while whole life "bundles" the cost with conservatively projected returns. Again, the original intent of UL was for anyone to plainly see where every penny of premium dollar went**.** However, the actually marketing evolution of UL by many companies has resulting in far greater cost bundling than was originally intended.

Policy Cost and Charges

Current Mortality Charges. Mortality tables are used to determine the rate at which people, in a given population, will die. According to the 1980 CSO (Commissioner's Standard Ordinary) mortality table everyone, for insurance purposes, is dead at age 100 for traditional Whole Life purposes and at age 95 for universal life. Tables have been updated historically about every 20 years since 1940 and the trend has always been toward lower and lower insurance rates due to the increasing longevity among Americans. Beginning on January 1, 2009 the 2001 CSO Mortality table went into mandatory use and it pegs the permanent life insurance endowment point at age 120, the greatest increase in life span ever recorded. This significantly reduces the cost of life insurance at all ages but especially for those who are young and healthy.

Mortality rates are subject to change but they are usually guaranteed on the basis of the current CSO mortality table, which is very conservative. Companies charge for mortality according to "current" mortality a factor (as recent as within the last year) which is far less expensive than guaranteed costs as established in the mortality table. Although mortality is the main basis of cost for UL contracts, there are other factors as well.

A company charges on a current cost basis to be competitive but, like most term insurance contracts, a table of maximum guaranteed cost is placed in the UL contract. A table of maximum guaranteed cost enables an insurance company to market term insurance at competitive current rates while allowing for the possibility of substantial increase (to a stated maximum amount as defined in the table) should the need arise due to rapidly increased mortality rates.

Load Variables (and other charges). Universal life is supposedly transparent, meaning a policyholder can view the internal cost workings of the policy itself. Illustrations of universal life can demonstrate the interaction of cost per thousand, premium, premium taxes, monthly charges, loads, surrender charges, rider cost and policy values. Therefore, this transparency results is the separation of cash value from charges for insurance amounts and policy administration.

A closer look at charges reveals that universal life policies are "loaded" either at the front end, back end or at both ends. A **front end load** places a charge at the beginning of the contract. The main disadvantage of a front end load is the reduced amount flowing into the cash value at the start. Such front end loads can be based on actual amount of premium paid (most common), the face amount of coverage or a fixed one time fee (uncommon).

A back end load has the disadvantage of assessing a charge which exceeds actual expenses. A back end load is deducted when a contract is terminated in the earlier policy years, usually the first through tenth and sometimes, fifteenth years. **A back end load is also referred to as a surrender charge**. Another common load procedure is to assess a **fixed percentage charge** (7.5% is currently used by many companies) against all new premium paid. Such loads are sometimes buried in mortality charges instead of being separately identified).

Any monthly administrative or ongoing charges are also deducted from cash values. Deductions for riders (if any) are added to the cost of premium before any interest earnings are credited. A state premium tax may be applied on premium deposited with an insurance company. The rate varies from state to state but is generally from two to four percent. Some states do not assess such a tax, but this is becoming rarer.

Interest Factors. The amount that survives deduction is placed in the policy account (cash value) and it is credited with an interest payment based on a specified rate of return. This rate of return fluctuates according to market conditions but is normally guaranteed for at least one quarter of a year (some companies fix the return for a full year). This is why universal life is classified as an interest sensitive insurance product. As general economic rates decline, an interest sensitive product can become less attractive to own than traditional whole life products because of the UL contract's potential for increased mortality cost. However, an interest sensitive product can be an excellent hedge against increasing inflationary pressures since its yield may reflect the economic environment much more accurately than will the fixed internal rate of traditional whole life.

<u>IRS Guidelines</u>

Without going into great detail regarding tax treatment, be aware that the interest payments credited to the cash value in a universal life policy are not immediately taxed. The interest credits accumulate with the cash values on a tax deferred basis. To prevent people from having too much of a good thing, the IRS placed certain restrictions, or "guidelines" as the government refers to them, on just how much premium can be placed in a universal policy relative to the amount of life insurance in force. The death benefit, expressed as a percentage of the policy account, must maintain a certain distance or **"corridor" (known as the IRS "risk corridor test")** of protection. A table of corridor percentages based on age is shown below. When the policy account reaches a certain percentage, the death benefit must be increased in a manner that provides the required amount at risk.

1980 CSO TABLE IRS RISK CORRIDOR

FOR LIFE POLICIES SOLD AFTER 12/31/1984

Age of Insured	Required Ratio Of Insurance To Policy Account
40 and under	250%
45	215%
50	185%
55	150%
60	130%
65	120%
70	115%
75-90	105%
95*	**100%**

* Age 95 represents the endowment point of universal life, or the age at which cash value equals the death benefit. The death benefit is paid to the policy owner if the insured is still alive at age 95.

Another test is called the "cash value accumulation test". This means that the cash surrender value **can not exceed a required net single premium** for basically the same type of insurance being offered. The addition of the **"modified endowment contract"** (7-Pay Life) change in the tax law in 1988 also applies. To be qualified as life insurance under the 1984 IRS code, the universal contract must meet either of the two tests described.

Without these IRS restrictions, consumers could purchase a policy that minimizes insurance protection while maximizing tax deferred cash value accumulation. This would lead to a situation tantamount to savings accounts with tax free accumulation periods. With the risk corridor, the IRS sets forth the minimum life insurance purchase required at specified ages for maximum cash deposit (premiums) amounts. Even with these restrictions, as we will see later, the opportunity for solid cash accumulation is very competitive compared to long term conservative investments that are not allowed tax deferred treatment.

Death Benefit Options A and B

Typically offered in the universal contract, it is a choice of two patterns of death benefit. **Option A is a level death benefit while option B is a level net amount at risk.** Under option A, the risk corridor test is applied to make certain the cash value in the policy account is not exceeding the required ratio when applied against the level death benefit. Option A (or option 1 as it is called in some contracts, depending upon insurer) is similar to the manner in which a traditional whole life policy works. The death benefit stays the same as the cash value grows annually and eventually endows and the death benefit is paid. The net amount at risk to the insurer actually decreases each year as cash value amount increases.

Option B (or option 2, again depending upon the insurance company) provides a death benefit equal to the face amount purchased plus the value of the policy account. Option B is sometimes called, technically incorrectly, an increasing death benefit. However, since the original insurance amount purchased is paid PLUS the existing cash value, the amount at risk to the insurance company is LEVEL, not increasing.

The choice of death benefit option is the policyholder's. Keep in mind that under option B, the mortality charges are assessed to reflect the increases in cash value at all times, and therefore premium is higher for this option. The insured is always paying for the death benefit that is in effect at any given time.

Special Features of Universal Life

Characteristics common to universal life are its flexible premium payment, a withdrawal feature and treatment of policy loans. Prior to the 1970's and a product called "Adjustable Life", all premiums were rigidly structured. The company told the insured the exact amount that had to be paid to keep the policy in force according to the contract. Universal Life is different. It allows the insured to decide both how much, and when, payment will be made. This type of freedom is both a blessing and a curse. If there is a major disadvantage to universal life it may well be caused by the ability to pay on this flexible premium basis.

Because of flexible payment, a major criticism of the UL contract is that it may be more prone to lapse than is the case with traditional whole life products because an insured does not have to make payments when they on a rigid schedule. In the early years of offering universal life contracts, insurance companies found a relatively high lapse ratio after the fourth and fifth years of policy ownership.

To combat this problem of lapse, companies recommend a regular monthly payment be taken directly from the checking account of the insured (at the authorization of the insured, of course). Another technique to lower the lapse rate is to establish a planned or target premium. The policy owner sets the amount he or she wishes to pay and the company sends a bill as a regular reminder.

The withdrawal feature of universal life was an interesting innovation. It allows the policyholder easy, fast and convenient access to funds in the policy account for a small transaction fee. This is not considered a policy loan and therefore no interest charge is made against the amount withdrawn. The normal limitation on withdrawal: a policyholder should never withdraw an amount that exceeds the amount actually deposited (without considering any interest added to the total amount in the cash value). If a policyholder wishes to remove an amount greater than the total premiums actually deposited in the policy, a policy loan should be made. Otherwise income taxes are owed on any excess amount removed. The FIFO, or first in-first out, accounting principal is applied by the IRS for removal of cash value from the policy account of universal life.

<u>For Example:</u>

Assume Bob has paid $1,000 per year in his UL policy for ten years and his cash value now equals $15,000 (premiums paid MINUS mortality cost, fees and all other deductions PLUS interest earned).

Bob has paid in $10,000 and can withdraw up to this amount without any income taxation. However, if Bob wishes to retrieve more than $10,000 he will be taking interest which will be subject to income taxes, unless he elects to "borrow" the amount rather than "withdraw" it.

Even the policy loan provision of most Universal contracts is different than traditional policies. In the past, companies established a contractual rate of interest in the event the policyholder wished to borrow cash value from the policy. This changed in the early 1980's to a floating rate to reflect current market conditions, not to exceed some maximum percentage. Many companies offering a universal life contract set a fixed policy loan rate on borrowed amounts that is offset, to a certain extent, by a rate of interest that is <u>credited to the money which has actually been removed.</u>

This "ghost account", as some have called it, reduces the effective rate of interest owed on money borrowed. This effective rate can range from 0% to 5%, but the norm is two or three percent. What is the reason for charging any interest at all? It enables the policyholder to utilize cash values in excess of the FIFO amount without being liable for income taxes. Which would you rather pay: two or three percent to an insurance company or 15% -38% to your Uncle Sam (plus more to your state government)? Since the UL contract owner is actually borrowing their own money, the requirement of a small loan interest rate avoids the imposition of income taxes when the cost base has been exceeded.

Variable Life

Variable life, first introduced in the United states in 1976, is considered a permanent plan of life insurance and a fixed premium is payable. It is very different from traditional life insurance because it's product design is to base death benefits and/or cash values on a variable basis tied to a separate investment pool of assets. Since variable life's performance is associated with equity markets, it is considered somewhat risky and it can only be sold by agents registered with the National Association of Securities Dealers (NASD), SERIES 6 level, or higher. Financial planning experts agree in their caution to purchase a variable life contract only in addition to meeting the normal death benefit need through other traditional sources of product (whole life, UL, term, etc.).

Variable life is approved in all states for sale, but it's growth has been slow. Even today it has limited market share and that share has increased in bull markets and decreased when the bears come out to play. It may someday capture a major share as consumers become more educated about financial matters. In general, the product offers the potential to out-perform inflation in the long run because of its relationship to the stock market. Stocks have traditionally been a strong hedge against inflation, but short term fluctuations can be disruptive or upsetting to the unsophisticated investor (for example September of 1987 and more recently the 2001 tech stock collapse).

To remove this short term susceptibility, variable products have expanded the number and types of accounts available for investment. In addition to stock accounts, and depending upon the product, the policyholder can direct funds into money markets, high growth stock funds, guaranteed accounts, global funds, balanced accounts and bond funds.

A second version of variable life called **variable universal life** combines some of the investment opportunities of variable life with the flexible premium payment aspects of universal life. It also is an interest sensitive product and is the same as variable life except for this flexible ability to pay premiums. On the other hand, straight variable life requires a fixed premium be paid on a regular basis.

The death benefit itself, under a typical variable contract, consists of two parts. There is a guaranteed death benefit which directly relates to the basic plan of life insurance stated in the contract. The second aspect of the death benefit is variable. Payment of the fixed premium assures full payment of the face amount regardless of policy account performance. If the underlying investments in the policy account perform well, then an additional death benefit is added to the original face amount purchase. As once lofty returns diminish, so to will any extra death benefits. However, the minimum death benefit will not fall below the original face amount purchased.

Loading Factors

Although transparent to some extent, cost is not as unbundled here as it is in a universal contract. In addition to mortality charges, there are deductions for state premium taxes, any riders selected and the usual administrative fees. One cost unique to variable life is an asset management charge based on the securities portfolio. Details of asset management charges are disclosed in the prospectus which must be provided to all prospects for variable life. The maximum sales load, with some exceptions, for variable life is 9% during the first 20 years of premium payment.

Interest Factors

Unlike traditional life and universal products, there is no cash value guarantee under a variable life contract. The actual cash value of variable policies will fluctuate daily, based on the market performance of underlying securities. If the policy has a guaranteed conservative account available under the contract, the cash value or a specifically directed percentage may be guaranteed.

The overall return paid will be dependent upon cash amounts invested in various available accounts and the investment income they produce. Normally, companies allow a policyholder to switch cash amounts form one fund to another and a fee may be assessed. If all the invested funds are in security type accounts, there is no guarantee of cash value. If more conservative accounts are chosen for placement of policy cash value, there will be little or no risk to capital. As discussed earlier, the concept of risk and return plays a key role in this contract. The placement of cash value into riskier accounts correspondingly increases the chance for gain or loss.

Since a negative return could conceivably eliminate all accumulated cash values within a policy, there are no cash value guarantees. Investment risk is placed solely upon the consumer in Variable contracts. In the event all cash value is wiped out, the company would require the policyholder to pay additional premium to keep the policy in force beyond the original premium payment period. For this reason, a variable contract is not like any other insurance contract. All forms of traditional Whole Life insurance offer fixed and guaranteed premiums.

Comparison: Universal and Variable Life

The most obvious difference between these two contracts is that UL policy accounts earn a rate of return carrying some minimum guaranteed amount (commonly 4.5 to 5.5%), while Variable contracts place all investment risk on the policyowner. Variable contracts normally offer investment refuge within a guaranteed account for the timid, but the returns are the same as they would be in a UL product. Anything invested outside of this guaranteed account is placed in a **"separate account"** where anything can happen and all money could be forever lost.

Since the long term UL policy account is intended to accumulate safely and somewhat predictably, opportunities for exciting profitability are unavailable. The main concern of UL is to provide a death benefit as expected, when it is needed. The variable contract owner is more interested in investment returns on cash values which will (hopefully) far exceed the rate of inflation. Death benefit, although a consideration, takes a backseat to long term profitability. Variable life owners are supposed to understand the nature of the risk involved.

The other central distinction is, of course, focused on premium payment schedules. **UL** allows enormous flexibility while variable life requires annual and fixed payments. In UL, both the amount and frequency of premiums can be altered based on individual preference. Variable contracts can lapse without the timely payment of premiums.

Which is the Best Choice? All these alternatives bear strengths and weaknesses relative to individual preferences. If you know your main weakness is disciplined saving, then selecting a program with flexible premium may not be the best decision. On the other hand, if a consumer is willing to risk losing principal in exchange for an exciting return, then a variable contract could be the answer. The consumer's best chance for proper selection is based on knowing his or her own investment preferences and tolerance levels for risk versus return. Another factor is the financial advisor the consumer has elected to retain. Obviously, the insurance agent licensed to sell securities products is allowed to serve both the insurance and investment needs of clientele.

Interest Sensitive Whole Life

Interest Sensitive Whole Life behaves **exactly like a traditional whole life contract (review earlier part in this section for WL details) except that the rate of return paid on cash values can fluctuate with fixed market conditions. This fluctuation is not available on all other whole life products.** This will mean ISWL will provide a higher yield during increased interest rate markets than will traditional whole life contract.

Guaranteed Product

Interest Sensitive Whole Life (ISWL) is designed to provide a **guaranteed and level** premium **cost** structure while also offering a **fluctuating rate of return** on guaranteed additions to accumulating cash values within the policy. **A fixed and guaranteed premium is required each and every year.** Like traditional whole life, ISWL has a cash value account which is owned by the insurance company until cash surrender, endowment or death. Therefore, any money removed through policy loans is assessed a rate of interest which matches current economic conditions.

The underlying premium cost is competitively based on the current mortality charges assessed for permanent, or whole life, insurance contracts. This **cost is guaranteed once a contract is issued.** Policyholders may also benefit in the future if mortality rates continue to improve but such a condition is by no means a certainty.

Cash Value Accumulation

Since **ISWL is a bundled product,** the consumer is unable to separate policy charges from returns. The ISWL contract adds a portion of regular periodic premium payments to guaranteed cash values. Although access to cash value is limited to policy loan procedures and interest charges, **liquidity is swift.**

The purchaser of an ISWL contract is looking for the certainty of **fixed mortality cost** and is willing to pay the required higher "up-front" charges. Since cost is fixed over the life of the contract, the policyholder is **paying more for death benefit in the early policy years** for the privilege of receiving a price break in old age (as the cash value nears the endowment point).

The surrender penalties are very steep in the early years of the contract because of the manner in which the expenses are incurred. Since commissions are relatively high in year one, no actual cash value is likely to exist. However, companies utilizing the back end load technique may pay interest on a fictional cash value fund. As long as the policyholder pays on time for the first 10 or 20 years, all surrender charges would vanish in the event surrender is requested.

Comparison with Universal Life

The main consideration in making the determination of whether to buy UL or ISWL hinges on flexibility versus guarantees. The freewheeling UL contract places considerable burden on the insurance agent to provide constant service while the policyowner must be more interactive in understanding the contract and its finer points. UL requires the owner to make many different policy ownership decisions.

Since the underlying **mortality charge in** the **UL** contract **is** one of **"current cost term",** the death benefit cost will likely increase each year with age. The contract will indicate the highest possible charge for mortality (in the table of guaranteed cost), prices generally double or triple "current" cost. If the policyowner grows older and careless when it comes to increasing premium payment amounts, he can be in for an unpleasant surprise and have no coverage.

Perhaps no decision is as complex as the one to decide the initial and subsequent premium payment amounts. **On the low end, the owner is required to pay only the current cost** for mortality on a yearly term basis plus any other policy expenses. Under this scenario there will be little or no cash value accumulation.

The **other extreme would be to pay a single premium** such that the entire contract was fully paid. This possibility allows for an initial maximum cash value which in turns earns a competitive rate of return. The earned interest would be ample to pay all present and future policy and insurance costs while allowing continued policy account growth. Between these two options, any amount is fair game and within the definition of insurance as determined by the Internal Revenue Service.

Beyond the decision of establishing premium is the further option of skipping and/or altering subsequent premium payment amounts. The insurance company strives to solve this dilemma by suggesting **the target premium.** This target sees to it that all costs are paid while cash values accumulate on a schedule assuring endowment by age 95.

On the other hand, an ISWL purchase carries with it a required and fixed annual premium payment, thus relieving the consumer of the obligation to decide. If you do not pay exactly what is owed within the grace period, your policy will lapse and fundamental contractual rights may be forever lost. Premium payments under the ISWL contract are comparable to traditional whole life in this regard of fixing and guaranteeing premium.

When it comes to **retrieving cash values, UL and ISWL are fundamental opposites.** The UL policyowner pays for all policy costs as they actually become due, therefore all money in the policy account is over and above policy cost. This means **the policyowner owns the cash value in the UL contract**.

Under an ISWL contract, the insurance company owns all cash values. If the policyowner wishes to use the funds, he must borrow at competitive rates of interest. At death, endowment or cash surrender, the contract concludes and the policyowner then takes possession of all existing cash value (or face amount).

In answering the fundamental question of **which plan should an individual choose,** it must first be decided **which aspects are more appealing to the particular consumer involved: flexibility of premium payment and easy access to cash value or fixed guaranteed price?** UL will be more popular for people craving flexibility while ISWL is the more comfortable choice for individuals who like to know that price always stays the same.

<u>Equity Index Life Insurance</u>

The most recent addition to the life insurance industry products portfolio was the introduction of an equity index life insurance product concept within the past decade (shortly after 2000). **The equity index policy takes the concept of charging an insured a cost of insurance amount each month and then crediting a return, either monthly or annually, based on a pre-selected equity index or indices combination rate of return.** ***The most fetching feature of this product type is that any gains credited to a policy account are protected in the future against any loss suffered in a selected index.***

This means that in year during which the selected equity index performs well, significant returns can be added to the policy account value while in poor performance and loss years the policy values do not suffer any loss. For example the selected index may increase cash value by 15% in Year 1 and then in Year 2, even if the market upon which the index was based crashes, the worst the policyholder can expect is a 0% return. In this manner the gains from Year 1 are protected in the policy account value.

This Equity Index life policy is essentially a hybrid product placed between the fixed and limited gain potential of the Universal Life and the non-guaranteed and great risk of loss potential of the Variable Life concept. Currently, a securities license is not required to market Equity Index life but the Securities and Exchange Commission is likely to keep trying to reverse this until all appeals would be exhausted in the US Supreme Court. Insurance industry representatives argue against federal licensing intervention based on the fact that the consumer never has any policy values at risk for loss.

Another appeal of the equity index life insurance product choice for mortgage protection is that if the insured lives to repay the mortgage loan then the tax-deferred accumulated policy values of the Equity Index policy, which may be substantial, can be used to supplement future retirement income. This “dual” use for life insurance protects the real estate ownership of the insured due to premature death while the mortgage loan is being paid and is simultaneously allowing the insured to build a tidy pile of money without income taxation for later use. This method combines income protection with “forced” savings. The insured enjoys the ability to deduct mortgage interest cost on his tax return while building his policy account on a tax favored basis. This one-two punch can create financial stability for an entire lifetime if the insured maintains premium payment discipline.

Time Value of Money

As a final concept to life insurance contract purchase, selecting the correct amount of coverage in the present becomes useless in the future if the iron clad law of changing values of money over time is ignored. The discussion that follows should demonstrate to you how crucially important this idea is to the financial well-being of every consumer as each day is crossed from the calendar.

The concepts inherent to understanding investment fundamentals based on maintaining purchasing power over time are often made to appear much more difficult than necessary. There is nothing mystical about mathematics or time and both underlie future and present value ideas. Future and present value is little more than the actual **value of an amount at specified points in time:** either looking ahead to a designated point in time to see **how much is needed at some distant point (future value)**; or taking **the real value of an amount known today** (**present value**).

A familiar example of these concepts is the use of an annuity in paying the winner of any state's lottery. When a Lotto winner hits a 1 million dollar payoff, does he really win a million dollars? Yes, eventually. For instance, some states pay such a prize over 20 years at $50,000 per year. However, in waiting so long to collect the prize in small pieces, the value of that money diminishes because of inflation (we won't even mention the income taxes that are paid along the way). As a matter of fact, the State buys the $1,000,000 payoff over 20 years for approximately $425,000 today. The state purchases an annuity from an insurance company and names the winner as the annuitant.

Bear in mind that given the existence of inflation, or increases in cost over time, one dollar today will not be worth one dollar tomorrow (refer to the "Consumer Price Index" in the table that follows for the impact of inflation on the value of a U.S. dollar since 1967). By the 1990's it takes nearly $4.00 to purchase the same goods that $1.00 could purchase in the late 1960's. In this sense $1 was worth $1 in the late sixties (its present value at that time); but in terms of the 1990's, it would be worth 25 cents (its future value relative to the late 60's).

Discounting is the process by which the present value of a dollar is payable at a future specified time. Again, the notion that **today's dollar is worth more than the dollar of tomorrow.** Consider the relationship between preservation of capital, inflation, and taxation of income. Earning returns that keep pace with inflation, let alone result in actual growth, becomes a formidable task.

CONSUMER PRICE INDEX*

PURCHASING POWER OF ONE DOLLAR 1967-2008

YEAR	INDEX	VERSUS 1967
1967	100	$ 1.00
1970	116	$ 0.86
1975	161	$ 0.62
1980	246	$ 0.41
1990	386	$ 0.26
1995	449	$ 0.23
2000	513	$ 0.19
2008	623	$ 0.16

* By late 1996 U.S. the government decided to shift away from using the Consumer Price Index to measure inflation. It was felt it no longer appropriately reflected “true” inflation percentages.

In 1967 the United States government decided to measure the change in the price of selected goods and services and compare them from year to year. This “urban” purchasing pattern became the statistical measurement for the U.S. economy inflation rate.

The effect of inflation on the purchase of life insurance is a fundamental relationship. Even if a policyholder's needs do not change over time, more insurance coverage becomes necessary simply because of the erosion of purchasing power due to increasing costs**. Applying the values shown in The Consumer Price Index of 1967 indicates that a $100,000 face amount of life insurance purchased in 1967 has the purchasing power in 2008 of only $16,000**! This means that coverage purchased in the past can no longer do the job it was intended to do in the present, if financial needs are the same or greater than when the insurance was originally purchased. Yet there are great numbers of insureds who purchase life insurance and rarely update face amount. **This failure to update coverage periodically is the main reason studies show that the vast majority of Americans do not own adequate amounts of life insurance.**

Refer again to the lottery example given earlier. The first $50,000 installment, after 33% taxes, has the purchasing power of $33,500. Although no recipient of such a quick and unearned sum would likely complain, this same amount will be paid annually for 19 more years. However, the purchasing power of this $33,500 will decline each and every year if the economy experiences inflation. For example, an inflation rate of 5% each year would mean that the 20th, or final installment, will have the after tax purchasing power of less than $ 12,000 in present (today) value. Without dedicated and planned investment, the lottery winner could find himself in dire economic straits despite this original good fortune.

Since most Americans will not win a lottery prize, saving for the future is even more difficult because of lack of capital. Whatever capital is invested must earn an after tax rate of return which will retain current purchasing power levels. Given the previous statement, systematically paying down the principal on a long term mortgage to reduce the years required to pay, and therefore lowering significantly the interest that would otherwise be paid to the lender, is an excellent tax free way to increase future capital by reducing this scheduled debt. The Consumer Price Index of 1967 indicates that in order for the 1967 investor to retain purchasing power, he had to invest $1 so that in 1990 it was worth $3.86 after all income taxes were paid!

The average rate of return after taxes for fixed and conservative investment (i.e. T-Bills and bank CD's) for this period shows that only $2.73 would have been available before income taxes were paid! This means the typical investor would have fared better spending all their money in 1967 when it was worth the most in terms of its ability to purchase goods and services.

What if the 1967 investor placed this money in tax deferred devices, such as an annuity or mortgage reduction? A substantial level of purchasing power would have been retained. Where do many Americans still place their money for investment? A large percentage of it goes into the very devices which are conservative in nature and currently income taxable. Many trillions of dollars are currently invested in bank certificate of deposits and passbook savings accounts.

The reasons investors place money in areas where they will be economically harmed over the long run is sad but predictable. Americans do not seem fond even limited risk or taking the time to investigate and learn about investment alternatives for their hard earned dollars.

It is human nature to avoid the unknown in favor of predictability even when the predictable carries with it known disadvantages. Doing what is easy is preferred to doing what is right. Is it any wonder with today's fast paced economic conditions, the vast array of investment opportunities and tax reform, that the average American would be confused and just play it safely: put the money in the bank, get low returns and pay taxes on the income? By reducing mortgage debt and eliminating years of payments, Americans can safely increase their wealth through advancing home equity buildup and enjoy a great tax free return in the process.

Chapter 6 : The Life Insurance Contract

(6 exam questions)

Introduction to Contract and Contract Formation

The application of state statutes, insurance regulations and generally held contract law directly impacts on the insurance contract. Legal principles relating to contract law in general and how they specifically relate to the life insurance contract need to be understood. It is of critical importance for the insurance professional to appreciate these applications and how they apply specifically to the life insurance contract.

Offer and Acceptance

One of the essential elements for contract formation is **"mutual assent."** Since a court cannot presume to know the actual state of mind of the parties to a contract, the words and actions of the contracting parties will be the controlling factor in any interpretation. Mutual assent is evidenced by one party making an offer and another party accepting the offer. The person who makes the offer is called the "offeror" while the person to whom the offer made is the "offeree." **An "offer" is simply a proposal which creates a binding contract if accepted.**

Before contract formation there must be intent by the parties to enter into a contract. An applicant for insurance is merely inviting an offer of coverage from an insurance company when the applicant does not pay a first premium but does select a policy, completes the application, determines a method of premium payment and designates a beneficiary. Such an invitation itself is pointless, for example, if an applicant does not have insurable interest with reference to the proposed insured.

When insurability of the applicant exists and a policy is issued, **the company is making an offer when the policy is issued for delivery by the agent** "during the lifetime and continued insurability" of the proposed insured. The offeror (insurance company) owns the privilege of withdrawing the offer at anytime before the offer has been accepted by the offeree. **Once an offer is accepted, it cannot be withdrawn.** If an offeree rejects the original offer outright, the offer terminates. In any contractual situation it is common for the offeree to perhaps suggest a counteroffer. **A counteroffer to an original offer immediately terminates the original offer.**

At the offer and acceptance phase of insurance contract formation, signatures of the parties are necessary for a contract to be binding. The signature of the applicant must be personal unless the applicant specifically directs somebody else to sign on their behalf and the insurance agent knows of this signature designation. **When an insurance company receives an application for insurance, it is duty bound to act on that application within a reasonable time frame.** When there is delay in acting on an application, there may be contractual liability to the company.

For example, if a doctor causes a delay in returning an Attending Physician's Statement is a company bound to coverage? The **majority view** in the United States is inaction or silence on the part of insurance company does not automatically constitute the acceptance of an applicant's offer for insurance. Some minority rulings extend this to mean such delay is an inference to the applicant of rejection and to act accordingly. Several other jurisdictions hold that when a company retains the money it is inconsistent with rejection. Other jurisdictions extend this idea by saying **"reasonable promptness" is expected** and failure to reject an applicant within a reasonable time implies acceptance. This example in the diversity of jurisdictional interpretations serves to illustrate the same set of facts can lead to coverage or no coverage depending upon which state is involved. In the final analysis the life insurance company has a duty to act on an application with reasonable speed and there is usually a possibility for civil or tort liability when a company moves too slowly.

Initial Consideration and Receipts

The manner in which an insurance company receives the premium can vary. The "**conditional receipt" says insurance takes effect** on a date which is before the delivery of a policy. It is stipulated within the receipt that the application will be approved if the applicant is deemed to be an insurable risk on the date the application was signed. **The "approval receipt" says that insurance is effective immediately on the condition the application is subsequently approved** (makes the insurance effective on the date the applicant is found to be an acceptable risk for the plan, an amount and a premium rate indicated). No insurance is effective, under the terms of an approval receipt, until the insured is found to be insurable. Insurability based conditional receipts are the most frequently used receipts. Another type of receipt is the **"binder"** which establishes coverage on the date of receipt subject to the right of the company to terminate coverage if the proposed insured is not found to be insurable.

Events which decide whether or not a life insurance company is bound to a promise are predicated on many conditions. The **"condition precedent"** of a conditional receipt means a condition must happen or be performed before the life insurance company is obligated to perform a promise. When a conditional receipt creates a condition precedent then the applicant for insurance must be found to be insurable and the application has to be approved before coverage is provided. A majority of insurance contracts fall into this condition.

On the other hand, **a "condition subsequent"** states that the rights already vested or established are taken away. In a binding receipt, insurance is effective immediately but if the applicant is found uninsurable, policy termination can result and the application is not approved. Because binding receipts can make insurance coverage effective immediately upon paying the first premium, they have not created as many legal problems as have conditional receipts. **There has been a recent tendency of courts to treat conditional receipts as binding receipts.** The overall concern in the selection process centers on the idea that life insurance risks must be undertaken with deliberate and great care. Since insurance companies do not usually have the right to cancel a policy, avoiding adverse selection (great numbers of insureds who are poor risks) demands people being offered policies must meet some standard of insurability.

At the conclusion of completing the application, it is customary for the initial (first) premium to be paid. **Initial payment is necessary before coverage can go into effect.** It is the responsibility of the agent to issue a receipt to the applicant upon receiving initial premium. ***There are three possible application and/or receipt scenarios***:

• **The Effect of the Application with Money** - It is common practice in the insurance industry to take an initial payment at the time of application. The key question when money is taken with an application is: **"When does coverage begin?"** Since policy issuance is strictly within the control of an insurance company, the most generic answer is **"When the company says so!"**

The receipt most commonly issued in this circumstance is called a ***"Conditional Receipt".*** ***This means if the applicant has complied with all that was requested of him and has not supplied any material misrepresentations, then coverage may become effective at the point the application is signed and the initial premium tendered, as long as he is at least an acceptable standard risk to the carrier and no additional limitations or qualifications are placed on his policy offer***. A contract will have been formed in this instance.

• Unconditional **Receipt ("Binder")** - this is a much **stronger receipt and indication that coverage goes into effect immediately.** The practice of issuing binders is not common among life companies, but many courts favor interpreting conditional receipts as binders in disputes brought before it as to when coverage actually begins.

• **The Effect of the Application Without Money** - When **no initial payment is made at the time of application,** there can be no insurance coverage at that point. Coverage only goes into **effect when the policy is then**

◆ **Delivered AND**
◆ **The first premium payment is made AND**
◆ **The applicant has signed a statement** attesting to the fact that **their health has not changed** since the time at which the original application was completed.

► The **MAIN CONCEPT**: since **no money was taken** with an application, both elements of initial consideration (signed statements in the application and the first premium) are not present, therefore **no contract yet exists.**

Risk Classification

Risk classification allows the insurance company to identify people who have the potential for similar loss to be placed in the same risk group for the purpose of setting the rate of premiums to be paid. Common underwriting considerations such as health condition, occupation, age, sex, hobbies, etc., are used in the risk classification process. The selection of risk means the insurance company makes choices from between proposed insureds and decides upon the individuals it is willing to insure.

Selection of risk is done by underwriters at an insurance company's home office. An **agent** who solicits business **does not have the authority to determine** the **insurability** of the proposed insured. The company reserves for itself this crucial right to select risk because the policy cannot ordinarily be canceled by an insurance company and, therefore, risks must be selected with great care. Risk classification involves discrimination in the literal sense of the word. Younger people are charged less premium than older people, healthy people pay premiums which are lower than sickly people, people working in more hazardous occupations pay more than those employed safer occupations and, since women live longer than men, females generally pay less for life insurance but more for annuities.

The main ingredient in determining whether or not a policy will be offered is the health condition of the proposed insured. Questions eliciting information from the purposed insured about cancer, hypertension, diabetes, heart disease, strokes and family health history are crucial to the underwriting decision. **The insurance company can send an Attending Physician's Statement to the proposed insured's doctor, solicit hospital records, send the proposed insured through physical exams, perform blood and urine tests or even undergo electrocardiograms.**

Tobacco use has a dramatic impact on the premium charged by an insurance company. Actuarial studies indicate cigarette smoking dramatically increases the risk of early death by as much as eight years or more for young people who smoke two packs of cigarettes a day. For many years insurance companies have been offering nonsmoker premium discounts for people who have not smoked for some period of time, usually one year or longer. Since the nonsmoker discount gives a lower premium, many insurance companies test urine for by-products of smoking, such as measuring nicotine, in addition to asking about smoking on the application.

An interesting issue arises when an applicant for life insurance represents the fact that they are not a smoker on an application when in fact they do smoke. **Is this a material misrepresentation such that it would allow an insurance company to rescind (void) the policy?** One leading case has found that misrepresenting smoker status is indeed a material misrepresentation of fact which will allow an insurance company to rescind coverage. If the smoker's systematically and routinely receive nonsmoker rates, the main party hurt will be the nonsmoker who will have to subsidize the premium rates of smokers by paying higher costs in the future.

If issued by an insurance company, a policy can have premium cost based on:

● "**Standard Issue "** means a policy is issued at normal rates for the applicant's attained age and without any restrictions.

● "**Preferred-Risk"** means having a mortality experience which is expected to be lower than average. The company will offer a cost which is lower than the standard charge. Eligibility is usually based on the fact the applicant is in excellent health and does not smoke or use tobacco products.

● **"Substandard Risk"** means the applicant will be charged an additional premium (a surcharge over the standard issue rate) because he is in a higher risk category (can be based on health and/or occupational factors)

● **"Uninsurable" -** is the label given to people who are such poor risks that they can not obtain any coverage at any cost. Normally individuals considered uninsurable are terminally ill.

Role of the Underwriter

Insurance companies risk billions of dollars in loss potential each year by issuing various contracts of life insurance across a broad spectrum of society. Underwriters appraise and select the risks their company will insure based on guidelines for acceptance established by the insurance company. An insurance company will not be competitive if the underwriter appraises risks too conservatively and, on the other hand, a company will pay more claims if the underwriting guidelines are too liberal.

Basically. underwriters decide whether an applicant for insurance is an acceptable risk and this can put him at natural odds with the insurance agent in the field. The agent tries hard to get as many people as possible to apply for coverage while the underwriter acts like a bouncer at the club door deciding who should or should not be allowed entrace.

The underwriter will analyze information in insurance applications, reports from loss control consultants, medical reports and actuarial studies and reports describing the probability of loss from the insured. They then decide not only whether to issue a policy, they are sometimes responsible for outlining the terms of the contract, including the amount of the premium. Underwriters spend much time writing to and speaking with policyholders, agents, and managers about policy cancellations or other matters. Once in a while they may even accompany a sales person on appointments with prospective customers.

Most underwriters specialize in only one of three insurance types: life, property and casualty, or health. They further specialize in group or individual policies. Property and casualty underwriters then further develop skills in even more focused areas such as fire, homeowner, automobile, marine, property, or workers' compensation

An increasing number of insurance sales are being made through group contracts. A standard group policy insures all persons in a specified group through a single contract at uniform premium rates, generally for life or health insurance protection. The group underwriter reviews the overall composition of the group and evaluates the total risk. Another type of group policy provides members of a specific with individually tailored products that accommodate their needs.

Key Underwriting Factors

There are many factors that go into assessing the risk a proposed insured poses to an insurance company but age and health are the primary concerns in underwriting. Each company decides on standards and requirements and therefore the market in which they select operation. Most requirements are very similar between companies. They rely on:

● **Medical Information Bureau (MIB):** The MIB is a central database supported by member insurance companies through which information about previous insurance applications are stored and checked against current application information. Because of the MIB it is essential that applicants for insurance tell the truth, the whole truth and nothing but the truth. Inconsistent statements of material information can lead to rejection of an application.

● **Attending Physician Statement (APS) : Among the most common third party sources used is the APS, perhaps second only to the MIB**. (A party other than the applicant or insurance company is called a third party source). The insurance company sends a short list of questions regarding the personal physician's opinion about the health of the applicant, his patient. The doctor is paid for taking a few moment to check his file, answer the questions and sign the form before returning it. The insurer would be reluctant to issue a policy with favorable rates if the applicant's own doctor is not very positive regarding insurability.

● **Financial and the use of credit reports**: The insured must have the ability to pay the premium. Policy Lapse costs insurance companies considerable amounts of money. Insurance companies can check the credit reports of the applicant. The **Fair Credit Reporting Act** is federal **regulation** designed **to protect the credit rights of insurance applicants** with respect to information obtained about the applicant **from third-party sources, like credit reporting agencies.**

Since the applicant gives written authorization in the application for the insurance company to corroborate statements made, credit reports are often requested by insurance companies. If information found in a credit report is used in a adverse fashion against the I applicant, federal says that the applicant is entitled to a free credit report from the original credit reporting agency. Often there are mistakes on credit reports and this law is meant to help people correct such errors that would otherwise be used against them.

On policy applications for larger amounts of coverage, questions asking about the purpose for the purchase are asked. Common reason for wanting large amounts of coverage can include mortgage loans, family income replacement, estate planning, and taking care of the financial obligations associated with final expenses and other outstanding credit obligations. Most insurance companies look at 10 to 15 times income earnings, depending on current interest rates, as the upper limit of coverage that will be approved..

●Age is a prime factor upon which rates are determined. The older you are, the more expensive the insurance will be. Current rates are based on the 1980 CSO Table, 1983 Smoker – Non-smoker Tables and Insurance Company Tables. However, a new mortality table, undoubtedly lowering premiums, is due out in the near future. Generally, the Laws of Probability are applied to life insurance from these mortality tables to help compute insurance rates. Professionals trained in actuarial science are responsible for translating the tables into premium rates.

● Health is evaluated by examining many related factors including:

- Examinations by a doctor or paramedical professional
- Blood tests
- Past medical history
- Cholesterol reading
- Blood pressure
- Alcohol or substance abuse
- Height and weight
- Family history
- Health impairments
- Smoking status – smokers could pay 2 to 3 times the rates of non-smokers.

Depending upon a professional evaluation of all the factors relating to health offered above, the underwriter decides on what premium basis, if any, coverage will be offered.

Occupation and Lifestyle are important and impact underwriting. Asking for a waiver of premium, accidental death benefit or a guaranteed insurability rider can cause rejection of application or a severe increase in premiums if the prospect has an occupation or life style that creates a higher possibility of premature disability or death. Occupations such as highway flagmen, rodeo riders, fire jumpers, high-steel workers, public figures, professional athletes, all can have restrictions in the underwriting guide as to how much life insurance they can purchase, if any. Sometimes riders are available for these riskier groups but restrictions in coverage will apply. Agents should review the insurance company occupational and lifestyle guidelines before submitting business. Each company will have different guidelines and procedures.

Dangerous lifestyle hobbies and activities include scuba diving, noncommercial pilot training, motor cross participation and skydivers to name a few. Such personal activity can result in higher premium rate or exclusions of coverage, if a claim occurs that is related to one of these activities. These are just a few of the life style exclusions. Refer to company guidelines for a complete list. Usually the company will exclude coverage by using a rider within or attach one to the policy.

The Standard of Insurable Interest

The idea that an **individual must have "insurable interest"** in order to own a life insurance policy dates back hundreds of years. When somebody other than the actual insured is applying for policy ownership, insurable interest must exist. It is critical in understanding the inherent nature of insurance that ownership must be placed outside of a wagering possibility. It is unacceptable, from the viewpoint of society, for one individual to own a life insurance policy on another when there is no real reason for such ownership other than for the person buying insurance wishing to profit from the death of the insured.

Generally, each individual has unlimited insurable interest in his or her own life and can buy as much insurance as an insurance company will allow them to own and can name anyone they like as a beneficiary. In most cases the beneficiary of a policy does not need any type of insurable interest to qualify in collecting the proceeds. It is assumed the insured names as beneficiary somebody whom they feel should benefit from the proceeds of the policy and nobody has the right to contradict this intent of the insured.

People who apply for insurance on their own life do not have to worry about the question of insurable interest. Cloudy areas come into play when another person wants to be the owner of an insurance policy on your life.

Insurable interest is normally defined as "any reasonable expectation of benefit or advantage from the continued life of another person." This advantage can be monetary but it is not a requirement and it can arise from natural affection or dependent status. It is not simple to identify the relationships that create insurable interest and such a listing is, at best, a grey area. Usually, one person has insurable interest in the life of another when they are closely related by blood or marriage or if they have a business relationship which would cause the beneficiary to suffer adverse financial hardship due to the death of the insured.

According the **majority court rule in America,** a **parent has an insurable interest in the life of their child and the child has an insurable interest in the life of the parent.** This also extends in most jurisdictions to that of a grandchild having insurable interest in the life of a grandparent. However, the reverse is probably not true. **Most modern cases support the position that sisters and brothers have insurable interest in each other because of the close blood relationship. However uncles, aunts, nieces and nephews do not necessarily have insurable interest in each other solely due to their blood relationship.** This lack of interest also extends to cousins. These more distant blood relations can have insurable interest when there is a financial dependency or business relationship.

Courts have long held that husbands and wives have insurable interest in each other. Some courts even extend this to people who are engaged to marry. Relatives by marriage, other than spouses, usually do not have any insurable interest just because of the marriage relationship. An example is the stepchild, stepparent relationship.

There are many business relationships possible in which the premature death of one of the key parties could result in serious financial hardship to a survivor. In such a situation insurable interest exists. It extends both to owners of a company and key employees in a company when a key employee's or owner's death would result the termination of the business. Creditors have insurable interest in the life of debtors but the amount of insurance and the premium paid has to be reasonable in relationship to the amount of debt. If a creditor takes out too much insurance relative to actual debt, the contract could be considered a gambling device and is therefore void according to law.

Generally, **if a policy is taken on the life of another, it is void if the insured does not give ownership consent to the third party, even if an insurable interest is present.** In other words, if somebody is going to buy insurance on your life, they must have your permission even when there is an insurable interest. If premiums are paid with the insured's money and without knowledge of the policy, the insured can recover those premiums from the insurance company.

Required Policy Provisions

About one hundred years ago, the first insurance laws requiring ordinary life policies, limited pay, endowment and term policies to have specified required policy provisions were enacted by the State of New York. Although specified provisions had to be included in policies, it was left up to insurance companies to decide which words would be used. The language had to **essentially meet the intent** of information required through the statute as prescribed by law.

Settlement option tables are a required provision and set forth certain options, available upon receiving the proceeds of a policy to whoever is entitled to the proceeds. Another required section deals with **"nonforfeiture"** and it basically applies to policies offering level premiums and cash value because in such policies, the policy owner contributes more premiums in the early years of a policy than is needed to meet the fair share of current mortality costs. When a whole life policy, which has been in effect for some minimum period of time (normally three years or more), has lapsed, the insurance company has to offer a table of **cash surrender value.** Alternatively, two other options are for the policy owner to take a paid up policy for a reduced amount or the full face amount of coverage could continue through extended term insurance. The nonforfeiture provision will be discussed in detail later in this section.

The **grace period** provision is required and it states that after the first premium on a policy has been received the policyholder has a **31 day period** of grace following the due date of any future premium in which **to make the premium payment and still have the policy** continue to exist in full force and effect. The grace period provision also provides coverage if the insured dies while the policy is on the grace period. The insurance company merely deducts, from the proceeds, any unpaid premium which is due up through the last day of the policy month in which the death occurred. Conversely, if the insured died in a period for which payment had already been made but was unused, the insurance company must add that amount as a refund to the policy proceeds.

The grace period concept began as a voluntary provision added by some insurance companies to their contract and was later found, upon investigation, to be widely used throughout the industry. Although the grace period is 31 days, **if the last grace period day is on a non-business day then the premium is payable on the following business day.** When premiums are paid at the end of a grace period rather than the beginning of a grace period the insurance company loses the investment opportunity of that premium for one month. Statutes in most states permit the insurance company to deduct from the death benefit paid any overdue premiums plus interest which could have been earned by the company had the policy premium been paid on time.

Another standard policy provision is the **incontestable clause.** This **unusual contract clause prevents a life insurance policy from being contested once it has been in force for two years from the policy issue date.** Without an incontestable clause a life insurance company could, at any time in the future, try to void a policy (get out of paying the death benefit) if the policy had been issued based on a misrepresentation of a material fact by the applicant at application time. A much more detailed explanation of the incontestable clause as well as its interesting history and variations is included later in this section.

The **entire contract provision states** that the life insurance policy plus the attached copy of the application constitutes the entire agreement between the parties and no statements outside the agreement can be used later to vary or contradict the terms within (The parole evidence rule). The **entire contract provision is designed to prevent the abuse in the past of insurance companies who incorporated the application by reference into the contract rather than making a copy and attaching it to the policy at delivery.** In the past, the insurance company would refer to the application as part of the contract but did not provide a copy of the application to the policy owner with the contract when it was delivered.

This provision makes it clear that a copy of the application must be attached to the policy and be provided to the policy owner thereby eliminating uncertainties to the policy owner about whether the contents of the application were the same as those provided at application time. It also enabled the agent, upon policy delivery, to have the policy owner examine the application for any misstatements or mistakes which could be corrected at the time of delivery. This makes it impossible for a company to say there was a misstatement, of which the applicant was unaware, which would result in voiding coverage. **The entire contract provision refers to the contract at the point at which the contract was entered into** but does not prevent later agreements, which relate to the contract, from being made between the parties as long as those parties agree in writing to subsequent changes.

The **misstatement of age provision** is required in insurance contracts and addresses the problem of when the age of the insured is misstated. In the history of life insurance going back a century or so, it was a very common mistake for a person not to know their exact or true age and to unintentionally misstate it. Since something had to be done about this problem, the misstatement of age provision was enacted. It said if the age of an insured had been misstated, any amount that was paid or any benefit that was accrued under the policy will be paid as if the premium had been purchased at the correct age. I**f the insured's age had been overstated** (as in a case where the insured said were 40 years old when and was really 37) the **death benefit would have been increased** to match the amount actually paid. If this age overstatement were discovered during the lifetime of the insured, most insurance companies would refund the extra premium which was paid unnecessarily.

On the other hand, **if an insured understated age** (the insured claimed to be 37 but was really 40 years old) **the death benefit would have been reduced** to what the premium that had actually been paid would have bought for a person at the proper age. Furthermore, the policy would have been adjusted to reflect the proper payment if discovered when the insured was still alive.

The misstatement of age provision stipulates that **when age is misstated it cannot void a contract except in the case of fraud or collusion.** An example of collusion is one insurance case dating back to the 1930's in which an insurance agent and the beneficiary of a policy got together and misrepresented the insured's age to be 30 years younger than it actually was. In this instance the court allowed the insurance company to deny paying the death benefit. The idea of misstatement of age also extends to incorrect sex either by clerical error or by misstatement.

The divisible surplus provision was added early in the 20th century as a policy provision to the life insurance contract and it **applies to participating policies issued by mutual insurance companies.** Many years ago, mutual insurance companies would credit policy owner dividends each year but would accumulate these funds for long periods of time, usually 20 years or longer, and only long time policy owners who still had policies in force at the end of this period of time were entitled to share in the funds that were accumulated. Other shorter term policy owners forfeited their shares and these forfeited amounts were added to the shares of those who had stuck in there for a long period of time. The divisible surplus provision in a life insurance policy requires that insurance companies must determine and apportion the divisible surplus to policy owners at very frequent intervals, thereby not rewarding long term policyholders and punishing shorter term policy owners. It is designed to make dividend dispersal more equal between policy owners regardless of the amount of time they have actually owned the contract.

The **policy loan provision** is a derivative of level premium cash building life insurance policies which allows the policy owner who didn't want to lapse a policy, yet had a need for cash, to utilize the cash value available within a life insurance policy. The **policy loan provision was at first a voluntary clause** added by some insurance companies and later it became a legal statutory requirement. It must be understood that **a life insurance policy loan is not technically a loan** and no debtor-creditor relationship exists. **The policy owner does not have to repay either principal or interest.** Policy loans are considered advances paid to a policy owner against either cash surrender or death benefit payment. Any policy loans which are not repaid are deducted from cash surrender or from a death benefit if the loan is not repaid at the death of the insured. This policy provision will be discussed later in this section.

The final required life insurance policy provision is the **reinstatement clause** and it came into general use in life insurance policies over 100 years ago. Until 1905 there were no laws that required a reinstatement provision but today more than half of the states have a law requiring this provision. It says that a policy owner who lapses a policy has a certain period of time in which to seek to have the policy reinstated. The provision usually **says the application for reinstatement must be made from within three years of the date of a policy lapse. The policy owner has to provide the insurance company with satisfactory evidence of insurability of the insured and unpaid premiums must be repaid with interest. Any outstanding policy loans must be paid with interest** and the policy neither may be surrendered for cash nor taken as a reduced paid policy before reinstatement can be an option for the policy owner. Since reinstatement is such an important contractual right to a life insurance policy owner, it will also be discussed in greater later.

Optional Policy Provisions

Beside provisions required by various state laws, there are also provisions which may be placed in a life insurance policy but are not required by law. **The more common provisions which fall into this optional category include assignment, suicide, ownership and change of plan provisions.** Assignment means the policy owner of a life insurance policy can transfer some or all of the rights held under ownership to another party unless the contract says assignment is restricted or prohibited. The policy owner can assign the policy as a simple matter of law and there is no requirement that the policy provide a provision permitting assignment.

Although assignment provisions do not legally grant the right to assign a policy, they may state that the policy owner does have this right. Assignment provisions define the insurance company's duties in the event the policy owner does elect to assign a policy to another party. The provision can stop or restrict a policy from being assigned and the insurance company would not be bound if the policy does not permit assignment. If the right to assign is merely restricted, the terms of the assignment must be complied with, but the insurance company would not be bound.

The suicide provision basically follows the logic that suicide (taking ones own life) is not a risk assumed by an insurance company, for a limited period of time. If there is no provision declaring this in the policy then courts will generally hold suicide must be covered. Most policies must contain a suicide clause which excludes proceed payments to a beneficiary or an estate if the cause of death of the insured was suicide within one or two years from the date of policy issuance. A two year period of time is typical but some states have a shorter suicide clause or even none at all. Suicide clauses are limited in time because suicide is not normally an activity planned well in advance.

Another optional provision allows the parties to the life insurance contract to change their agreement as long as they do so by mutual consent. New terms can be incorporated into the existing policy but must be agreed to by both parties.

The final important optional provision is **the ownership clause.** Most policies are issued to an insured that completes an application, names a revocable beneficiary and has full ownership and control over the policy. Insurance companies also sell policies which are applied for and issued to people who are not the actual insured. In this instance **the insured has no ownership rights under the policy when a third party applicant owns the contract.** Most of these policies are utilized for business purposes as opposed to most personal insurance which is issued to the proposed insured.

Rights of ownership include the following:

1) naming a new owner or a secondary owner at anytime while the insured is still living by filing a written request,

2) the owner is entitled to take policy loans,

3) taking policy dividends in cash or any other manner allowed by contract,

4) exercising any of the nonforfeiture options including surrendering the policy for cash, taking a reduced paid up face amount or placing the policy on extended term coverage,

5) the owner may name or change a beneficiary at any time in writing as long as the beneficiary is revocable and not irrevocable.

Other Contract Provision Concepts

■ **Warranties and Representations**

• **Warranties** are statements or conditions that the applicant for insurance represents to be **absolutely true.** The application becomes a part of the policy when attached thereto and any material misrepresentation, concealment or fraud can lead to voiding the insurance contract. False warranties, therefore, would preclude recovery of benefits in the event of loss. However, **under modern insurance law, statements made by applicants in the negotiation process are deemed to be representations and are NOT considered to be warranties.**

• **Representations** are written or oral statements made by the applicant during negotiation for an insurance policy. The maker of a representation is saying "my statement is true to the best of my knowledge and belief." When a statement is false, it is a **"misrepresentation" and it may lead to voiding coverage ONLY IF the misrepresentation deals with a MATERIAL FACT** (a fact so crucial that had the company known it originally, the application would have either been rejected or offered in a substantially different manner). Consequently, minor facts and information, if misrepresented, will not allow the insurance company the ability to void or rescind the contract.

■ **Free Look/Free Examination (10, 20 or 30 days)** clause says that once a policy has been **delivered (delivery date is key as the test concept) to an owner,** the owner has a specified period of time to decide whether or not to keep the insurance. At any time during "Free Look" the **owner may return the policy** to the company for a **full refund** of premium paid.

DIVIDENDS AND DIVIDEND OPTIONS - are available to owners of "participating" plans (offered only by "Mutual" insurance companies, and not by "Stock" insurance companies). Mutual policy **dividends** are declared annually (and paid at the end of a policy year) by the company and **are not considered, by the Internal Revenue Service, to be either profit or income and are therefore not taxable.** Instead, they are treated as overcharged premium which is being returned. The most common dividend options offered by an insurance company to a policy owner are:

• **Cash**

• **Accumulation at Interest** - (Commonly found in older policies) means the dividend is invested with the insurance company to earn interest at a rate of interest specified in the policy. While dividends are not income taxable, all **interest earned upon dividends** is income and taxable. As the dividends and interest accumulate, they are compounded and are available to the policy owner at any time. If they are not cashed-in by the policy owner, then dividends and accumulated interest amounts are paid in addition to the face amount of the policy in the event of death to the insured.

• **Paid-Up Additions** (Commonly found in older policies) apply the dividends to purchase additional amounts of (all paid up) death benefit. Essentially, it is a "mini" single premium death benefit purchase. Whatever additional insurance the dividend amounts purchase (always at the insured's “attained age") is added to the original policy face amount. Again, the owner may take the dividend in cash at any time and thus eliminate any additional paid-up insurance that may have been purchased.

• **One-Year Term Option** - uses the annual dividend to purchase one year of term insurance coverage at the insured’s attained age, which would be paid in addition to the face amount of the contract if the insured dies in that year. If this option is selected at a time later than original issue, the company may require evidence of insurability.

• **Premium Application** - simply applies the cash dividend due as a credit against the very next premium charge, thus lowering the premium cost.

• **Endow the Policy -** uses the dividend to pay the insurance faster by adding it to the tax-deferred cash value accumulation, thereby creating a closer endowment date.

• **Paid-Up Option** - means the dividend is added to the cash value of the policy to create a fully paid-up policy prior to the time full payment would otherwise have been made. It is **used** in the insurance industry **to "vanish"** future premium payments. When the dividend plus interest and cash value equal the net single premium due at the insured's attained age, the policy can be endorsed as fully paid, but it will not mature until the original endowment point.

Three other crucial ideas to understand about dividends:

● The **main benefit** of a participating policy dividend is: **insurance cost is reduced.**

●**Policy loans taken will not reduce future dividend payments** as long as regular premiums are paid on time.

● Dividends paid by mutual insurance companies are never guaranteed. Instead they are projections guided by actuarial and economic principals. For an agent to state or even imply that the dividends paid on a policy are guaranteed is grounds for suspension or even revocation of the insurance license.

Beneficiary Considerations

Types of Beneficiaries

After the purchase of a life insurance policy is made, the **policy owner should review the designation of a beneficiary on a regular, periodic basis** to make sure the designation coincides with current circumstances and intentions. It is always wise to name a contingent beneficiary in addition to a primary. An insurance company must honor the designation and fulfill it according to the intent or direction of the policy owner. The policy owner should describe the beneficiary who will receive the benefits in a manner which enables the insurance company to easily identify the intended party. When designating a spouse, the **proper given name** of that person should be used. The name will be the controlling factor in the designation and wording like "wife of the insured" or "husband of the insured" is merely descriptive and should be avoided.

Children can be listed as beneficiaries and can be designated **by "name" or as a "class."** The **advantage of using the actual names of the children who are beneficiaries is the actual identity of the beneficiary is clear and easy for the company to identify.** The disadvantage is any children born after this designation would not be included unless the policyholder remembered to name them after they were born. When a class designation for children is used, a group is named without individual listing. Language such as "all the children of the insured" is an example of class designation. **Problems usually associated with class designation include finding all the members who belong to the class after the insured dies.** Furthermore, since the legal definition of the word "children" differs from state to state, it can include illegitimate children, grandchildren and even step-children. It is **the burden of the policy owner to make sure that the designation is clear.**

There are **eight basic types of beneficiaries.** The first two are **"revocable" and "irrevocable."** The revocable beneficiary has no rights under the policy which cannot be terminated by the policy owner. **The revocable beneficiary can be changed at anytime by the policy owner who simply makes such a request in writing to the company.** The policy proceeds are paid to the revocable beneficiary when the insured dies but the right to collect the proceeds are lost if the beneficiary dies before the insured. **The irrevocable beneficiary has a vested right to the death benefit when named as beneficiary and the policy owner cannot change an irrevocable beneficiary without the beneficiary's consent.** The rights of the irrevocable beneficiary end if the policy is not in force when the insured dies and if the irrevocable beneficiary dies before the policy owner, the policy owner would have the right to name a new beneficiary. The new beneficiary designation could be either revocable or irrevocable.

Two other types of beneficiaries include the **"primary"** and the **"contingent"** beneficiary. The **primary is first in line** to the throne and receives the entire death benefit and the only requirement is for the primary to outlive the policy owner. More than one party can be named as a primary beneficiary and the benefit would be shared equally or as specified by the policy owner. The **contingent beneficiary is a second choice** and will receive nothing as long as the primary beneficiary outlives the insured. Contingent beneficiaries can be named according to order of preference and no contingent beneficiary would receive any benefit if the primary beneficiary is alive at the time of the insured's death. The second contingent beneficiary, called a "tertiary," would be the second contingent choice of the insured.

A **fifth type** of right is the **"donee" beneficiary**. The donee is a person who is named a beneficiary but who gives no consideration to the policy owner for being named. **This is the most common type of beneficiary.** A **"creditor"** beneficiary **is the sixth type** of possible beneficiary and is named sometimes when the policy owner owes money to a creditor. The benefit from the policy is paid to end a debt and is limited to only the amount necessary to satisfy the debt which remains at the death of the insured.

The **seventh right is that of an "intended"** beneficiary, a person who is intended by the parties of a contract to benefit from the performance of a contract. This beneficiary may have to sue to enforce the rights they feel they have. Both donee and creditor beneficiaries are intended. **The last type** of beneficiary **is the "incidental"** beneficiary. An incidental beneficiary is a party who benefits from the life insurance policy but who originally has no rights under that contract. This means the parties to the contract did not procure the contract initially to benefit the incidental beneficiary.

Common Disaster

In this ultimate "what if" scenario the insured and beneficiary die together in a common disaster and there is no way to know who died first. To collect, the beneficiary must clearly survive the insured, usually by at least 30 days. Otherwise, the courts apply the **Uniform Simultaneous Death Act** which requires that, in cases of common disaster and death, the **POLICY PROCEEDS ARE DISTRIBUTED AS IF THE INSURED SURVIVED THE BENEFICIARY.** Without a named contingent beneficiary, the proceeds would be paid into the estate of the insured and would be subject to probate.

Such state statutes are necessary to presumptively decide what would otherwise be long, drawn out legal issues. By assuming the insured outlives the beneficiary the issue of which party receives the proceeds is decided without a potential legal mess.

Ineligible and Incompetent Beneficiaries

When an insured is killed by the beneficiary listed in the policy there is law applicable as to whether or not the beneficiary can receive the proceeds from the policy. It is normally held that, when **a beneficiary applies for the insurance** on the insured **and then purposely murders the insured** in order to collect the death benefit, **the policy can be declared void** and the beneficiary will not collect the proceeds.

When **the insured applies for the coverage, and the beneficiary later kills the insured, the proceeds will be payable to the beneficiary as long as the killing was not "wrongful."** A wrongful killing means the beneficiary will not collect and the proceeds will be paid to either the contingent beneficiary or the estate of the insured. **An example of a killing which is not wrongful includes self defense.**

The killing of the insured by the beneficiary represents the classic case of an ineligible beneficiary. To allow a beneficiary to collect the death benefit of a life policy of an individual whom he has murdered would set a dangerous and unacceptable occurrence that society can ill afford to condone. While the proceeds will likely be paid to someone, it will not be the ineligible beneficiary.

The standard situations in which beneficiaries are incompetent include mental incapacity and persons under specified legal ages. The mentally incapacitated person is dealt with by society on the same level as would be a child. The child is not competent to collect proceeds paid from a life policy upon the death of an insured. However, this is not to say that the child will not benefit from the money. Usually, the court will appoint a guardian and will oversee the distribution of the funds. Such a system will result in extra cost and less of the proceeds being directly used by the child for his or her benefit.

It is usually not a wise idea to name children under the age of eighteen as life insurance beneficiaries for the reasons stated in the previous paragraph. The best possible way to leave the most proceeds dollars for the care of a child or an incapacitated adult is to establish a life insurance trust. Such a trust will have some initial setup costs but can be created to specifically carryout the intentions of the trust creator without the court system intervening and making the decisions regarding expenditures. The upcoming chapter on the basics of trusts will make clear these important distinctions.

Chapter 7: Trust Basics

(3 exam questions)

Creation of A Trust

A trust can be created for many different reasons including professional property management, trust asset investment, assure income for designated beneficiaries or it may be quite useful in strengthening a financial or estate plan. Also, changing family relationships such as second marriages and having children by more than one spouse can utilize the trust structure to achieve multiple goals. **The central concept of trust creation is a grantor's objective of income and principal payment to beneficiaries can be achieved through the flexibility afforded because of creating a trust.** Some common purposes for trust creation include the following:

1) estate taxes can be saved through the use of certain irrevocable trusts;

2) relatively modest amounts of trust assets can be invested in common funds and thus enjoy high quality portfolio management which would otherwise not be available;

3) a grantor can make desired income and principal arrangements for a spouse which will enhance the spouse's life even after the grantor is dead; and

4) wealth accumulation can be achieved with favorable income tax results which allow income to be taxed at a lower beneficiary's rate rather than the higher rate of the grantor.

The **trust is usually defined as a legally binding relationship in which a fiduciary acts on behalf of the best interest of the property of another for some desired benefit to a beneficiary.** The fiduciary is the "trustee" who holds title to property from a "grantor" for the benefit of a "beneficiary" according to the terms of a trust agreement.

One of the distinct advantages of trust establishment is the **extraordinary flexibility the grantor has,** especially in the areas of locale and trustee discretion. The situs (geographic presence) of the trust can be anywhere, not necessarily the grantor's domicile state. The trust instrument will indicate in which state the situs of the trust is located. The trustee is usually granted wide discretionary powers of management and investment actions.

Ideally the grantor wants the trustee to have powers sufficient to implement distributions to beneficiaries in much the same way the grantor himself would have done. Correspondingly, the greater the latitude given to the trustee, the more likely it is the grantor's wishes in establishing the trust can be achieved.

<u>Elements of a Trust</u>

All trusts consist of the following five elements:

1) The grantor (sometimes referred to as the trust creator

2) The trustee (fiduciary who owes the highest duty of good faith to beneficiaries)

3) the beneficiaries (the party benefiting from the property being held in the trust)
4) The property, legal title of which passes to the trustee

5) The terms of the trust as written in the trust document

The **"grantor" creates the trust** and is also called the "trustor", "settlor" or, in the case of a testamentary trust, a "testator". The grantor transfers title to property to a trustee who agrees to manage the property for the benefit of the beneficiary. Unless the grantor keeps some type of power over the trust, his interaction with the trust is completed once the trust begins operation.

The **"trustee"** can take the form of one or more individuals, a corporation (bank) or a combination of corporation and individual appointees. The trust requires a trustee but the incapacity or death of an individual who is a trustee will not invalidate the original trust. The worst that will happen is a new trustee will have to be appointed and the trust would temporarily become inactive until the new trustee is named. It is wise to designate a trustee successor at the inception of a trust, but in the absence of such a designation, a court appointment will have to be made.

An exception occurs when there is but one trustee and one beneficiary and it happens to be the same individual: the trust ends and the legal and equitable title become one again according to the common law **legal doctrine of "merger".**

The beneficiary is the party for whom the benefits of the trust were created. Whereas the trust holds legal title to property, **the beneficiary owns equitable title.** Various classes and corresponding beneficial interest can be created by the trust. Designations can include primary and contingent beneficiaries. A beneficiary may be entitled to only the income from a trust with the principal passing to a "remainderperson" upon the termination of the trust. Trusts created in the United States must include as beneficiary only legal persons (individuals or corporations) and may not include pets.

The **trust property is also known as "principal", "res" or "trust corpus".** Although not all property should be placed in a trust for various practical reasons, virtually any property capable of being owned can be placed in trust. Therefore real and personal property, as well as contractual rights including life insurance contract ownership can be held in a trust.

The **terms of the trust are written in** a document referred to as either **the "trust instrument", "indenture of trust" or "deed of trust".** All conditions of the trust are recorded and they, along with applicable law according to the jurisdiction in which the trust was created, will apply. The duties and powers of all parties to the trust are defined and any restrictions or limitations on the powers of the trustee are also included in the deed of trust.

Investment of trust principal can be designated by the grantor or broad discretionary powers of investment may be given to the trustee. In the event trust terms and state law conflict, it is the law which must control. When no trust directive exists on a particular point, again state law will provide the answer.

The **sprendthrift clause is** an important provision which can be included in a trust. It prevents the creditors of a trust beneficiary from being able to attach the assets of the trust. Therefore the trust protects the beneficiary who exercises poor spending judgement from unpleasant consequences.

Another standard trust clause protects the trust from violating **the rule against perpetuities** (the next concept to be discussed). A provision outlining the grounds required for removing a trustee is also a common part of a trust instrument. Finally, the deed of trust spells out the exact manner in which the corporate trustee is to be compensated.

Rule Against Perpetuities

A trust may last quite a long time even after the grantor's death, but it cannot last forever. The rule against perpetuities has been followed for hundreds of years dating back to English common law to determine the viability of a trust from inception. **If any interest in property granted through a trust vests later than 21 years and 9 months after any living being who was in existence at the time the trust was created, then the trust is invalid.**

Determining the inception date of the trust becomes important when considering the rule against perpetuities (RAP). The RAP beginning date varies depending upon whether the trust was revocable or irrevocable. In an irrevocable trust the RAP clock begins ticking the date upon which the trust is created. When a revocable trust in involved, the RAP begins when the interest in the trust becomes irrevocable. When an interest is created by will the RAP starts upon the date of the testator's death. When a trust is being assembled, the drafter of the document must take care to make certain that no interest in the document will be vested so far into the future that the RAP will be violated. Therefore the creation date of the trust is critical. The RAP creates a problem for a trust if the possibility of a RAP violation exists; whether or not the RAP is actually violated at a later time is irrelevant.

Applying the RAP is extremely complicated. Completely eliminating a RAP violation is simple as long as the trust or will includes what is referred to as a **"perpetuities-saving clause".** Typically, such a clause may read, in part, as follows:

"... every trust established by this Will shall terminate, if it is not already terminated, 21 years after the death of the last survivor of my wife, my children, and any lineal descendant of mine alive on the date of my death. At the termination of such trust, my trustee shall immediately transfer, convey and pay over the principal of each trust to the lineal descendants then living of the child of mine on whose account the trust was established, in equal shares..."

If the above trust was **"inter-vivos" (a living trust)** then the date of death language above should be replaced with "on the date of the creation of this trust."

Another common law rule applied to interests vesting too far into the future is called the rule against accumulations. It operates under the same principle as the rule against perpetuities as the interest must vest within the same time frame. Some states have shortened the period when implementing the rule against accumulations and a few states allow accumulations only during a child's minority or for charitable purposes.

The Living Trust

A living trust accomplishes the goals of property transfer during the lifetime of the settlor and is legally referred to as an "inter vivos" trust. The living trust can be revocable or irrevocable. The revocable trust can be changed or ended by the grantor at any time and all trust property ownership is returned. There are no tax benefits to be realized through the creation of the living trust, but there are many other reason to establish one. The living trust should be viewed as an incomplete gift and the main reasons for creation are as follows:

1) the grantor can evaluate the operation of the trust under the auspices of a current trustee and decide if this trustee is acceptable prior to the trust becoming irrevocable. The trustee can also become more comfortable with the grantor and gain a better knowledge of how to achieve the grantor's goals;

2) since the revocable trust becomes irrevocable upon the death of the grantor, probate cost is avoided;

3) the grantor may be incapable of managing the property while a need for professional management exists;

4) the grantor has the ability to create a gift arrangement with the ability to take back the gift before the grantor's death;

5) intangible property not located in the grantor's domicile state can be included in the trust thus eliminating the possibility of multi-jurisdictional review; and

6) the sole proprietor or partner in a business can transfer ownership of the business to a trust and avoid the termination of the business at the owner's death.

Alternatively, an irrevocable living trust can be created whereby property is permanently transferred to the trust and cannot be reclaimed by the grantor until or unless the trust otherwise terminates allowing such reclamation. Unlike a revocable trust, **the irrevocable trust is a completed gift for estate, gift and income tax purposes.** An irrevocable trust enables the grantor to reduce his estate value and to shift income to beneficiaries. A drawback to the irrevocable trust is the possibility of gift tax liability. Unless the client feels comfortable in permanently relinquishing ownership of property, an irrevocable trust may not be desired. In addition to tax benefits, the other reasons for establishing an irrevocable trust include the following:

1) trust property is out of reach of the grantor's creditors and will provide benefit to beneficiaries;

2) trust property is not subject to probate when the grantor dies;

3) a beneficiary with special or peculiar needs can be cared for under the terms of the trust and with professional money management. In this manner the beneficiary must deal with the trustee rather than with the grantor thus avoiding interpersonal conflict; and

4) the trust can protect assets from spousal election rights upon the grantor's death and enable children from a former marriage to be provided for.

Any living trust must clearly state whether or not it is revocable. If revocable it must be stated within the trust document when and to whom property ownership is retrievable.

The Life Insurance Trust

Since ownership of a life insurance policy is an intangible personal property right, it is freely transferable to any party as are the rights afforded under the agreement to the policyowner. When a life contract is purchased, especially one with a very large face amount, the issue of ownership must be considered very carefully. Should the contract be owned by an individual or the legal entity of an irrevocable living trust?

The individual owner creates an asset that is generally includable in his or her estate for estate taxation purposes. However, by granting policy ownership to an irrevocable life insurance trust the individual no longer has estate taxation problems or worries. Such a trust arrangement must be irrevocable. A separate bank account should be established to pay policy premiums as well.

The enormous flexibility a trust affords is well suited to creating a mechanism by which a large sum of money like proceeds can be managed and distributed, not to mention the aforementioned avoidance of possible estate transfer taxes.

Fiduciary Relationships

A fiduciary is a person or institution (such as a trust department in a bank) holding and managing property for the benefit of another party. The fiduciary holds only legal title while the other party or beneficiary is the beneficial owner and holds equitable title. The ethical principles to which fiduciary parties are held are defined according to state laws.

There is no obligation to become a fiduciary when asked however, upon acceptance, there is a legal obligation to perform properly until the fiduciary relationship is dissolved.

A fiduciary draws the power to act from possibly one or more than one source. In one instance the power source is state law as in the case of court appointment of an executor (or administrator) or a guardian to a minor or incompetent person.

The fiduciary must account for their actions to the court who oversees all fiduciary activity. Another method of creating fiduciary power without the court is through a trust (a more detailed discussion of trust creation appears later in this section). This private creation is established when a "grantor" appoints another person or an institution (trustee) to hold legal title for the benefit of the grantor. The power of the trustee flows directly from the written trust agreement.

When a fiduciary has been appointed by the court as in the case of an estate matter, the executor must file an accounting with the court as a final element of the discharge of duty. A trustee makes no such accounting to a court, but may be required to regularly account to the trust beneficiaries.
The fiduciary powers and duties of a court appointed fiduciary are relatively short since it is the goal of the legal system to complete its business in a timely fashion. The estate process is ideally designed to take no more than 12 to 24 months to complete. Once an estate is closed the fiduciary obligation evaporates with the completion of duty.

Although a **trust may exist** for only a short time, it is much more common for it to exist **for many years, sometimes for many decades.** The trust and ensuing fiduciary relationship begins once property has been transferred to a trust. The powers and duties of the trustee are thus terminated when the trust ends.

Fiduciary Duty

Regardless of the power source, a fiduciary owes nothing less than absolute loyalty to all beneficiaries in matters related to actual fiduciary duties. Rules governing the fiduciary relationship have evolved through common law and are today embodied by statutes written and passed by individual state legislatures. There are three fundamental principles common to every fiduciary relationship:

1) responsibilities borne by the fiduciary cannot be delegated to another if they can be performed by the fiduciary; and

2) it is the duty of the fiduciary to act solely for the benefit of the beneficiary for all matters within the confines of the fiduciary relationship; and

3) anytime a fiduciary transacts personal business with another who is a party to a fiduciary relationship, the fiduciary must fully disclose all facts related to the transaction to the power source.

Furthermore, if the fiduciary is a professional (i.e. attorney) then they will be held to an even higher standard than would be the case with a lay person.

Four main elements of fiduciary duty will be discussed. The **first duty requires a trustee (fiduciary) to be impartial** when dealing with beneficiaries. The legal standard imposed upon the conduct of the trustee when dealing with the beneficiary is one of ordinary prudence, skill and care. When the trustee exercises the same ordinary prudence he would with his own property as he does with trust assets, then he has fulfilled this requirement.

Secondly, the trustee must preserve trust property yet make it productive. Income must be produced by the trust or the trustee can be held personally liable. It is advisable for a trustee to generate an amount equal to generally prevailing rates of return for the same or similar assets.

A **third duty concerns the special responsibility of a trustee when acting on behalf of a corporation.** The corporate beneficiary must be especially cautious not to profit from the relationship. This includes when a bank is a trustee and the corporation wishes to maintain an account at the bank. Although rules vary from state to state, generally such a practice is acceptable when the bank handles the trust funds in a reasonable and prudent manner.

A special problem arises when a trustee is fiduciary for two separate accounts and property ownership is being transferred from one account to another. This is a conflict of interest even when fair market price is involved. An extension of this prohibition also prevents the corporate trustee from selling any entrusted property to any employee, director, or business affiliate by which the trustee is employed.

In the reality of the fast paced economy of modern times, trust companies do have authority to pool the assets of many small estates and trusts into one commonly managed fund **called a "common trust fund".** The small trust client saves on expenses while the trust management has greater investment flexibility because of a larger pool of assets. Federal regulation allows their existence and the common trust fund is not a taxable entity.

Perhaps the **oldest and most universal fiduciary responsibility is the duty not to self deal** at the expense of the beneficiaries. The trustee must not personally buy trust assets regardless of whether or not fair market price is offered. The only exception might be if all pertinent facts were disclosed to each beneficiary as long as each beneficiary was competent to accept the offer. However, the trustee who purchases trust assets in an approved sale for less than fair market price would be legally liable for the difference. The duty of the trustee to the trust is always greater than duty to self when trust assets are involved.

When self dealing is at issue and one or more beneficiaries are incompetent due to either mental incapacity of age, the transaction which would otherwise be valid can be set aside. Even if the trustee wishes to sell personal assets to the trust at bargain prices and all beneficiaries agreed, the transaction is **not binding on the incompetent beneficiary.**

To complete this discussion of fiduciary duty, the concept of breaching the duties must be addressed. Clear breach of duty includes personal use of trust assets or leaving trust property idle rather than making the property productive. There are however, more subtle ways to breach duty including electing to invest trust funds in a very low but safe return vehicle, when other relatively safe investments are offering greater returns. Such grey areas tend to place the fiduciary in situations rife with personal liability. This does not imply the fiduciary may select higher yield at the expense of safety. However, when two equally safe opportunities are present, there is a clear duty on the part of the trustee to place the assets in the greater yielding investment.

Fiduciary Power

Fiduciary power is usually broadly based but it could also be quite restrictive depending upon the powers granted in the trust agreement. Common duties include the right to keep or sell trust assets, mortgage property, take a loan or use assets as collateral; hire attorneys, investment advisors or accountants.

If no specific investment provision defining fiduciary investment power has been written into the trust agreement, then common law, state statutes or the courts will define the qualifications.

Most states use **the "prudent-man" rule or,** in other words, under similar conditions what action would an average, ordinarily intelligent person take? Following the law and or the written provisions of the trust are required but, in situations not clearly addressing the matter at hand, the prudent-man rule is the prescribed duty.

While the prudent-man rule is widely followed, some states use **the "legal-list" method** which describes by statute the investments which are available to the trustee for trust assets. Investing outside of the list is an automatic breach of fiduciary duty and all resulting loss would become the personal liability of the trustee.

Fiduciary power includes the restriction that conflicts of interest between the trustee and beneficiaries are not allowed. This includes the corollary concept that impartiality of trustee action among different classes of beneficiaries must be maintained. When a trust contains the corporate stock of the trustee at the inception of the trust, the shares may be retained in prudent-man states, but may have to be sold in legal-list states. When the trust did not already contain trustee corporate stock, there is a duty not to purchase.

<u>Fiduciary Selections</u>

Although this text has generally been referring to the fiduciary as a trustee, the fiduciary can also be called an executor (administrator when a written will does not exist) and a guardian, depending upon the type of fiduciary relationship. Regardless of the occasion, the suitable candidate for selection as a fiduciary should be honest, possess a high degree of integrity and be interested in the welfare of the beneficiary.

Fiduciaries with prior background in property management and asset investment are also preferable. The ability to serve the beneficiary is foremost and the ideal fiduciary should always have enough time to devote to the fulfillment of the obligation involved.

The Trustee

In establishing the trust, a grantor faces a formidable task when selecting the trustee. Sometimes the temptation to name a spouse, other relative or even one's self is too great to overcome. Such a selection tends to defeat diversification and flexibility otherwise available to a trust when an independent third party, usually a corporation (bank), is named as trustee. The following **five elements need to be evaluated when deciding upon whether to select either a corporation or an individual as the trustee:**

1) The individual can become incapacitated or die and therefore a disadvantage of selecting the individual is the inherent temporary nature of such an appointment.

2) An individual who is a relative of the grantor can be placed in an environment ripe with conflicts of interest leading to breaching of duty or, the very least, to hard feelings among family members.

3) If the individual trustee breached fiduciary duty and caused economic loss to the beneficiaries, holding the trustee liable may be useless if the individual lacks sufficient assets to make restitution. On the other hand, the corporate trustee who is held accountable has the assets of the corporation available to make restitution.

4) A beneficiary is sometimes named as the trustee. This can create many unfavorable tax consequences especially when the trustee is not the only beneficiary. Tax rules can lead to gift taxes being owed or to having the entire value of the trust being includable in the estate of the trustee. Seeking the advice of a competent tax expert is always advisable prior to naming a beneficiary as a trustee.

5) Since tax laws are complex and can change quickly, the trustee responsibility is one of increased specialization, not to mention a comparatively arduous assignment.

In analyzing the above considerations, the conclusion to be drawn **favors the corporate trustee** if the goals of the grantor include flexibility of management and investment, properly meeting beneficiary needs and "positive" taxation.

Guardians

The **guardian is a court appointed** position charging a party with the **responsibility of caring for another person** who is legally incompetent (mentally of physically impaired of not of legal age). The individual needing the care is called a **"ward".** Guardians do not take legal title to the property of a ward but instead discharge specified duties according to the authority they are granted. The guardian serves until his or her duties are formally discharged by the court. Although guardianship runs concurrently with the incompetency of the ward it can include a ward's entire lifetime.

A person who assumes the status of guardian falls into one or more of the following types of guardianship:

1) **Testamentary Guardian** - named as the guardian of minor children in a will. Absent a bona fide reason to the contrary, the court will accept such a choice automatically.

2) **Guardian of person or property** - this is the most common variety. If only the ward's property is involved then it is a simple business relationship and the guardian receives a fee for services rendered. When the guardian is to care for the person, any property managed by a different guardian is given to provide for the ward's necessities including food, shelter, clothing and education.

3) **Guardian ad litem** - is appointed by the courts to engage and complete a specific purpose such as when a minor is named as a party to a legal action. Once the legal issue involved has ended, so to does the guardianship.

4) **Guardian de son tort** - sometimes an individual assumes the role of caring for a minor or incompetent person but was never officially appointed by the court for such a purpose. Such a guardian is still held to the same standard of action that would be applied to a court appointed guardian.

The responsibilities attached to the guardian mirror that of the trustee or executor: do not assume the position unless you are willing to perform all required services and a duty according the dictates of the position as it was established.

Executors

The requirements for being an acceptable executor include mental competency and the absence of a felony conviction and, in some states, a surety bond must be posted. Special attention should be given to the selection of an executor because **experience managing assets as well as knowledge of the workings of the court system can be helpful.** Even if the executor is a close relative of the decedent, the same standard to duties applies and all beneficiaries must be treated on an equitable basis. Expertise and/or background in the following areas and/or matters will prove valuable as well as the considered evaluation of certain situations, as follows:

1) business or administrative ability to assemble, conserve and distribute estate property properly;

2) if there is a conflict of interest between the executor and other beneficiaries, the individual under consideration may not be suitable;

3) the candidate should have the time to carry through with the responsibilities involved; and

4) personal knowledge of the decedent's personal and business affairs can be helpful.

When the will is being written it is a good idea to name a second party as the executor in case the first choice is either unwilling or unable to fulfill the responsibility involved. Sometimes it may be wise to name a corporation and an individual as co-executors to make certain that complex matters are properly handled while at the same time, the personal touch is not overlooked. Ultimately, however, **the size of the estate is the probable determinant of executor selection.**

Trustee Substitution

Who should have the power or authority to remove a trustee? Should the beneficiaries be able to do it, or should some other party have the authority for removal? When a beneficiary can remove a trustee and appoint himself as a successor, the tax consequences of the estate may alter. It usually wiser for the beneficiary to name a different corporate trustee as a successor. Arguments supporting the position that a mechanism to change the trustee should exist, include:

1) new changes in the tax law or local requirements; it may prove beneficial to switch the situs of the trust from one jurisdiction to another;

2) corporate trust personnel may change and the relationship could become less than harmonious between the new regime and beneficiaries, prompting the urge to switch; and

3) when a beneficiary moves further away, the relationship between the trustee and beneficiary can make it quite inconvenient to transact trust business.

<u>The Use of Trusts with Home Ownership and Life Insurance</u>

Due to the flexible nature that a trust can offer, this form of property ownership lends itself quite well to both real property ownership and Life insurance policy ownership. Since the trust is a separate legal person with its own tax identification number, the insured keeps the face amount of the life policy out of the estate of the insured, thereby reducing estate tax liability potential. The private nature of the trust allows the homeowner, if the mortgagor agrees to trust ownership, to make it more difficult and even impossible for members for the public to learn the identity of the true beneficial owners of real property.

Once such property is in trust the grantor can direct many use and distribution factors that would be impossible to achieve without placement in the trust. **Life insurance ownership in a trust is especially valuable in the event the actual beneficiaries at the time of proceed distribution are minors or adults with special needs.** Guardians of minors named in a trust can follow the directive of the grantor for use of proceeds while such proceeds would otherwise be tied in probate with great restrictions without trust ownership in the case of minor beneficiaries**. Further the home ownership placed in trust can avoid forced sales between beneficial interest holders, thus following better the original intent and wishes of the grantor.**

Chapter 8: Disability Income Insurance
(6 exam questions)

Need for Income Replacement

Imagine for a moment that an unexpected illness or accident robs you of your ability to be employed and therefore all the income that you enjoyed. Your regular source for funds suddenly dries up yet you still have bills demanding payment. This is the possible nightmare scenario for people who choose to ignore the need to transfer this risk to an insurance company through some form of disability income coverage.

Although a person might qualify for the meager benefits offered by social insurance or have generous family or friends, the **best way to transfer the risk of disability is through insurance.** The greater a person's income the more likely it is that the individual has purchased, or should purchase, a disability income policy. However, this is not to say that the person with a middle or lower income should ignore this concept altogether. While disability coverage has historically been purchased by professionals and higher income classes, there are coverages available to most income level groups.

Perhaps one of the best methods for the average income earner to **insure that the mortgage is paid despite disability is to buy a term plan offering a disability income rider.** Such options are available and within the budgets of most income earners no matter how limited their wages might be.

Other important reasons not to ignore this potential threat to income are reflected by the following realities:

● At age 40, the chance of a disability is 3 times greater than death.

●Disability is 16 times more likely than death to cause a foreclosure.

●According to U.S. Department of Housing and Urban Development one out of two mortgage foreclosures result a disability.

●According to the Commissioner's Individual Disability Table A, the chance of disability within 30 years at age 20 to 40 is one in three, and from age 40 or greater is 1 in 2.

●According to 1985 CIDA Experience Table, the chance of at least one disability lasting 90 days or longer before age 65 at age 30 is 33%, at age 40 is 29% and at age 50 is 23%.

●In 1999, at least 44 million Americans reported having a disability according to Morbidity and Mortality Weekly Report, February 23, 2001.

●The chance of a disability over the next year is greater than death, a fire or a serious car accident according to Commissioner Individual Disability Table A.

Individual and Group Disability Coverage

Individuals are typically protected against disability through either individual or group disability income policies. The great majority of about 80% enjoy coverage through group plans available through employers. Such programs are usually referred to as "salary continuation plans" and are an important fringe benefit offered by some companies. The other twenty per cent of the market is represented by higher income earner like doctors, lawyers, accountants and small business owners who purchase individual disability contracts in an effort to protect their very comfortable lifestyle from the disaster of lost income due to disability.

The typical policy provides periodic payments for a specified length of time to an insured for the inability to work and earn income due to injury and/or sickness. **Benefits received under DI are usually 1/2 to 2/3 of the gross income** of the insured (but never more than 80%) salary because:

- The insured would have little incentive to return to work if the benefit was too high, and

- The **income received** as a benefit **is free from federal income tax** (as long as the insured has paid their own premiums as an individual) and therefore insurance for the full amount of wages is unnecessary.

The **indemnity period (IP) is the total time a contract will cover** any **single accident or illness.** The IP can be one, two, five years or longer with even lifetime coverage available to certain qualified occupations. Typically, white collar professionals (doctors, lawyers, CPA's, etc.) will select coverage to age 65 while benefits to age 100 are optionally available if the insured continues to actively work in their profession.

When an individual policy is purchased the insured is directly contracting with the insurance company and is personally paying the premium cost. All rights of ownership under that contract will belong to the insured who was the policy applicant. The policy will remain in effect as written in the contract between the parties and so long as premiums are paid in a timely fashion.

In a group disability situation, the employer is securing one contract, called a master policy, which protects all employees who are enrolled into the coverage. The employer may pay all the premium cost or it might be shared in some ratio between employee and employer. **While this is a terrific fringe benefit for any employee lucky enough to be part of the group there are some notable disadvantages.** One major drawback is losing the coverage due to either employment change, being let go from the company or the employer deciding to drop the group coverage. When group coverage no longer exists it creates a gaping hole in the financial protection umbrella. If the health of the individual has deteriorated he or she may not be able to secure an individual coverage for disability.

Most disability coverage, available through employment, is for the short term and typically lasts only 13 to 26 weeks. This is great if you are fortunate enough to recover with three to six months and devastating if you remain unable to work for a significantly longer period. If you are lucky enough to have a long-term disability policy, the group coverage is usually reduced by any income an employee receives from:

●Any employer

●Any occupation

●Any other group insurance

●Any distributions from a retirement plan

●Any employer-sponsored salary continuation plan

●Primary social security benefits

Disability Product Taxation Concepts

● **Disability premiums** paid by corporations are tax **deductible** if the employee receives the benefits, otherwise the premium is not deductible (in the event the employer receives the benefits).

● **Proceeds that are paid to the employee are taxable income if the employer paid** the premium of the policy (and therefore deducted the premium as an expense). When the **individual** pays his own premium for disability insurance, the **premium is not tax deductible** but the benefits are **exempt from federal income tax.** It is for this reason that the purchase of a 100% benefit based on gross income is not allowed by insurance companies. To permit otherwise would violate the principle of indemnification and would enrich the insured. Another likely ramification of 100% tax free benefit payments would be the dramatic increase likely in the number of insureds who would never recover from an injury no matter how minor. If you were paid your entire gross income tax free without working would you wish to recover anytime soon?

There is **no option for the individual to take a deduction** for premium paid in exchange for a taxable benefit. Then Internal Revenue Code does not allow the option to deduct premium cost for disability coverage to an individual.

PREMIUMS

EMPLOYER PAID –DEDUCTIBLE	INDIVIDUAL PAID - NOT DEDUCTIBLE
EMPLOYER RECEIVES -TAXABLE	INDIVIDUAL RECEIVES – TAX FREE

PROCEEDS

One final point concerning the group contract, with respect to taxation must be addressed. If an employee is paid a taxable disability benefit (because the premium was employer paid and deducted as a business expense) the level of protection must be determined to be aware of possible gaps in coverage. It is common for group plans to cover two thirds or three fourths of wages in the event of disability. Therefore if the employee is receiving seventy fives cents on the dollar through the group disability policy, the income taxes are still owed on this lesser income amount. The after tax benefit now may be only half the gross amount normally paid rather than the usual two thirds enjoyed through actual employment. This gap in coverage should be addressed by the employee who needs to procure an appropriate individual disability coverage amount.

Total, Partial and Residual Disability Definitions

Total Disability is defined by contract to mean that more than 50% of job duties are incapable of performance due to disability. Traditionally, there have been two definitions of total disability according to whether the contract is covering the insured for "any" occupation or their "own" occupation, as follows:

- Insured's inability to perform the duties of **any occupation** for which he is suited or trained, or

- Insured's inability to perform any of the duties of his **own occupation** or profession.

In the marketplace, the availability of the "own" occupation definition has become scarce since its introduction in the early 1980's. This definition became far more costly to insurers in terms of paying benefits than was originally anticipated. **The "any" occupation standard is the one in prevalent use today.** Bear in mind that the benefit cost to an insurance company for a disability plan can far exceed the average payout of a life insurance contract. If a thirty year old, highly successful surgeon becomes permanently disabled his income earning potential over the next forty years is staggering compared to a one time payout of one million dollars as a death benefit for example.

Both the concepts of partial and residual disability, mean the inability of the insured to perform **one or more important duties** of his profession or occupation. Therefore the insured is able to do some job duties, just not all of them.

The benefit payable and the coverage time are reduced or limited compared with total disability. **Usually the breakpoint is 50%**. This means more than 50% disability translates into "total" disability while **at least 50% and no less than a 20%** inability to work **is defined as "partial"** or **"residual."** Less than 20% inability to work does not trigger any payable benefit and means there is no disability in contractual terms.

- **Partial Disability** means that the duty or duties which can no longer be performed are analyzed with respect to their relative dollar worth. The **amount of benefit paid is based on the value of the duties no longer performed**. This is the old-fashioned way of providing less than a total benefit and the language that was used in most disability contracts issued prior to 1980..

- **Residual Disability** is the modern approach used in contracts and it differs from loss of time as outlined above in "partial" disability because the **main function of "residual" contracts are to protect income rather than occupational duties**. Benefits are paid to the insured when they return to work but are unable to perform one or more important duties of the job. Since less than a full percentage of income is earned, **this residual benefit of the policy will pay the difference between full wages and the reduced amount paid by the employer due to the remaining disability.**

Under the modern residual disability definition an insured that has lost forty percent of wages due to a disability will get paid that amount under the policy while his reduced duties at work will be paid by the employer (the other sixty percent of his income). The insured is still being paid at the 100% rate of income he enjoyed prior to his inability to perform one or more job functions.

Uniform Provisions Policy Law

(In 1950 the National Association of Insurance Commissioners (NAIC) adopted the Uniform Individual Accident and Sickness Policy Provisions Law. This law has been accepted in all states).

"Accident and sickness insurance" is an old term for health insurance and is defined in the uniform law as "insurance against loss resulting from sickness or from bodily injury or death by accident or both." One person or more than one person can be covered. Additional people can be insured under a policy including a spouse, other dependents and dependent children less than 19 years of age. Sometimes children who are still full time students are covered up until age 23. Most states have a law requiring that newborn children be included under parent's policies but insurers may require an additional premium. **In 1979 the NAIC simplified the uniform law** and it is supposed to serve as a model for readability. There are seven required or mandatory provisions under this Act and five that are optional.

Required Provisions

1) The entire contract provision - the policy is the entire contract between the insurance company and the insured and no policy change is valid unless the approval of the change is made by an executive officer of the insurance company and is endorsed on the policy.

2) Time limit on certain defenses - designed to limit the period of time which an insurance company can rescind a policy or to defend a claim denial due to material misrepresentation in the policy. There are **significant differences between this and the life insurance incontestable clause.** The incontestable clause, as you will recall, in the life insurance contract runs for a two year period of time from policy issue. Health insurance contracts cannot exceed three years and when fraud is involved, health insurance contracts hold **policy is possible at any time in the future.**

3) Grace period - policies in which premiums are paid other then weekly or monthly must be at least 31 days. It can be as short as seven days when weekly premiums are collected. Policies are renewable at insurance company option and there will be no grace period when the insurance company gives timely notice of intent not to renew.

4) Reinstatement provision - if a policy lapses, the company can ask for a new application, require a premium be paid and will issue a conditional receipt. Reinstatement will be effective as of the date of the insurance company approval. If an application is not required and the premium is accepted after the lapse this results in automatic reinstatement. When an insurance company fails to act on a reinstatement application within 45 days a policy is automatically reinstated. Furthermore there is a 10-day waiting period after reinstatement concerning sickness. During the first 10 days from reinstatement the policy will not cover any sickness for the insured, but it will cover accidents.

5) Claims provision - The insured has to provide a notice of claim within 20 days, the insurance company must issue claim forms within 15 days of receiving a notice of claim and the insured must submit a written proof of loss on a claim within 90 days of the loss. An insurance company must pay claims immediately and no legal action can be taken against an insurance company for at least 60 days after written proof of loss has been furnished.

6) Misstatement of age - an equitable adjustment of premiums or benefits, or both, will be made in the event the age of a person insured has been misstated and such provision must contain a clear statement of a method of adjustment.

7) Beneficiary change provision - required in policies paying death benefits and the policy owner can change the beneficiary at any time unless the beneficiary is irrevocable. In addition to the seven mandatory provisions there are five optional provisions that the company can use (they are not required to use them).

Optional Provisions

1) Payment of claims provision - The company must pay claims and the insurance company can be allowed to pay benefits directly to a hospital, physician or other providers.

2) Change of occupation provision - Benefit or premium is adjusted according to whether a new occupation is more or less hazardous. If the insured switches to a more hazardous job they adjust the benefit down, if they switch to a less hazardous occupation the premium is reduced and any excess unearned premium that was collected is returned to the insured.

3) Over insurance provision - Benefit is reduced proportionally for extra coverage of which the insurance company was not informed. The insurance company must return premiums for excess insurance. This generally applies to companies that are on expense-based systems, like major medical plans.

4) Illegal occupation provision - There can be no coverage if loss results from the insured committing or attempting to commit a felony or engaging in illegal occupations.

5) Intoxicate/Narcotics provision - The company does not have to pay for losses resulting from the insured's getting injured as a result of the use of intoxicants or drugs which were not issued by a licensed physician.

Rights of Renewability

These are contractual definitions that describe which party has the right to renew a contract under specified conditions for precise periods of time. A general **rule of** thumb for **premium cost** is: **the more favorable the rights are to the insured the more expensive the cost.** Therefore, the most costly to least expensive options are:

- **Noncancelable (Noncan)** is a health insurance contract under which the **premium is always level** **(guaranteed)** and, as long as the owner pays premium in a timely manner, the **company has no right to change any stated contract provision or cancel the contract.** This provision is normally available with DI and LTC policies. While this provision is preferred to any other, past losses to insurance carriers from noncancelable contracts have made their availability scarce in the marketplace today. Usually only very low risk occupation groups have access to this type of renewability.

- **Guaranteed Renewable** means the policy cannot be canceled by the company once it has been put into force and so long as all premiums due are paid in a timely manner. **The premium rate is not guaranteed** and may change with claims experience as to same “class” of insureds at their original insuring ages. Rates charged cannot be increased to a single individual.

<u>NOTE:</u> A **"class" of insureds** means all policyholders owning the exact same policy type, within an entire state. Guaranteed renewable is used for DI, LTC and sometimes medical expense insurance.

Guaranteed renewability in a health contract essentially provides a two year incontestable period to the policy owner, exactly the right enjoyed by the life insurance contract owner. Many types of health contracts do not offer this right of certain renewability. So long as the premium is paid on time, the insurance company has no right to refuse coverage after two years from the policy issue date.

- **Conditionally Renewable** provides that the owner of the insurance contract may renew the contract to a specified date or age, **subject to the right of the insurance company to decline** renewal only under conditions as defined in the contract. The **company may not refuse to renew solely because of changes in the insured's health condition** after issuance of the policy. Refusal may be applied to an entire class within a state or because of a switch to a more hazardous occupation or if the economic need for the product has ended (as would be the case if the insured retired, for example.)

- **Optionally Renewable** or renewable at company option provides the company with the right to renew the contract on a year-by-year basis. Such a policy can only be terminated at the completion of, and not during, the coverage period. There are options to the owner either for renewal or for level of premium.

- **Period of Time** provides coverage for a limited period as agreed to and set forth in the contract. Coverage is for a term of time that is normally very restricted in nature when compared to the others, as listed above.

- **Cancelable** - The insurer can end the contract at any time, even during coverage, as long as a specified number of days notice is provided.

<u>NOTE:</u> When DI coverage is added as a rider to a life contract, there is a two year incontestable period because a life insurance is a unilateral contract, unlike most health insurance policies.

Common Policy Provisions

Elimination (Waiting) Period

Benefits under a disability contract are usually paid monthly after an **elimination period,** ranging from a few days to a year (up to two years is the normal maximum), has expired. This elimination period is **a deductible of time** that can keep the cost of coverage lower if a longer (i.e., 90 days, six months or one year) waiting period is selected. **The longer the insured is willing to wait to start the benefit, the cheaper the premium will be.** While some contracts offer almost immediate benefits upon disability, the premium cost can be prohibitive. While the applicant will need to decide a personal comfort level in terms of being able to pay bills without normal income flow, this selection of waiting period is essentially a premium management tool. The normal elimination period selected tends to be in the 90 to 180 day range for most disability income policy purchasers. **Once the elimination period has ended, the first benefit check is normally not paid until up to thirty days later.**

Cost of Living Adjustment

COLA (Cost of Living Adjustment) will adjust benefits each year during long term claims **which are in effect** to reflect increases in the cost of living as recorded and published by the U.S. Department of Labor. Under the terms of a Disability Income Policy, **the insured must be disabled and collecting benefits before this rider will trigger benefit increases.**

The purchase of this rider means the insured will enjoy an income from the policy that will increase to keep place with the inflation rate. This is a crucial idea if the insured is disabled for many years. It will allow the insured to retain purchasing power no matter the length of the disability period. The failure to add this rider would mean that the long term disabled insured is locked into the same dollar benefit every month for the remainder of the indemnity period. Unless the insured's costs to live are frozen in time this rider is a virtual requirement.

Waiver of Premium

No premiums are due after you have been disable for period of 90 consecutive days. Premiums paid for the 90 days will be refunded. This rider takes into account the notion that the insured does not need an extra bill to pay when they are not working due to disability. Since the disability policy is meant to help the financial strength of the insured it makes sense to end the premium cost of the policy once disability is established and benefit payments begin.

<u>Social Security Offset Benefit</u>

Purchase of this rider reduces the benefits paid by the policy to the extent that the insured receives a benefit amount from Social Security. This rider is a key to reducing the overall cost of an individual disability policy. Since the Social Security Administration denies about half of all disability claims, the insured is protected with a full benefit whether it comes solely from the insurance company or it is shared by Social Security. Since insurance companies know that some contract holders will be entitled to these social insurance benefits, they are able to allow individuals full coverage at a lower cost with this rider.

<u>Disability Buyout Contracts</u>

This is a concept similar to the buy-sell agreement concept most commonly associated with life insurance. It **is a business continuation approach** in which the owners of a business agree to buy a disability contract on each other (called a **"cross purchase"**) with the further agreement that should any owner become disabled, the receipt of benefits from the DI contract entitles the non-disabled owners to have the disabled owner's share of the business transferred to them**.** Sometimes the business itself will purchase and own the policies on the insured (this is called an "**entity purchase")**.

<u>Elements of the Buy-Sell Agreement</u>

A buy-sell agreement provides sufficient authority to continue the business in all cases following the disability of a business owner, especially when the owner is a partner or the shareholder of a corporation (particularly a closely held corporation). It is the most common, and usually the most efficient method of providing for the orderly continuation of operation and transfer of ownership of the business entity. Use of such an agreement minimizes the risks inherent for survivors, heirs and estate administrators, and is preferable for creditors, as well.

<u>General Nature of Buy-Sell Agreements</u>

The buy-sell agreement is a contract which provides that one party will buy, and another party will sell, the outstanding ownership interest of another upon the death or other triggering event, such as permanent disability, of the owner.

At the outset, the desire must be present for the business to continue. Assuming that such a desire exists, a preliminary step to creating a buy-sell arrangement, the proper party to continue the business must be identified. If the business a partnership, identification of the proper party may be somewhat simple, because the successor party will usually be the remaining partners. If the business is a closed corporation, the successor may be one or more of the remaining shareholders. In any case, *identification of the proper successor is key to the success* of the buy-sell. If the successor cannot be identified, there is no reason to attempt to implement the agreement.

Assuming that the desire for continuation exists, and that the successor is identified, a buy-sell agreement is crafted. The terms of such an agreement may vary, but generally will provide that the successor will purchase the interest of the owner upon the owner's death, retirement or other triggering event (such as disability). The purchase price and terms will be clearly set forth, as well as the time frame in which the purchase is to take place.

Just as the buy-sell agreement is the preferred method of transferring control of a proprietorship to a chosen successor, the *partnership buy-sell agreement* is the best way to continue a partnership. The buy-sell has the advantage of being Pre-arranged and, unlike some other attempts to continue a partnership, legally enforceable. It also removes the possibility of conflicts of interest on the part of the administrator of the decedent's estate.

Like proprietorship buy-sell agreements, partnership buy-sell agreements are in the form of written contracts between partners under which the surviving partners agree to purchase the business interest of the deceased partner at a price set forth in the agreement. Alternatively, the business can be valued at the time of the triggering event according to a calculation set forth in the agreement. As is the case with proprietorships, it is critical that the successor partner be identified and be capable of, and motivated to, continue the business of the partnership.

The preferred method for transferring control of a corporation is a buy-sell agreement. Normally, such agreements are for the purpose of transferring the stock of a deceased or retiring shareholder. However, similar agreements can be used to transfer title to assets.

In most respects buy-sell arrangements for corporations are similar to those for other types of business organizations. However, the great flexibility of ownership structure provided by the corporate form allows similarly increased flexibility in formation of the agreement.

As mentioned above, corporate buy-sell agreements can be any of several types. These include arrangements under which:

- The corporation (or, if impossible, the surviving shareholders) must buy and the estate of the surviving shareholder must sell.

- The corporation, or the surviving shareholders, have an option to purchase the stock of the deceased shareholder.

- The estate has the right, but not the obligation, to offer the stock to the survivors or to the corporation. Normally, if the stock is offered, the offeree is obligated to purchase.

- There is no obligation to buy or sell, but if a shareholder or his estate wants to sell, the shares must first be offered to the corporation or to the surviving shareholders before it can be offered to third parties.

The possible combinations are nearly without limit. However, as in other buy-sell arrangements, the success of the arrangement may hinge on identification of the successors, their motivation to continue the business, and their financial ability to purchase the stock.

The agreement itself can provide for the necessary funding by specifying the use of insurance. Use of insurance to fund buy-sell arrangements is generally the most predictable and efficient way to guarantee the availability of funds.

Cross Purchase

A cross purchase agreement is used in situations where there are just a few partners. One reason is that such a plan is more expensive to implement because of the number of insurance policies which must be purchased. In essence, each partner insures the health of all the other partners against total and permanent disability, with himself as beneficiary. The partnership does not participate in the transaction directly.

Due to the expense, the cross purchase arrangement is usually not workable if there are more than three or four partners. For example, if there are two partners, A owns insurance on B, and B owns insurance on A, so a total of two policies is required. Where there are three partners, A owns policies on B and C, B owns policies on A and C, and C owns policies on A and B. Thus, six policies are required. Generally, the number of policies required is

$$P * (P-1),$$

where P is the number of partners. Thus, in a 4 man partnership, twelve policies would be required, while if there are five partners twenty policies would be used. It is easy to imagine that the cost quickly becomes prohibitive as the number of partners increases. For that reason, the cross purchase arrangement is seldom used for larger partnerships.

Entity Purchase

The business entity will purchase and own the disability policy on the lives of all business owners. The prearranged buy-sell contract will call for the disable partner to accept a one time, lump sum payment from the insurer in return for their stake of ownership in the business. The remaining, healthy owners then will absorb this additional ownership in shares as stated in the agreement. This one time lump sum payment is normally the equivalent of five years income and is available from a limited number of specialty insurance carriers who exclusively work in this market.

Use of Insurance: Premium Selection and Payment

It was noted above that premiums on life insurance contracts are normally paid (and the policies owned) by the partners, if the contemplated transaction is of the entity purchase type, and by the partnership itself if the cross-purchase arrangement is used. However, other arrangements may be made. How the premium payments are allocated should be spelled out in the agreement, since calculation of the allocation can be somewhat complex. **This is because many of the same factors discussed above may apply. The partners may all have equal interests, or they may not. There may, or may not be great disparity in age and health consideration.** As set forth above, inequities may result if all eventualities are not planned for from the outset. These concepts must be addressed and resolved in the written buy-sell document

Disability Underwriting Considerations

Disability underwriting is different in form and scope than is than life insurance underwriting. Generally it is harder to qualify for standard rates with disability insurance. The underwriters look at:

● Health – Any recurring sickness or injury will cause elimination riders and rejection.

● Income – Must have earned income for a period of time, such as 2 years prior. Tax returns must be submitted for verification.

● Occupation – Occupational classifications have a direct impact on benefits, eligibility and premiums. The more "blue collar" and manual labor involved in the occupation, the higher the risk, resulting is higher prices, shorter benefit periods and possible rejection. However, people in the glamour occupations like highly educated and paid professionals pay the least amount per hundred dollars of coverage while enjoying the longest coverage periods.

● Driving – DUIs, speeding tickets and reckless driving could get you rejected.

● Underwriting must also include compliance with provisions of the Fair Credit Reporting Act - this is a fed**eral law that helps insure** that applicants for insurance are treated in a fair, accurate and confidential manner. The Act says that these reports ***can only be furnished for certain purposes*** and one of those purposes is for underwriting insurance. The Act prevents any party, including an insurance company from obtaining reports from outside agencies unless the applicant is aware that such reports may be obtained. ***Permission must be granted in writing*** before an insurance company can obtain a report from a credit reporting agency.

All applicants for insurance must sign disclosure statements in order to assure compliance with the Act. In the event information contained in a credit report results in an lesser offer (which is technically called and **"adverse action"**) from an insurance company to the insured, the **insured has the right to a free copy** of the credit report **and a description of the rights** afforded under the Act. This **free copy must be provided by the original credit reporting agency,** not by the insurance company.

The Act also provides consumers with an opportunity to find out information that an investigative agency has used about them and to whom such reports have been made. If consumers are dissatisfied or dispute any information within the reports, they may demand a reinvestigation with corrections sent to anyone who received the prior incorrect consumer report. This Act only applies to investigative reports that are made from outside (third party) sources.

● Attending Physician Statement (APS) are another manner in which underwriters can verify the statement made by an applicant concerning current state of health. The insurer will ask for the opinion of the personal physician of the applicant as to current health.

● Driving Record- to obtain preferred rates, insurance companies will do a motor vehicle report. They are looking for DUIs, speeding and reckless driving charges. A bad driving record will not qualify you for preferred rates. If your driving record is bad, especially with a DUI, you will get rejected. The thinking is that a person prone to reckless driving histories are more likely to become injured and disabled than those who have excellent driving histories

● Substandard -there are certain companies that will take greater risk than most companies. They are called substandard companies. They will charge more, adjust benefits and limit coverage. They base their underwriting on the same factors plus their experience in suffering losses historically. These companies will underwrite and approve policies which the majority of companies will likely reject. They also will specialize in certain conditions such as heart problems or cancer. It takes a very experienced agent to know these companies and how they operate.

Business Overhead Expense (BOE)

Business Overhead Expense (BOE) is **designed to help business owners** meet regular periodic and relatively stable business expenses for which the owner is responsible during a period of total disability to the owner(s). **Expenses such as rent, utilities, employee salaries, etc., can continue to be paid even when the owner temporarily cannot help bring in as much revenue to the company because of a total disability**. The BOE is usually added as a rider to the individual DI policy of a business owner, but it is also offered as a stand alone policy.

The theory behind the use of the BOE is simple: once benefits are drawn on a personal disability income policy, the disabled business owner also faces additional expenses associated with running a business. Since the owner is unable to attend to the normal duties of the business, income to the firm is likely to suffer. Without BOE coverage the disabled business owner could be faced with some difficult choices such as closing the business or be forced to sell it hurriedly for a fraction of its worth .

Since a BOE policy can usually be purchased for up to a two year period, it provides ample time for the insured to either recover from the illness or accident or make sale arrangements without immediate pressures to sell for a reduced price.

Social Insurance

Social insurance, also referred to as **OASDHI** (Old Age, Survivorship, Disability and Health Insurance), is a safety net of risk transfer created by government and paid for by tax dollars.

■ **Old Age** benefits refer to the monthly income amount paid to the recipient upon attaining retirement age. Age 65 is the standard age for full benefits while a reduced benefit can be taken by age 62 for those who qualify.

A worker must normally have 40 quarters or ten years of participation under social security to be entitled to OASDHI benefits under the definition of "fully insured," otherwise an individual is called "currently insured" and receives a correspondingly lower benefit amount in the various benefit categories. Each working American has a social security tax amount deducted from wages and the actual amount paid varies according to wages earned.

There are several Survivorship Benefits:

- Lump Sum death benefit of $255

- Widows or widowers age 62 or over.

- Widows or widowers disabled age 50 - 59.

- Widows or widowers any age if caring for deceased worker's child (up to age 18 {age 19 if completing last year of high school} regardless of education) are entitled to survivorship benefits.

- Dependent parents age 62 or older.

Social Security Disability Income

This very important social insurance benefit but qualifying for it can be elusive. Disability insurance through Social Security is available to qualifying participants under the system. Here is all a citizen must do to receive a social security disability benefit:

► The earliest a benefit will be paid is at the end of 5 **completed months** (under age 65) of disability. However, most applications are denied. An appeal process can usually take up to year or longer and again, the majority is upheld in favor of the SS administration;

AND

► **To qualify for benefit,** an insured **must have a disability** which is **expected to last at least 12 months** (or longer) or result in death (sooner, before the 12 month period is completed). Blindness is automatic qualification.

This means you have to be starting a six consecutive month of disability AND a doctor has to commit in writing that the only reason you will not be disabled for at least one year is because you will likely die first! The frustrated and denied applicant can always resort to ripping the eyeballs from his sockets to get the benefit, however.

Disability Rider Use in Mortgage Coverage

Probably the most important insurance rider could ever purchase for the use of term for covering the balance of a mortgage loan is a disability income rider. It is recommended to purchase enough to cover the monthly mortgage payment including taxes. If it is affordable, it is also a good idea to purchase additional monthly income to cover other expenses associated with the house. Most riders to mortgage term policies cover up to a max of $1,500/month. Purchasing additional coverage above the rider amount will require the use of a separate individual disability contract. Disability income riders usually provide a benefit of from two to five years.

Chapter 9: Ethical Considerations

(2 exam questions)

Disclosure

Full disclosure of life insurance is not only a good idea, it is required by law. A policy summery and buyer's guide to life insurance must be left with everyone no later than policy delivery. If the insurance buyer upon delivery decides not to accept the coverage, the Free Look provision of the contract entitles them to a complete refund of all premium paid. Insurance companies may call potential insured's to see that disclosure compliance has been satisfied. The outline of coverage will briefly explain the insurance and review the underwriting procedures.

Compliance and State Advertising Laws

Today, every insurance company has compliance departments who oversee that the consumers are treated fairly according to company policy and the law. These compliance departments protect the agent as well as the insurance company. State insurance departments are very consumer oriented and will do whatever it takes to protect the insurance buying public. Insurance companies and agents are licensed by the state and must comply with all regulations and laws. Insurance companies will do the same.

All companies require advertising materials to be approved before use with the public. **Virtually every state has laws governing the spreading of deceptive or false advertising as illegal, with punishment as a misdemeanor.** Another common prohibition stops insurance companies from using a person's name or likeness for advertising without consent.

There are **three main state laws that regulate insurance** advertising and they include the **Model Unfair Trade Practices Act, Model Rules Governing Advertisements of Accident and Sickness Insurance, and Model Rules Governing the Advertisement of Life Insurance.** Under the Unfair Trade Practices Act there are **five prohibited trade practices** which are considered to be unfair and they include discrimination, rebating, defamation, false advertising and unfair claims settlement procedures. False advertising specifically includes misrepresenting a policy benefit, advantage, etc., also misrepresenting dividends, an insurance company's financial condition and the insurance policy's true nature by stating an insurance policy is a share of stock.

Under the Model Rules Governing Advertisements of Accident and Sickness Insurance every state except three including Alaska, Montana and Hawaii has adopted this rule. Model rules are designed to make certain that **truthful disclosures** of all important and relevant information regarding accident and sickness insurance are being advertised. These rules apply to any sickness, accident, medical, surgical or hospital expense policies intended for distribution or sale within a state. The important terms defined by the model rules include; a policy meaning any accident or sickness policy plan, contract agreement certificate and statement of covered rider or endorsement. It also defines exception, eliminates specific hazards from coverage, defines reduction provision which reduces the amount of the benefit and also limits any provision which restricts coverage as not an exception or reduction.

There are three types of advertisements defined by the model rules they include an institutional advertisement which just promotes viewers or readers interested in the concept of accident and health insurance or the promotion of the insurance company, an invitation to inquire further about a product and an invitation to contact. Included is the cost of the insurance which is being advertised. Exaggeration of benefits beyond the policy terms is prohibited. **Words that are exceptionally objectionable** in such advertising include "all comprehensive," "up to", "as high as" and "complete". Preexisting conditions must be expressly defined and must not appear to be a benefit in the advertising. A paid third party endorsement must be genuine and must also be the endorser's current and actual opinion. An insurance company's identity must be clearly disclosed and no statements discrediting other insurance can be used.

In the Model Rules Governing Advertisement of Life Insurance, words like "profit," "savings" and "investment" must be used in conjunction with life insurance contracts carefully. Disclosure requirements must include that policies cannot be issued upon a guaranteed basis upon application and it will depend on answers to health questions. Advertisements must clearly indicate the policy to be life insurance and the advertisement has to disclose any changing benefit features, for example increasing or decreasing premiums as an insured gets older. Guaranteed dividends may not be implied and interest rates must be disclosed. Finally, the ad must state deferred annuities or deposit funds do not give a cash surrender value before a benefit payment begins.

Model laws are passed by the National Association of Insurance Commissioners NAIC and they seek to make the administration and regulation of the insurance business more uniform from state to state. In referring back to the section on state laws, three model laws were described. These model laws all set forth some uniformity in the application of state attitudes and regulation of the life and health insurance contract business.

<u>Direct Response Advertising</u>

When an insurance company does not use an actual soliciting agent but rather solicits the inquiry about the sale of an insurance product to consumers through direct mail, mail order and mass merchandising it is a direct response advertisement. Direct mail and media advertisements include television, radio and print which are used to sell life and health insurance products supplementing basic individual life and health policies sold through traditional sales channels.

The problem with direct response solicitation is the applicant for insurance does not have the ability to discuss the terms of the contract with an agent. Therefore, this applicant has to rely heavily on the advertisement to understand the nature of the contract. Some court jurisdictions have held the advertisement is binding on the insurance company. In the event there is a claim settlement action brought by an applicant, the NAIC Model Unfair Claim Settlement Practices Act, which is part of the Model Unfair Trade Practices Act, states a claim cannot be settled for less than the amount which a reasonable person would have believed an applicant was entitled to because of the reference to written and printed advertising which accompanied and was made part of the application itself.

Another main concern is direct response advertising is often done on an interstate, rather then just intrastate, basis. Unless an insurance company is licensed in a state it is considered to be an unauthorized insurance company and is not legally allowed to transact direct response business in that state. **Insurance companies must make certain that direct mail advertising is not sent into a state where the insurance company is not licensed to conduct insurance business.** It is difficult to have this control since newspapers, radio and television often cross state lines. If companies print a disclaimer that a policy will not be sold a specific state, it usually offers protection for the insurance company against violating this model law.

<u>Agent and Group Insurance Advertising</u>

Insurance advertising is any oral or written material whose purpose is to invite public interest or to influence the purchase of life or health insurance policies. An advertisement includes promotional literature, actual sales presentations, direct mail and use of media including radio, television and print. Since each state has advertising laws and advertising is done across state lines, complex situations are created. Rules governing advertising apply to both agents and contracts offered for group coverage purposes. One standard question which often arises about the sales presentation of an agent is whether an illustration is considered as part of the contract or simply as promotional literature.

The **most often followed rule is illustrations are estimates and are not intended to be part of the insurance contract.** The Parol Evidence Rule stops the admission of evidence outside of a written contract if it would alter, contradict or vary the terms of the contract. Since illustrations are not written statements attached to the contract, they are not part of that contract. Any agent that provides intentionally false statements in trying to effect a sale allows the person who is harmed to sue on the basis of fraud in order to rescind, void or even reform the contract.

The concepts of waiver and estoppel are available to insureds to broaden their coverage under group life and health insurance policies. The rationale is an individual covered under group insurance probably did not have the opportunity to read the master policy. If an insured depends on promotional and advertising literature and the group certificate for policy information, any information in those documents can be held to be used in favor of the insured in a court action. If the literature of advertising contained terms which are more favorable to the insured than the actual master policy, the insurance company will be forced to waive the terms of the master policy and be estopped from denying and providing the more favorable terms listed in the promotional literature.

The main purpose of these federal and state advertising rules is to protect the public from possible wrongs done, either intentionally or unintentionally, by insurance companies, their agents and independent contractors. Insurance law and regulation is a dynamic field which is constantly changing and the struggle between where state law ends and federal law picks up is constantly changing. In today's modern legal environment, consumers have more protection then ever have before and the trend continues to broaden public protection as much as possible.

Replacements

Most states have replacement laws to protect the consumer. Replacements should only be done if it benefits the insured. DO NOT replace policies if it is not in the insured's best interest. If your state requires replacement forms, make sure you fill them out and make the proper disclosure to the insurance companies. Replacements are considered unacceptable when such action is unjustified. Policies should be shown to office supervisory personnel when there is any doubt about replacing existing coverage so that a proper comparison and explanation can be provided to the client.

In many states **Replacement is defined as**: any transaction where it is known that as a part of that transaction, any existing life insurance will be:

- Lapsed or surrendered.
- Converted to other nonforfeiture benefit.
- Be converted so that a loss of benefit or time in force occurs.

- More than 25% of cash value will be drawn from one or more existing policies.
- Reissued with any reduction in the cash value.

Replacement is therefore defined much more broadly than only lapsing or surrendering an existing contract. It also includes the idea of lessening or reducing, yet keeping, an existing coverage.

Illustrations

Most insurance companies require illustrations to be signed and submitted with the application. This is required for all whole life, variable or universal life policies due to the cash value and dividend projections. It is not required for term policies. This is again to protect the consumer. Only use company illustrations and never create your own illustrations. Remember, anything you show a prospective client is considered advertising and subject to compliance with all state regulation.

Professional Liability Insurance

Malpractice

This c**overage is designed for the physician, surgeon dentist and hospital category of professionals**. Within these groups are specified forms for specialty practitioners such as anesthetists, psychiatrist, chiropractors, etc. **Other forms are available to such diverse occupations as beauticians, morticians, veterinarians, etc.** The central risk of liability in malpractice is created from harm done to the person, rather than property for the most part, although there are some exceptions (i.e. the veterinarian). In addition to **coverage for bodily injury, other personal injury losses are covered such as mental anguish**. **Intentional harm is not excluded** since the act of a professional inflicting damage on purpose is not the exercise of due care of the skill expected of the members of a professional group.

Past malpractice policies were written on an occurrence basis but this proved very costly for insurers and a **switch has been made to the claims made form.** Another fundamental change has been to eliminate the requirement that the insurer had to get **the permission of the insured to settle a legal act**. This was designed to protect a professional's reputation but resulted in losses that grew out of control in some cases. **Today most malpractice policies are written without a clause requiring permission from an insured** to settle a lawsuit.

<u>Errors and Omission</u>

Most insurance companies are starting to require Errors and Omission insurance. In fact, some states are starting to require E&O as a condition of licensing. **In today's litigious environment, a licensed insurance professional should consider the purchase of E&O insurance**. E&O insurance will not cover fraudulent or dishonest acts. One out of seven insurance agents is involved in an E&O claim each year.

Errors and Omissions coverage protects the professional from the failure to render professional services which result in property damage (including intangible property such as insurance, real estate and other legal contracts) to customers. **Occupations typically purchasing** E&O insurance include

- Accountants
- Architects,
- Engineers
- Insurance agents
- Real estate brokers and agents
- Stockbrokers
- Travel agents

Most policies offered today are of the claims made variety and do not require the permission of the insured in order for the carrier to settle a lawsuit.