CONSIDERATIONS FOR BUYING LIFE INSURANCE

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CHAPTER I

INTRODUCTION

The insurance industry has always been somewhat of a mystery to consumers. New product designs are confusing to insurance consumers. The problem is further compounded, according to a recent Consumer Reports article (July 1986), by a lack of understanding of some of the policies by insurance agents themselves. How can consumers be sure if they're buying the right amount of coverage at an inexpensive price? Furthermore, can consumers intelligently evaluate the agents' answers? Many experts believe that most consumers cannot evaluate insurance needs and policies because of lack of knowledge on insurance matters (Tobias, 1983).

Some insurance product designs are innovative, but others are old products with mild variations and catchy new names. Today, the insurance buying consumer is faced with a myriad of policies with different names, examples include: universal life, variable life, excess interest, current assumption life, vanishing premium, and modified "5" life. Insurance product names tend to confuse consumers.

The biggest problem consumers have with buying insurance is a failure to understand the various policies (Tobias, 1983). The saying, "insurance is not often bought, it is sold" is more than a saying--it's often a fact. This was corroborated by the Oklahoma State Insurance Commissioner's Office. Mr.

Grimes, the Insurance Commissioner, stated that many of the complaints his office handled were due to the consumer's failure to understand the provisions of their policies.

The need for insurance to many consumers is nebulous. Insurance consumers tend to confuse insurance programs with investment programs.

In an attempt to keep ahead of inflation and keep their policies current, consumers are switching policies, often with disastrous results (Smith,November 1984). Insurance agents often perpetuate this with their inculcating sales pitches and by manipulating the real rate of return on cash value policies (Quinn, January 1986). The lure of having a lump sum of money after twenty or thirty years makes people lose sight of the basic purpose of life insurance: to provide an efficient predeath arrangement for an effective postdeath balance between resources that will be needed and those that will be available (Mehr and Cammack, 1972).

NATURE OF THE PROBLEM

Buying life insurance can be perplexing. There are considerable differences in policies. A good insurance program may be difficult to plan if the person does not understand some of the basic tenets for buying life insurance. One type of insurance cannot fit neatly into all financial plans.

The insurance industry is a complex and changing market, leaving consumers at the mercy of insurance salesmen (Tobias, 1983). Some agents may not be acting in the consumer's best interest. Many insurance policies sold by agents offer excessive or insufficient coverage. Without the ability to accurately evaluate various policies, the consumer's decision can have detrimental results.

PURPOSE

1. This paper was written to help consumers understand basic principles for buying life insurance.

2. Information will be presented that will help the reader maximize his/her insurance dollars.

ASSUMPTIONS AND LIMITATIONS

1. For the purpose of this paper, life insurance has been classified into three categories; term, whole life, and universal life.

2. No attempt was made to deal with specific policies offered by specific insurers.

3. Due to the complexity of the life insurance field, evaluation of differences in insurance policies is limited.

4. Some of the legal principles and regulations affecting policies have been presented only to add clarity to the provisions that the insured may encounter. Contract analysis is beyond the scope of this paper.

Definition of Terms

The following definitions clarify terminology:

1. Agent. The insurance companies's salesman who may represent one or more companies. He takes your application but does usually approve it. This term is used in this paper to represent persons engaged in the sale of insurance.

2. Beneficiary. Person or persons designated to receive the proceeds of the policy in the event of the insured's death.

3. Cash surrender value. The amount the policyholder would receive if he were to surrender the policy. The owner receives the money but the policy is cancelled.

4. Face Amount. The amount specified on the policy that the beneficiary would receive if the insured were to die. Same as face value.

5. Insurability. The determinant of medical qualification. A person with a poor health would be a high risk for insurance companies. Such a person could be said to be uninsurable.

6. Insured. The person covered by the policy. May or may not be the policy owner.

7. Insurer. The company that writes and accepts some degree of risk for the insurance buyer as specified in the policy.

8. NASD. National Association of Securities Dealer.

9. Nonparticipating Policy. A policy that does not pay dividends.

10. Participating Policy. A policy that pay dividends to policyholders.

11. Premium. The charges for the policy. Premiums are charges the policyholder will pay, for the insurance and, if applicable, for cash value buildup.

12. Recission. Means cancellation of a policy.

13. Rider. Attached options to the policy that may give the insured increased flexibility. Usually a charge is added for the rider.

13. Risk. The chance that loss will occur.

14. Underwriters. A staff of full-time risk analyzers. They determine whether an applicant should be approved for insurance.

CHAPTER II

INSURANCE CONSIDERATIONS

Many consumers who buy life insurance rely on information presented by insurance agents. Usually it is the agent that assesses the consumers' needs and the amount of insurance needed. However, consumers should have the ability to determine his or her needs.

Life insurance does not guarantee a longer life. Its prevailing function is to provide death benefits and peace of mind that the insured's financial's affairs will be taken care of should he or she die unexpectedly. In a sense, the term, life insurance is a misnomer--it is death insurance (Mehr and Cammack, 1972).

The amount of coverage needed to attain the desired peace of mind cannot accurately be assessed as a strict percentage of your current income. Other things to consider include:

1. Marital status
2. Amount of outstanding debts
3. Children's ages
4. College fund for children
5. Cost of funeral arrangements
6. Spousal employability
7. Family dependence on two incomes
8. Financial condition of insured's business
9. Social Security provisions

Often these item are never considered until an agent sells the insurance (Consumer Reports, June 1986).

Before buying insurance, the consumer should develop a chart listing of assets. Next create a chart listing all liabilities. Future expenses, such as college expenses or burial costs, should be included in the liability chart. Following is an example of what an insurance chart should include (Consumer Reports, June 1986):

ASSETS	LIABILITIES	FUTURE EXPENSES
Saving accounts	Mortgage payments	Probate costs
Equity in real estate	Personal debts	Funeral costs
Securities	Business debts	Uninsured medical costs
IRA or Keogh accounts	Subtotal:	College fund for kids
Current life insurance		Taxes
Social Security		Total:
Other assests		
Total:		

Total both charts; then subtract assests from liablities. If liabilities exceed assests, a basic insurance need exists.

This process does not incorporate investment considerations. It is a calculation to determine income needs.

A common criteria for insurance need is dependence. Single people normally do not need insurance unless someone is dependent on their income for support (Belth, 1973). Young married couples also have very little need for extensive coverage. With the exception of two-wage earners dependent on each other for debt reduction. Married couples with young children have the greatest needs. If the main provider were to die unexpectedly, young children must be provided for, for a number of years. In addition, college expenses may be anticipated. Life insurance amounts on the husband/wife policy should be based on need. Does he or she have an income to be replaced? Is there a dependence on both incomes?

Children usually have no incomes to replace and no one dependent on them for financial support. Smaller amounts of insurance may be bought to cover burial and other related expenses should their death occur. Remember, the basic reason to buy life insurance is to replace income lost by death. If there is no income to replace, then insurance need is nonexistent or minimal (Mehr and Cammack, 1972).

A family's insurance needs usually decline as the parents age. The children have matured and college age has passed. The mortgage may be paid off. The couple may be retiring or retired. There are exceptions, such as people who marry spouses that are many years younger and/or have young children.

Once a person's needs have been assessed, one should determine what the insurance should accomplish. Should it simply provide death protection, or should it also be an investment vehicle (Wasik and Quade, September 1986)? The amount of insurance dollars available may be a determinant. Income and future income projections are also important, Buying the cheapest policy in town is not the smartest way to use insurance dollars (Consumer Reports, June 1986). A person has to evaluate what the policy offers and what the policy will cost over the years.

If investment return is important, then term insurance is not the policy to choose. In considering "cash value" policies one must determine the real rate of return. Furthermore, there may be management and administrative costs. Many times the costs and how they are assessed are not fully explained to the insured. The costs detract from the real rate of return (Quinn, January 1986). Insurance policies that emphasize investment are being aggressively promoted (King, February, 1986). Older whole life policies guaranteed a rate of return between two and five percent. Newer policies, such as universal life, have flexible rates of return. Other policies guarantee no set rates and in most cases, are more expensive. If the insured is greatly concerned with investment value, he/she must take into account tax considerations. Interest accrued is not taxable unless the policy is surrendered. In other words, if the money is removed and the policy cancelled it may be taxed. The tax will be levied only on the amount that is in excess of the premiums paid.

Dividends paid are usually taxed unless they exceed the premiums paid. Not all companies pay dividends and the amount usually varies from year to year. Agents should not guarantee dividends. They may present figures illustrating dividend figures (Consumer Reports, June 1986), but they are not guarantees nor estimates. They are the company's current dividends scale. In actuality, dividends are partial refunds of premiums.

The size of estate upon death will determine if Federal Estate or State Income taxes will be assessed. An estate under $600,00 will not incur taxes. If the estate exceed $600,000, the policy owner may wish to transfer ownership.

Ownership may be transferred to the beneficiary or anyone else (Lang and Gillespi, 1984). If the insured is not the owner then the policy proceeds will not be included as part of the deceased's estate. New tax legislation is currently before Congress. Changes to the tax code may affect insurance needs and investment philosophy. Many families will need to re-evaluate their present financial situation. Insurance goals and policies should also be re-evaluated.

Lastly, when determining insurance needs, consider health and employment future:

*State of health?

*Possibility of losing job?

*If self-employed, stability of future income?

*These same questions need to determined for a spouse.

Poor health could cause a lack of insurability. Whole life policies cannot be cancelled for declining health reasons, if the policy has been in force for two years. If the policy is term insurance, it may not be renewed. If job loss occurs and the premium cannot be paid, this is grounds for cancellation. With some policies, options are available that could answer these contingencies (Huebner and Black, 1982). That is why insurance needs vary and the policy must fit individual needs. Special provisions and riders will be discussed later in this paper.

Once insurance needs have been determined, one must now find an agent. Consumers will be more prepared to buy life insurance that fits both his budget and requirements when he meets with an agent.

CHAPTER III

CHOOSING THE AGENT AND THE COMPANY

When choosing an agent consider the qualifications of the agent. The criteria for selecting an agent should be as stringent as choosing any other professional advisor. How much confidence can one have in a doctor who attended medical school in Grenada and finished last in his class? Would it be wise to hire a lawyer to handle one's precarious legal matters if he failed the bar exam numerous times? How reliable would an accountant be if he received his degree from Bob's Engine Repair and Accountant's Correspondence Course. Though the analogies may be extreme, these premises can all mean disaster, The point is, agents must be competent.

The search for a good agent in buying insurance is essential. We can assume that a good agent is associated with a good company (Mehr and Cammack, 1972). However, one cannot assume a good company is represented by a good agent. Many life insurance agents represent more than one company.

The qualities of an agent vary. Look for agents that are conscientious and have a good reputation. Integrity is important. All agents have to be licensed but the requirements vary in each state. Agents that have a professional certification, such as Chartered Life Underwriter (CLU) or Chartered Financial Consults (CHFC), are preferable. Certifications imply that agents have studied life insurance and family services extensively

(Macaller, Spring, 1985). This is not a guarantee that the agent will be helpful, but it does demonstrate competence. Depending on which form of insurance the consumer may want to buy, there may be further licensing requirements.

Some of the new product design such as variable life policies require that the agent be licensed with the NASD. According to <u>Consumer Reports</u> (September 1986), only 30 percent of all insurance dealer's are NASD licensed.

There are really two sources of information concerning quality of agents: other agents and former buyers. Depending on their individual experiences with the agent, buyers' information may vary. Negative comments by other agents could be for business rivalry reasons. After considering the source, give weight to what is said. Attempt to get pertinent answers to pertinent questions:

1. What is the extent of his experience?
2. Does he specialize in certain policies?
3. Who are the majority of his clients?
4. What is his reputation with buyers/peers?
5. Does he engage in continuing education?
6. Does he thoroughly evaluate one's needs?
7. Does he answer questions and complements them with "current" figures when applicable?

Remember, few insured people read and understand their policies (Huebner and Black, 1982). If a claim was settled to their dissatisfaction, ill-feelings may exist. Depending on the individual's knowledge of insurance, the consumer must evaluate their reasoning and decide if their opinion is valid (Huebner and Black, 1982).

Agents are businessmen. Often the lure of profits transcend their desire to give good advice. An agent should not come prepared to sell a specific policy. He or she should discuss insurance needs in depth with the consumer. After serious consideration, recommendations and alternatives should be presented. The insurance agent should not be allowed to make the decision of which policy to buy. Agents who indirectly refuse to answer questions or deny presenting requested amplifying figures should be avoided.

Consumers are often attracted to policies by erroneous information presented by the agent. Manipulation of figures, partial truths and ommission of clarifying information can convince consumers they are buying the right policy (Consumer Report, July 1986). It is the consumers' responsibility to demand the information. If requested information is denied, another agent should be contacted. After the agent makes the presentation, the consumer is not obligated to buy anything. Careful analysis of the information presented is critical, if the agent becomes impatient, find another agent. Consumers should never capitulate to an impatient agent if they feel uncomfortable.

The agent ultimately chosen should be concerned with the family's welfare. Whether or not he has good contacts, is knowledgeable, thorough in his analysis of policies, and respectable is irrelevant if the agent is not concerned about each consumer's specific insurance needs (Macaller, Spring 1985). Agents may be reluctant to sell term insurance because of low commissions. However, if insurance is what the consumer needs and the agent attempts to dissuade the consumer to buy a more expensive whole life policy, another agent should be sought. An agent should provide the desired policy at the most favorable price.

If the insured has a claim, the agent could help. Although the agent has no "official" position, he can provide advice and information (Mehr and Cammack, 1973). Don't expect agents to support invalid claims. Once comfortable with being able to evaluate an agent, the consumer must evaluate the insurer.

CHOOSING THE COMPANY

It seems like everyone is trying to sell life insurance. A person can buy life insurance in the airport, over the phone, through the mail, in department stores, and at banks. Buying the best policy in the world at the cheapest price would be irrelevant if the company folds the next day. A person should choose a company that will provide the coverage needed and remain solvent throughout the life of the policy.

Life insurance companies are classified as stock or mutual. There have been attempts to further classify them into "participating" and "nonparticipating" companies. Most sources deem this as inappropriate (Huebner and Black, 1982).

Both stock and mutual companies offer both kinds of policies. Stock life insurance companies are owned by policyholders. Numerous laws, varying by state, regulate the organization and operation of both types of companies. The intent of this section is to provide information that needs to be evaluated when selecting a life insurance company. The law and regulations imposed on insurance companies will be dealt with only to the degree necessary to clarify an understanding of differences.

Stock life insurance companies are run to profit the stockholders. Stocks are issued and dividends aid. Both participating and nonparticipating policies are offered. The dividends vary each year and are paid on a basis corresponding to a percentage of the face amount. For example: if the face amount of the policy was $10,000 and the company paid a dividend of $4.50 per $1,000 of coverage, the policy would earn $40.50.

Stock companies are controlled by a management group. Stockholders that own the largest percentage of shares are said to have "controlling interest." Policyholders have very little control over the operation of the company, although they are occasionally given the right to vote for members of the Board of Directors (Huebnerand Black, 1982).

The policyholders are the owner of mutual life insurance companies, but only in theory do they control the company (Huebner and Black, 1982). Control by policyholders is limited because: 1) The policyholders are numerous; seldom holding more than one policy. 2) The geographical locations of the policyholders are also numerous and widespread. 3) The interest of the policyholder is minimal because there is relatively little at stake. 4) Even if there were a great deal of interest, the information they may have is usually minimal. Basically, the company is run by the Board of Directors and the company's officers, with very little input from the policyholders (Huebner and Black, 1982).

Mutual companies most commonly offer participating policies. They can offer both participating and nonparticipating in some states. Other states such as New Jersey and New York prohibit the sale of nonparticipating policies from mutual companies (Huebner and Black, 1982). All three classes of insurance (term whole life, and universal life) have participating policies . Participating term insurance dividends are small; therefore, cannot be used as a basis for making a decision.

The quality of the insurance company and its management are key factors in choosing a life insurance company. These qualities are not easily identifiable. As in choosing an agent, the consumer must seek knowledgeable people and weigh their comments based on experience. Any experience with claims department should be discussed. Adverse comments should be considered, taking into account the individual's knowledge of insurance matters, financial acumen, and specific experiences with the insurance company. Unbiased comments may be difficult to find.

The library is a good source of information. <u>Best Reports</u>, the insurance industry's equivalent of <u>Standard and Poor's</u>, rates insurance companies annually. Best Reports give in-depth details on company history, personnel, investments, operating results, underwriting results, and other financial data (Mehr and Cammack, 1972). The company's rating scale is as follows:

A+=Excellent

A =Excellent

B+=Very Good

B =Good

C+=Fairly Good

C =Fair

Best Reports also has a rating scale for net safety factor. The scale ranges from AAAAA, a net safety factor of over $25,000,000 to a CC rating, a net safety factor of less than $25,000. This rating is based on a surplus to policyholders, plus equities, minus any indicated shortage in reserve (Best Reports, 1986). Choose companies that have the A+ or A ratings. (MacAller, Spring 1985).

Questions on life insurance companies can be answered by contacting the American Council of Life Insurance, toll-free, 1-800-423-8000. Also, the National Insurance Consumer Organization will evaluate your policy for $25. Consumer Reports also rates insurance companies, it's available in local libraries.

CHAPTER IV

TERM, WHOLE LIFE, AND UNIVERSAL LIFE

There are many forms of insurance policies on the market with a myriad of intentions. The insurance industry, galvanized by universal life, has realized the need to offer sweeping new product designs in an attempt to recapture declining insurance dollars. Some products are hybrids of old offerings, but all of the new products do offer more flexibility (Weston, November 1985). Inclusive with the added flexibility is the added risk. Insurers are emphasizing insurance as an investment vehicle. As a result, consumers are paying for insurance that have attractive investment features but poor death protection (Carrol, November 1985). Review of current literature suggests that term is the most economical form of insurance. But, because of individual circumstances, that are unique to all consumers, term may not be practical for all insurance buyers. The insurance industry has designed policies that meet most special needs. With all the different types of policies available, complemented by their ambiguous features, it is difficult to understand the financial implications.

This section is a review of the three forms of insurance: term; whole life. and universal life.

TERM

Term insurance is the most economical form of insurance. However, most companies do not encourage term because of low profits. Consumers should buy term if it meets their needs. Even for term policies, consumers should shop around for the best policy. There are differences in policies offered by the various insurers despite what agents tell buyers.

There are two forms of term: level term and decreasing term. Level term's face amount remains constant but the premiums will increase each time the policy is renewed. With decreasing term the premiums remain level but the face amount is reduced.

When buying a policy, the consumer should look at the initial price, as well as the price of the policy over the years and the options. Consumer Reports, in their survey of term policies uses a method of comparing cost called the interest-adjusted net cost index (June 1986). Long-term cost are calculated for 5, 10, and 20 year policies. The index is expressed as a cost per $1,000. For example, if the index was 5.35 then the insurance cost would be $5.35 per $1,000. For a $100,000 policy the cost would be $535 annually. This method is accepted by the insurance industry as a method for measuring cost. When considering a specific policy, ask to see the net cost index (Consumer Reports, June 1986).

Many insurers call term "temporary" insurance. Consumers are often told they need a more "permanent" form of insurance (Huebner and Black, 1982). However, the need for life insurance may decline or be eliminated as the insured advances towards the retirement years. Term can fill a family's insurance needs usually until age 65. Insurers will not usually write or continue term policies beyond that age (Lang and Gillespi, 1984). If insurance is still needed, then policies with a convertible feature should be considered. This will allow the insured to switch to whole life and continue the insurance coverage. Its important to note, the more options the insured has included--the more expensive the policy will become. Consumers should never buy or be sold options and riders that are not necessary.

Premium payments on term policies can be made monthly, quarterly, semi-annually, or annually. Payments should be made annually in one lump sum if the insured is able. The more the insured stretches out the payment plan wthin a single year, the higher the cost of the policy.

Group term (Weston, November 1985) and policies offered by banks (Consumer reports, June 1986) are the most economical term policies on the market. The prices are affordable and they consistently rank high on insurance surveys (Consumer Reports, June 1986).

The protection that term offers and the overall cost are good reason to buy term insurance. There are a myriad of other reasons consumers buy term--some may have no validity. Here are some reasons and uses for term insurance:

*Low income.
*Started a new business.
*Term insurance with conversion features supplement to investment insurance.
*Protection against mortgages.
*Potection for the future of young dependent children.

*Contingency expenses that may be realized upon death.

Insurers that sell contingency term policies, e.g., credit life and flight insurance, charge relatively high premiums. These types of term policies are not considered good insurance buys. If the policyholder is killed in an accident, a good insurance program should be sufficient to reduce the financial burdens on the family. Some insurers may push "double-indemnity" riders, but its been estimated that less than 6 percent of all people are killed in accidents (Consumer Reports, June 1986).

Consumers who need term for a number of years should buy annual renewable term or renewable term. With annual renewable term the policyholder, upon request, may have his policy renewed with evidence of insurability. With renewable term, the policyholder may renew his policy without a medical examination. Both options can be exercised until the insured is 65 (Mehr and Cammack, 1972). Premiums will rise if the face amount is maintained as the insured gets older.

Term is pure life insurance. There are no investment features with term. The proponents of term feel that's its selling point. Their philosophy is the insured can invest the difference of what a whole life policy would have cost. This point may or may not be valid, depending on the investment skills of the individual and if the insured would really invest the difference--if not forced by policy. The prevalent reason for buying, or not buying, term would depend on each individual's unique needs.

WHOLE LIFE

Many insurers call whole life policies "permanent" insurance. There are no policies to constantly renew and it continues beyond age 65. Whole life has been the cornerstone for the insurance industry for years. However, new investment strategies among insurance consumers and current investment alternatives have made whole life almost obsolete as an investment vehicle.

Whole life insurance provides death protection for a fixed premium throughout the life of the policy. The policy is kept in force until the policyholder dies or he reaches the age of 100. One stipulation would be that the policyholder continue to pay his premiums throughout the life of the policy. When the policyholder reaches 100 years old the face amount is usually paid. This is because the face amount is actually the cash value being paid. The cash value has built up over the years and the policy is said to have matured.

Premiums are high for whole life insurance. During the earlier years a large portion of the premium is used to build the cash value and pay administrative costs. The higher cost also goes to providing the policyholders insurance in the later years. This is how the premiums are able to remain constant during the entire life of the policy: the policyholders is overcharged in the initial years to pay for the later years.

Whole life premium payments can be made annually, annually for a limited number of years, or in one lump sum. It is important to note, the shorter the payment terms the faster your cash value will increase. Today, insurers offer adjusted payment policies such as "Modified 5" and "Modified 3" plans. The premiums are lower during the first five or three years and then rise in subsequent years.

After a specified number of years the policyholder can surrender the policy and receive the cash reserve. The insured cannot make partial withdrawals: the entire amount must be withdrawn. The insured is permitted to take out loans against the cash value at a specified rate of interest. If the insured dies before the loan is repaid then the unpaid amount is deducted from the face amount and the balance is paid to the beneficiary.

The policy's cash reserve is sheltered from taxes. Under current laws if you borrow against the policy the interest paid is deductible. Once the insured surrenders the policy for the cash value, taxes must be paid on the amount that exceeds the premiums paid.

How fast the cash reserve accrues depends on two things: 1) rate of return and 2) how the insured makes the premium payments. The rate of return on a whole life policy is not very high. Often agents will not tell the insurance consumer the rate of return or he may promise an excessive one. One method to determine the rate of return was used by Consumer Reports (July 1986) in their survey is called the "Linton Yield." This method should only be used as a rough estimate. Its accuracy has been questioned on a number of occasions. Joesph M. Belth, author of insurance books and literature, observed that when the Linton technique is applied to policies issued by many insurers, substantial variations are found amount the policies in their rate of return (Belth, 1973). The variations were large enough to suggest that it is difficult to predict rate of return. A caveat to that is the rate of return is not adjusted to reflect charges that may be assessed by the company for various reasons.

Whole life insurance is expensive. However, the available options give the consumer more flexibility in using insurance to provide protection and at the same time force the policyholder to save. Insurance consumers should not buy whole life if reduced insurance coverage is the trade-off (Wasik and Quade, September,1986). Whole life policies vary with great degree, but all of them require a long-term commitment. If the insured exchanges or drops the policy, he may lose money.

Participating policies are normally better buys than nonparticipating policies (Consumer Reports, July 1986). Consumers should compare and use the interest adjusted cost index for whole life policies. Additional options will raise the price of the policy. Consumers should ask the agent if there are any other charges that have not been brought to their attention.

UNIVERSAL LIFE

Universal life is the savior of the insurance industry, already accounting for 40 percent of all life insurance sold (Consumer Reports, August 1986). Universal life provides the same functions as whole life but in a different fashion. The differences are: premiums are flexible, the interest rates on loans fluctuate, rate of return varies, cash value build up fluctuates, and increased flexibility in premium payments. Overall, universal life is more competitive with other investment instruments.

When the policyholder makes the premium payment the insurer credits the cash value account. The money is deducted to pay for the insurance and any other charges. Whatever is left goes toward building the cash value account. Many companies guarantee a minimum interest but it is the higher interest the company is paying that attract buyers. Universal life sellers uses the lure of these higher stated interest rates complemented with the tax advantages of life insurance to sell these policies.

There is a minimum amount the policyholder must pay but beyond that the payments are flexible. Insurers set up what is called "target" premiums for their policyholders (Consumer Reports, August 1986). This premium allows for build up of the cash value and insurance cost. A policyholder can accelerate his cash value by paying more than the target premium. Unlike whole life the policyholder could make partial withdrawals from the cash reserve. He still could also take a loan against the cash reserve.

If the insured had financial difficulties and could not afford to make a payment, the accelerated payments paid in would allow for smaller or missed payments. Minimum payments would take on the characteristics of term insurance. The policyholder is paying for just the insurance, there is no cash value build up. As his financial condition improves, the policyholder could again resume normal or accelerated payments. Current tax laws disallow for excessive premium payments. The amount paid in has to be somewhat relative to the amount of insurance the policyholders has (Consumer Reports, August 1986). This prevents policyholders from using their policies as tax shelters or money markets.

The premiums are broken down as: mortality charges, administrative charges, cash value payments, and management fees. Mortality charges go towards paying death claims; the cash value payments are used to build the cash reserves; management fees are assessed for managing the investments that build the cash value. It is the administrative and management fees that detract from universal life. These charges are not included when determining the rate of return. When these fees are included it reduces the rate of return. If the insured buys the policy when interest rates are good, the payment schedule may appear lucrative. However, if interest rates fall then the insurer will mandate a higher minimum payment just to cover the insurance protection (Quinn, January 1986). The reason: as the cash value grows, the interest earned will help pay for the morality charges. If interest rates fall and more death claims are made, the insured will have to bear the burden through his premium payment. If the policyholder misses too many payments and drains the cash reserve, the policy could lapse.

Many of the charges assessed on universal life are either "front-loaded" or "back-loaded". For policies that are front-loaded, the fees and charges are assessed when the policy is first taken out. Very little of the premium goes toward the cash value. Policies that are back-loaded have the fees assessed when the insured attempt to surrender the policy. The charges can be exorbitant. A survey conducted by Consumer Reports(August 1986) found that the cost can be as high as 150 percent of the first year's premium if the policyholder surrenders the policy within the first two years. Some companies have a stipulation called the "excess interest" penalty. If policyholders surrender the policy early then the insurer pays only the minimum interest guaranteed. For example, if an insurer guaranteed the insured 4 percent on the policy when it was taken out, but the insurer is currently paying 11 percent, then the insured would be docked the extra 7 percent that was paid into his account.

Still, universal life is a step up from whole life. However, from universal life came variable universal life.

Variable universal life is a combination of variable life and universal life. This product is the subject of much controversy because it shifts the responsibility of the cash value performance to the policyholder (Schreiner and Synder, November 1985).

Variable life has fixed premiums but the cash value fluctuates with the changing stock market. Variable universal life has flexible premiums and its cash value fluctuates with whatever investment vehicle is chosen. With variable life and variable universal life two accounts are set up for the insured. Part of the premium payment is credited to an insurance account and the rest is credited to the cash value account. The difference between these forms of insurance and universal life is the policyholder chooses the investment vehicle and/or the stocks. How fast the cash value grows depends on the policyholder's investment acumen. Conceivably, the investor could lose the entire cash value with a single investment decision near his/her retirement years. Insurance consumers should avoid these types of policies if they have neither the time or skill to manage their investments.

CHAPTER V

POLICY CONSIDERATIONS

Life insurance policies are essentially contracts. Legally, they have the same provisions as contracts and are enforced by the courts. Policies, like contracts, do not all look alike. However, they have the recognizable principles, such as: exclusions, declarations, insuring agreements and conditions (Mehr and Cammack, 1972). It is important to understand all the provisions and riders in a policy.

The initial step in buying the insurance is completing the application. Completing the application does not constitute having insurance, it is an offer to sell or buy insurance (Mehr and Cammack, 1972).

If the agent does not issue a binder then one must wait to receive the policy before one is insured. A binder is a temporary contract basically saying the consumer is covered (Mehr and Cammack, 1972). If the binder is oral and a claim is made before receiving the policy, the consumer may have prove to the courts, in a dispute, that an insuring agreement took place. Insurance companies do not like to issue binders (Mehr and Cammack, 1972). The insurance agent is a salesman, he is not in the business of approving policies. Policy approval is handled by the underwriting department (Huebner and Black, 1982).

During the application process, accuracy is critical.

Any attempts to misrepresent facts may be grounds for cancellation. Research indicated that court decisions lean heavily in favor of the insured in insurance disputes (Huebner and Black, 1982). Because of the variety of policies and the ambiguity of wording, the courts give the insured the benefit of the doubt in many cases (Mehr and Cammack, 1972).

Contracts that have been in force for two years are difficult to rescind by the insurer. For age misrepresentation. insurers can adjust the face amount based on what they would have paid an insured of the actual age with the premiums paid. There are other grounds for reducing payment. But, if the insured can prove that fraud was not the intent and the instructions were not clear, then the court's decision could be lenient towards the insured. (Mehr and Cammack, 1972).

The overall court perception of fraud is that two years is enough time to investigate fraudulent statements (Belth, 1973). The decisions preclude insurance companies from taking in premiums knowing the application was falsified, then denying a claim. In contrast, the insured can exercise his right to recission if he determines the company made false and misleading statements to him (Mehr and Cammack, 1972). He is entitled to a refund of all charges plus interest.

In some cases, the insured may volunteer information that he thinks may jeopardize his application. Under common law, courts have precluded insurers from using that information against the insured. This falls under the legal doctrine of "waiver" and "estoppel". Having knowledge of adverse information on the insured is viewed by the courts as an abandonment of the insurer's right to enforce remedies of detriment (Mehr and Cammack, 1972). Separately defined, the term "waiver" means the insurer has waived right to deny a claim if the agent overlooked facts that would have negated or reduced his clients insurability. The agent's acceptance of the clients information in fact changes the terms of insurability. The term "estoppel" means that the insurer is restricted from using previously known adverse information about a client as evidence during litigation.

A rule that places limitations to the operation of waiver and estoppel is the "parol evidence" rule. Parol evidence states that the contract in writing is: as stands. Most insurance companies put clauses on the application stating agents may not alter the written terms of application or policy. Deliberate misrepresentation by either party can lead to recission by the wronged party (Mehr and Cammack, 1972).

Policies are contracts of adhesion, or unilateral contracts. The terms of the contract are framed and put in writing. Negotiation is limited and can only be done by certain officers in the insurance company (Mehr and Cammack, 1972). Courts have given any difference in interpretation to the insured. Nevertheless, consumers must understand all the provisions of the policy. Policies should be carefully studied; questions should immediately be posed to the agent or to the insurer.

There are many variants of riders and special provisions contained in insurance policies. The ones discussed in this section do not encompass all the riders or clauses available.

INCONTESTABLE CLAUSE

An incontestable clause states that once a policy has been in force for two years, it shall be considered incontestable. Even if the policyholder's health was to decline the policy could not be revoked. For term insurance, the company would not have to renew the policy. There may be exceptions to this clause.

GRACE PERIOD

This clause gives the insured a specified number of days after the premium due date before coverage lapses for non-payment. Without a grace period, a policyholder could have a lapse in coverage if he was one day late. Reinstatement may require evidence of insurability.

NONFORFEITURE PROVISION

Failure to make payments does not result in forfeiture of the cash value. The insured has three options: 1) Convert to a lesser amount of paid up insurance, 2) take the cash value, 3) accept an extended period of term insurance.

If cash value is requested, there may be an additional clause that specifies payment may be deferred for six months.

POLICY LOANS

This provision states the arrangement if the policyholder were to take a loan against the policy.The clause should include the interest rate and how it is calculated, repayment terms, options for non-payment, and if the insured were to die before the loan is repaid, the insurers options.

ANNUAL DIVIDENDS

Annual dividends for participating policies and how they are calculated and paid is included in this policy. Also gives details on having the money credited to a cash value account.

MISSTATEMENT OF AGE

The laws of most states require that all policies include a provision that in the event the age of the insured is found to have been misstated, the amount of insurance shall be such as could have been purchased by premiums actually paid at he the correct age of the insured.

SUICIDE CLAUSE

This clause states whether the company will pay if a suicide was determined to be the cause of death. There may be certain restriction on time. For example, if suicide were the cause of death during the first two years the policy was in force then payment will amount to premiums paid, if any payments are made.

AVIATION CLAUSE

If the policyholder were to die in an airplane crash, as other than a passenger, the insurer would not be liable to pay benefits. Today there are policies that pay double if policyholders were to die as a passenger.

WAR EXCLUSION

This clause stipulates if the insured were to die in a war the insurer would be have to pay benefits. There may be added stipulations that refund all premiums. There have been questions that aviation and war exclusion riders contradict the incontestable clause. The leading case in this dispute was Metropolitan Life Insurance Company vs. Conway, 252 N.Y. 449 169 N.E 642 (1930). The courts decided that exclusions do not conflict with incontestable clause, these provisions merely enforces standard policy provisions (Huebner and Black, 1982). There are two types of war clauses: "status" type and "results' type. Under the status type, if the insured were to die while in the military then the insured in covered by his policy. The cause of death is immaterial, as long as a war war is going on and the insured is serving in the military. Under the results type, the cause of death must be related to military conflict.

CHANGE OF PLAN

This provision provides the limits of changing the insurance program to another form. Some insurers may not allow policyholders to change to a lower premium policy; others may levy charges and request evidence of insurability.

TRANSFER OF INSURED

Some insurers have policies that allow the insured or the owner to switch the policy to a "new" life. Corporations use this provision for changes in personnel. If one person were to leave, the employer can switch the policy to the new employee. There may be requirements for evidence of insurability or an increase in premium.

DISABILITY

Most life insurance policies do not contain disability benefits. However, life insurance policies may contain disability riders. These clauses define "total" and "permanent" disability. The two most common benefits provided in this rider are: 1) waiver of premium and 2) disability income. There are a number of variations to this rider.

WAIVER OF PREMIUM

The waiver of premium rider may be added to a policy. In the event the policyholder becomes disabled before a certain age, the premium will be waived and coverage continued. There may be a waiting period, usually six months, before the options becomes effective. If the policy pays dividends, the dividends will also continue to be paid.

REVERTIBILITY

This provision allow policyholders to pay a preferred rate if their health is deemed to be good. The premium on the policy, at the preferred rate, is lower than the standard rate for the same policy. If policyholders fail their physicals they will have to pay the standard rate which could be considerably higher. Careful attention should be given to the standard rate of policies that have this option. Sometimes the standard rate is lower than other comparable policies. When policyholders are young, the preferred rate may be attractive as long as their health is good. After failing the physical, it is difficult to find another insurer, especially if the insured is past 35 years of age.

CONVERTIBILITY

This clause allows policyholders to switch from a term policy to whole life. Policyholders may have to pay the difference if they want the policy to be retroactive to the initial date of the policy. This rider is good for people who require insurance in their senior years.

GUARANTEED INSURABIILITY

This rider guarantees the insured will be able to renew his policy without fail until a specified age. If the insured anticipates poor health, then this may be cost effective. Policyholders may have to pay a higher premium for this rider.

ACCIDENTAL DEATH

This clause is usually called "double indemnity" clause. It states the insurer will pay twice the face amount for accidental death. The cost is minimal, leading consumers to find this rider acceptable. Insurance experts agree that the beneficiary's economic loss will not be any greater as a result of death by accident. The chances of dying in an accident are very small: the benefit of this option only benefits the insurer. The clause will define "accidental" death. Typically, the policy will state that death must occur within a specified time and be a result of the accident. There may be some exclusions to this clause even if the death is considered accidental.

There are a number of provisions that were not discussed, such as, provisions regarding the beneficiary and the regulation of creditors' rights. As stated earlier, it is very important that the policyholders understand all the provisions of the policy. For further reading on policy analysis and special provisions, read Life Insurance, tenth edition, by S.S. Huebner and Kenneth Black. Also, principles of Insurance, by Robert Mehr and Emerson Cammack. All the provisions described in this section were taken from those two titles.

CHAPTER VI

SUMMARY AND RECOMMENDATIONS

Insurance policies are contracts. They should and do contain all the requirements necessary for a legal document. If their is a dispute, then the wronged party can seek legal recourse hoping the courts will grant a favorable decision. Insurance companies like to settle out of court. It save them from bad publicity and usually they can get the insured to settle for smaller settlements. The risk of going to court for a policyholder is--it could years before a decision is reached--or he could lose altogether.

The last thing any family would need is a interminable court battle after a loved one has died. Good planning and sound fundamental insurance decisions could preclude hassles later. There are numerous books written about insurance. Some are basic and others go into great detail. The reading can be confusing and boring. Nevertheless, it is the policyholder's responsibility to ensure he has the protection he think he is buying. Today's insurance market does not facilitate for a easy understanding of various provisions.

This paper was written so consumers could understand the fundamentals in buying life insurance. The process starts from determining the needs of the family, to understanding features offered by different policies and different companies. Understanding the fundamentals should prepare the consumer to make sound decisions. Ostensibly, many people are depending on the good faith of their agents. The bottom line can be summed up in this aphorism--"we reap what we sow."

RECOMMENDATIONS

Here are some steps that summarizes this paper and will help when buying life insurance:

1) Estimate needs

2) Don't let the agent determine needs

3) Decide what is affordable

4) Decide between term, whole life, or universal life

5) If not term, determine what rate of return a policy is paying

6) Decide between participating and nonparticipating policies

7) Consider the experience, knowledge, and quality of service of the agent

8) Shop around for the best price on the policy desired. Use rating guides whenever possible

9) Consider the companies financial condition and the quality of their claims department

10) Thoroughly the features and terms of the policy.

Policyholders should always keep up with their policies and any changes that may occur with them. Newer forms of insurance shift the risk of the investment performance to the policyholder. However, if the agent sells insurance that involves NASD licensing, then they must have the proper credentials. The more common licenses are series 6, 7, 22, and 63:

*Series 6-Needed for the sale of mutual funds, variable contracts and investment products.

*Series 7-Needed for the sale of stocks, bonds, options, municipal funds, tax shelters, and municipal securities.

*Series 22-Needed for the sale of limited partnerships, oil and gas programs, tax shelters, real estate syndications, and real estate limited partnerships.

*Series 63-Not a federal requirement but is required in 33 states for persons selling securities.

If the agent possesses one of these licenses he incurs some liabilities. If agents engage in fraudulent acts then they could be disciplined by the Securities Exchange Commission, under the Securities Exchange Act of 1943. Other life insurance agents may be disciplined by the insurer. The severity will depend on the insurer and their policies. Any complaints can be referred to the State's Insurance Commissioner's office.

Insurance needs are not static. As circumstances change, so will the family's insurance needs. Every few years the needs must be re-evaluated to see if the current policy still meets individual needs. For the most economical form of insurance, term is recommended. However, special needs may require another form. Nevertheless, insurance's basic purpose is to reduce financial risk.

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