Life Insurance

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Background

A life insurance policy is simply a contract between an insurance company and the person who buys the policy, the policyholder. In exchange for payment of a specified sum of money, known as a premium, the life insurance company pays a named BENEFICIARY a certain amount of money if specific events occur while the policy is in force. In life insurance policies the most common event is the death of the person who is insured, in which case the payment is made to the beneficiary, which may be a person, a trust or other legal entity, or the estate of the owner. Some policies also allow the owner to surrender the policy for its cash value or to take advance payments on the insurance in the event of diagnosis of a terminal condition. The sale of life insurance in the United States has historically been a highly competitive commission sales business with a number of products which combine life insurance and investments.

Types of Life Insurance

Despite their various names, all life insurance policies fall into either individual or group insurance policies. The difference between Individual and Group Life has become less distinct. Many associations sponsor life insurance plans that are called Group Life coverage but which actually require the same underwriting criteria as for Individual Life.

Individual Life Insurance

Individual Life insurance generally is underwritten taking into account the actuarial risk of death of the one individual being insured. Life insurance companies' underwriters typically use a combination of factors that statistics indicate equate with the risk of death. These include, but are not limited to applicant's age, applicant's gender (except in states which have uni-sex rate requirements), height and weight, family and applicant health history, marital status, number of children, hazardous occupations, tobacco use, alcohol use, dangerous hobbies, and foreign travel.

Group Life Insurance

Group Life insurance policies cover the lives of multiple persons within a group. Group Life insurance historically was based on the risk characteristics of the group as a whole. The group might consist of employees of a business, members of a professional organization, members of a CREDIT UNION, or perhaps members of a LABOR UNION. There are many other possibilities for these groups. The owner of the master group policy is the group itself, such as the employer, the union, the association, or whatever the group may be.

Second-To-Die and First-To-Die Insurance

Most so–called Second–to–Die policies which pay upon the death of the second of two insured people are still regarded as Individual Life insurance. Similarly the so–called First to Die life insurance, where the lives of a small number of people are covered and the life insurance is payable on the first death is also Individual Life insurance. First to Die is often used to cover partners in a business. The proceeds can be used to buy out the share of the partner who dies first.

Term Life Insurance

Either Group or Individual polices can be Term Life Insurance. Term Life Insurance is basic insurance in the event of death. The policy owner pays a premium to the insurance company; it can typically be paid monthly, quarterly, or annually. If the insured dies during the time period that the payments are being made, the insurance company pays the face amount of the life insurance to the beneficiary. As the risk of death increases as people get older, the premium generally also increases. At advanced ages, term insurance costs are extremely expensive.

Cash Value Life Insurance

Cash Value Life Insurance has the same benefits of Term Life Insurance with a savings or investment account. There are several types of Cash Value Life policies.

Traditional Whole Life and Universal Life

In Traditional Whole Life and Universal Life Insurance policies, money that does not go to pay insurance costs or the sales representative's commission is invested by the insurance company in fixed dollar type investments. Whole-life policies combine life coverage with an investment fund. Cash value builds tax-free each year, and policyholder can usually borrow against the cash accumulation fund without being taxed. Universal life is a whole-life policy that combines term insurance with a money-market-type investment that pays a market rate of return. To get a higher return, these policies generally do not guarantee a certain rate. However, sales of universal policies tend to be higher than those of plain whole life, due to the higher potential yield.

Variable Life and Variable Universal Life

In Variable Life and Variable Universal Life policies, money that does not go to pay insurance costs or the sales representative's commission is invested by the insurance company in SECURITIES MUTUAL FUND accounts selected by the owner from among the insurer's available choices. Returns are not guaranteed. Variable products are regulated as securities under the Federal Securities Laws and must be sold with a prospectus.

Insurable Interest

A basic requirement for all types of insurance is the person who buys a policy must have an insurable interest in the subject of the insurance. With respect to life insurance, an insurable interest means a substantial interest engendered by love and affection in the case of persons related by blood and a lawful and substantial economic interest in the continued life of the insured in other business related cases. Everyone has an insurable interest in their own lives and in the lives of their spouses and dependents. Business partners may have an insurable interest in each other, and a corporation may have an insurable interest in its employees' lives. The insurable interest requirement is designed to prevent people from taking out a life insurance policy on some randomly selected persons and then killing them to get the insurance proceeds. The rule also prevents life insurance from becoming a gambling device and prevents someone from taking out insurance policies simply because people are known smokers or known to drink and drive. However, it is not necessary for the beneficiary to have an insurable interest in the life of the insured.

Examinations

On larger policies, most life insurance companies require the applicant to undergo a physical EXAMINATION by a medical professional. Samples of the applicant's blood and urine typically are taken by a paramedical person contracted by the insurance carrier to conduct such tests. The insurer will typically also request the applicant's medical records from his or her physicians and have them reviewed by the underwriters. The insure usually will also check the applicant's health history with the Medical Information Bureau (MIB).

MIB is a not-for-profit incorporated association of U. S. and Canadian life insurance companies. It is a provider of information and database management services to the financial services industry. Organized in 1902, MIB now consists of over 600 member insurance companies who agree to share information in the form of medical and avocation codes. There are approximately 230 codes, which MIB uses to signify different medical conditions. Some of the codes indicate risks involving hazardous avocations or adverse driving records. While the MIB does not report actual details about the person's medical condition or problem, the codes alert insurance companies to the fact that there was information obtained and reported by a member insurance company on this particular impairment or avocation risk. Individuals can request their own MIB record and can request that the company correct any errors. There is a small processing fee to obtain a report, which is waived if the request is within 60 days of an adverse underwriting decision. All MIB codes are supposed to be purged seven years from the report date.

Claims

Every life insurance policy specifies certain actions that must take place after a loss has occurred. Typically the beneficiary provides the life insurance company with a CERTIFIED COPY of the death certificate. After proof of the death is submitted to the insurance company, the life insurance company should promptly pay the benefits, assuming that the premiums were paid, making the policy in force. Even if premiums on the policy were not currently being paid, the policy may still have been in a paid status, or the company may have failed to send the necessary notices of cancellation, in which case it may be possible to recover on the policy. Usually, once the policy is at least two years old it is beyond the incontestable period and must be paid, except in extraordinary circumstances.

Denial of Claims

The most common reason life insurance companies use to deny claims is that there was a material misrepresentation in connection with the insurance purchase. The claim regarding material misrepresentation may arise out of the original application for the insurance or from an amendment to the application or in an application for reinstatement. A material misrepresentation sufficient to deny a claim cannot be just any incorrect statement. A material misstatement is almost always one that if it had been disclosed would have meant refusal by the insurer to issue the policy. The most commonly alleged misrepresentations involve an applicant's medical history. Delays in processing claims can sometimes result from legal questions regarding whether the policy was currently in force as of the date of death, or, if the death was a result of foul play, any possibility that the beneficiary may have played a role in the death

Exclusions

An exclusion is a part of an insurance policy which describes a condition or type of loss that is not covered by the policy. In life insurance, a common exclusion is an exception for accidental deaths caused by acts of war or while in active military service. Certain activities may also fall under the exclusion category. Some policies have an exclusion for deaths that occur while the insured was involved in the commission of a FELONY, or deaths resulting from suicide.

Insurance Regulation

Because insurance companies handle large amounts of money on behalf of individuals and businesses, the level of PUBLIC INTEREST is sufficient to WARRANT governmental regulation. Historically, the purpose of insurance regulation has been to maintain the insurers' financial SOLVENCY and soundness and to guarantee the fair treatment of current and prospective policyholders and beneficiaries. There is no central Federal regulatory agency to specifically oversee insurance companies, and as a result, insurance companies in the United States are regulated by the individual states. These regulations include rules about matters such as forms, rates, sales agents, and general insurance business practices.

State laws regulating insurance business also include rules about unfair trade practices and unfair claims practices. It is illegal to refuse to sell insurance to someone because of the person's race, color, sex, religion, national origin, or ancestry. In some states the list of prohibited classifications includes marital status, age, occupation, language, sexual orientation, physical or mental impairment, or the geographic location where a person lives. Insurance underwriting decisions generally must be based on reasons that are related in some way to risk. A person has the right to be informed of any reason for refusal to issue an insurance policy.

Rates

Insurance companies have a range of payment or premium levels which can be charged for insurance. These are based on such factors as the applicant's age and health condition. Rating factors must be reasonably related to the risk being insured. The rates and rating factors for insurance must be filed with the insurance regulatory agency for each state where the insurance is to be sold. While a policyholder may elect to cancel an insurance policy at any time by giving notice to the insurance company, once a policy is issued, the insurance company cannot simply revoke it at will. The insurance company can only cancel the policy for reasons specifically outlined in the policy. State laws typically put limits on what an insurance company can include in the cancellation section of its policies. Generally, policies will be subject to cancellation only for some type of serious misrepresentation by the policyholder or for failure to pay the required premium on time. State law

often requires insurers to allow a GRACE PERIOD of as much as 30 days after a payment is late before any insurance coverage can be terminated. Once the grace period expires, however, reinstatement is the sole option of the insurance company.

Minors as Beneficiaries

While children can lawfully be named as beneficiaries on a life insurance policy, the insurance company will not be permitted to pay benefits to a minor. The funds would likely be dispersed to the legal GUARDIAN of the minor child. Many divorced parents are shocked to discover that naming their minor children as beneficiaries makes their ex-spouse the direct recipient of any insurance proceeds. This situation can be avoided by creating a trust which can hold the funds until the children are of LEGAL AGE.

Additional Resources

Insurance: From Underwriting to Derivatives: Asset Liability Management in Insurance Companies. Briys, Eric, Wiley, John & Sons, Incorporated, 2001.

True Odds: How Risks Affects Your Life. Walsh, James, Merritt Company, 1995.

Organizations

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