Contents

About the Authors .......................................................... xix
Acknowledgments .......................................................... xxi
Introduction and Overview ........................................... xxiii
Executive Summary ....................................................... xxvii

PART I
THE LIFE INSURANCE PURCHASE 1

CHAPTER 1
Introduction to Life Insurance ........................................ 3

Psychological Aspects of Death and Planning ...................... 4
    Anxiety ................................................................ 4
    Emotions ............................................................ 5
Dealing With the Financial Consequences of Death ............... 6
    Relatives ............................................................. 7
    Additional Savings/Investments ................................ 7
    Employer-Provided Death Benefits ......................... 8
    Individual Life Insurance ....................................... 9
Life Insurance in Family, Estate, and Business Planning ....... 10
    Determining Whether Life Insurance is Needed ............ 11
    Determining the Appropriate Insurance Amount .......... 12
    Determining the Most Suitable Policy ...................... 13
    Determining from Whom to Purchase the Policy .......... 15
        Organizational Structures of Life Insurance Companies .. 15
        Importance of a Life Insurance Company's Target Market . 18
### Evaluation of Life Insurance as a Financial Instrument
- Advantages of Life Insurance
- Disadvantages of Life Insurance
- Conclusions

### CHAPTER 2
**Life Insurance Advice, Advisors, and Distribution**
- The Life Insurance Purchase Decision
- Life Insurance Advisors
  - Insurance Agents
  - Personal Financial Planners
  - Financial Institution Employees
  - Attorneys and Accountants
- Life Insurance Distribution Channels
  - Captive Distribution
    - Career Agents
    - Multiple-Line Exclusive Agency
  - Independent Distribution
    - Brokerage
    - Producer Groups
    - Independent Property/Casualty Agents
- Evaluating Life Insurance Agents
  - Tenants of Professionalism
  - Fairness
  - Competence
  - Integrity
  - Diligence
- Sources of Information on Agents
- Conclusions

### PART II
**ASSESSING LIFE INSURANCE COMPANY FINANCIAL STRENGTH**

### CHAPTER 3
**The Importance and Nature of Life Insurance Financial Strength**
- Why Assessing Life Insurer Financial Strength is Important
- The Special Nature of Life Insurance
- Life Insurers in Financial Difficulty: Lessons from the Past
- Insurer Management of Financial Strength
  - Incentives to Have Strong Financials
  - Incentives to Avoid Holding Excess Capital
Overview of Life Insurers’ Investments .............................................. 53
   Bonds ....................................................................................... 55
   Mortgages and Real Estate.......................................................... 56
   Stocks ...................................................................................... 57
   Policy Loans ............................................................................ 57
   Cash and Miscellaneous ............................................................. 57
Assessing Insurer Financial Strength .................................................. 58
   Capital and Surplus Adequacy ..................................................... 59
   Leverage ................................................................................... 60
   Quality and Diversification of Assets .......................................... 60
   Liquidity ................................................................................... 62
   Operational Performance ............................................................ 62
Conclusions ................................................................................... 64

CHAPTER 4
Life Insurer Financial Regulation and Policyholder Protections 65

Nature and Purpose of Insurance Regulation ....................................... 66
Areas of Insurance Regulation: Protecting Policyholders ..................... 66
   Organization and Licensing of Insurers ....................................... 67
   Insurance Policy Forms and Rates ............................................... 67
   Marketing Practices .................................................................. 68
   Agent Licensing ....................................................................... 68
   Unfair Trade Practices ............................................................... 69
   Solvency ................................................................................... 70
   Liability Valuation .................................................................. 70
   Asset Limitations and Valuation ............................................... 71
   Accounting Standards ............................................................... 71
Solvency Surveillance Methods ........................................................... 72
   Financial Statement Filings ......................................................... 72
   Ongoing Capital Requirements .................................................. 73
   NAIC Automated Solvency Monitoring ....................................... 74
   Dividend Restrictions ................................................................. 75
   Cash Flow Testing ................................................................... 75
   On-site Financial Examinations ................................................... 76
   Professional Oversight ............................................................... 76
Regulatory Responses to Financially Impaired Insurers ......................... 76
   Informal Actions ...................................................................... 77
   Formal Actions ....................................................................... 77
   Rehabilitation ......................................................................... 77
   Liquidation ............................................................................. 78
   Role of Guaranty Associations ................................................... 78
Implications to Policyholders of Insurer Financial Difficulty ................. 79
## CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Implications to Policyholders of Regulatory Solvency Intervention</td>
<td>82</td>
</tr>
<tr>
<td>Conclusions</td>
<td>83</td>
</tr>
<tr>
<td><strong>CHAPTER 5</strong></td>
<td></td>
</tr>
<tr>
<td>Life Insurer Financial Strength Due Care</td>
<td>85</td>
</tr>
<tr>
<td>The Role of Rating Agencies</td>
<td>85</td>
</tr>
<tr>
<td>The Importance of Rating Agencies</td>
<td>86</td>
</tr>
<tr>
<td>Four Major Rating Agencies</td>
<td>86</td>
</tr>
<tr>
<td>A.M. Best Company</td>
<td>86</td>
</tr>
<tr>
<td>Fitch Ratings</td>
<td>87</td>
</tr>
<tr>
<td>Moody’s Investor’s Service</td>
<td>88</td>
</tr>
<tr>
<td>Standard &amp; Poor’s</td>
<td>88</td>
</tr>
<tr>
<td>An Example of an Agency’s Rating Methodology</td>
<td>89</td>
</tr>
<tr>
<td>Business Profile</td>
<td>90</td>
</tr>
<tr>
<td>Financial Profile</td>
<td>91</td>
</tr>
<tr>
<td>Other Considerations</td>
<td>92</td>
</tr>
<tr>
<td>The Nature of Rating Agency Reports</td>
<td>92</td>
</tr>
<tr>
<td>Rating Agency Reports</td>
<td>92</td>
</tr>
<tr>
<td>Rating Categories</td>
<td>93</td>
</tr>
<tr>
<td>Using Rating Agency Reports and Ratings</td>
<td>94</td>
</tr>
<tr>
<td>Other Sources of Insurer Information</td>
<td>96</td>
</tr>
<tr>
<td>The NAIC and State Insurance Departments</td>
<td>96</td>
</tr>
<tr>
<td>Financial Statement Information</td>
<td>97</td>
</tr>
<tr>
<td>Complaint Data</td>
<td>99</td>
</tr>
<tr>
<td>Risk Based Capital Ratios</td>
<td>100</td>
</tr>
<tr>
<td>Securities and Exchange Commission</td>
<td>101</td>
</tr>
<tr>
<td>Insurance Companies</td>
<td>102</td>
</tr>
<tr>
<td>Insurance Agents</td>
<td>102</td>
</tr>
<tr>
<td>Stock Analysts’ Reports</td>
<td>103</td>
</tr>
<tr>
<td>Publications</td>
<td>103</td>
</tr>
<tr>
<td>Conclusions</td>
<td>103</td>
</tr>
</tbody>
</table>

**PART III**

**LIFE INSURANCE POLICY FUNDAMENTALS**

**CHAPTER 6**

Life Insurance Basics

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Generic Types of Life Insurance Policies</td>
<td>107</td>
</tr>
<tr>
<td>Term Life Insurance</td>
<td>107</td>
</tr>
<tr>
<td>Cash Value Life Insurance</td>
<td>108</td>
</tr>
</tbody>
</table>
Life Insurance Pricing .......................................................... 111
  Mortality Charges .......................................................... 113
    Mortality Experience and Tables .................................... 113
    Influences on an Insurer's Mortality Experience ............... 115
    Deciding on the Mortality Charges to Assess ................... 116
    The Effect of Mortality Charges on Policy Values .............. 122
  Interest Crediting Rate .................................................. 123
    Investment Returns ...................................................... 124
    Influences on an Insurer's Investment Returns ................. 124
    Deciding on the Interest Rate to Credit ......................... 125
    The Effect of Interest Crediting Rates on Policy Values ...... 126
  Loading Charges ........................................................... 127
    Costs of Doing Business ............................................... 127
    Influences on an Insurer's Costs of Doing Business .......... 128
    Deciding on Loading Charges to Assess ............................ 129
    The Effect of Loading Charges on Policy Values ............... 130
  Persistency .................................................................. 131
    The Importance of Persistency ........................................ 132
    Influences on an Insurer's Persistency ............................. 133
    Deciding on Persistency Rates to Use ............................. 135
    The Effect of Persistency on Current Assumptions ............. 135
Putting It All Together ....................................................... 135
Conclusions .................................................................. 137

CHAPTER 7
Common Life Insurance Policies ........................................ 139
  The Effects of Income Tax Law on Life Insurance Policy Design and
    Operation ................................................................. 139
  Tax Favored Status of Life Insurance ................................. 140
  IRC Definition of Life Insurance ....................................... 140
  IRC Definition of Modified Endowment Contract ................. 141
  Term Life Insurance ....................................................... 142
    Types of Term Policies .................................................. 142
    Key Features Unique to Term Policies .............................. 144
    Considerations ............................................................ 144
  Universal Life Insurance ................................................ 145
    Operational Details ....................................................... 145
    Considerations ............................................................ 149
  Equity Indexed Universal Life .......................................... 151
    Operational Details ....................................................... 151
    Considerations ............................................................ 152
Variable Life Insurance .................................................. 154
  Operational Details .................................................. 155
  Considerations ......................................................... 156
No-Lapse Guarantee Universal Life .................................. 158
  Operational Details .................................................. 158
  Considerations ......................................................... 159
Whole Life Insurance .................................................. 162
  Participating and Nonparticipating Life Insurance ............ 163
  Types of Whole Life Policies ..................................... 165
  Considerations ......................................................... 166
Specialized Life Insurance .............................................. 167
  Proprietary Life Insurance ....................................... 167
  Private Placement Life Insurance ................................. 168
Life Insurance on Multiple Lives .................................. 168
  Second-to-Die Life Insurance ..................................... 169
  First-to-Die Life Insurance ....................................... 170
Conclusions ................................................................. 170

CHAPTER 8
Life Insurance Policy Attributes .................................... 171

Overview of Generic Policy Attributes .......................... 171
Specific Life Insurance Policy Attributes ........................ 173
  Policy Overview ...................................................... 174
  Death Benefits ........................................................ 176
    Nature and Duration of Guarantee ................................ 176
    Adjustability of Policy Duration ................................ 176
    Adjustability of Death Benefit Amount .......................... 178
    Choice of Level or Increasing Death Benefit Amount .......... 178
  Cash Values ............................................................ 179
    Existence and Nature of Guarantees .............................. 179
    Location and Nature of Investments Backing Policy Reserves . 181
    Likelihood of Lapse with Adverse Development of Current Assumptions ........................................... 182
    Impact on Cash Values of Changes in Investments’ Market Values .... 182
    Policyholder Control Over Fund Allocations .................... 183
    Availability of Policy Loans ..................................... 183
    Availability of Policy Withdrawals ............................... 184
    Relationship Between Cash Values and Death Benefits .......... 184
    High Early Cash Values ......................................... 185
    Protection Against Claims of an Insolvent Insurer’s Creditors . 185
  Premiums ................................................................. 185
    Premium Flexibility .................................................. 185
    Ability to Mimic Any Other Type of Policy ...................... 187
CONTENTS

Provisions Providing Policyowner Flexibility .......................... 205
Right to Return Policy ......................................................... 205
Death Benefit Provision .............................................. 205
The Beneficiary Clause ..................................................... 206
Settlement Options .......................................................... 208
Nonforfeiture Options ....................................................... 211
Policy Loan Provision .......................................................... 212
Dividend Options ................................................................. 213
Assignment/Ownership Provision ......................................... 214

Common Life Insurance Policy Riders ........................................ 215
Riders Providing Life Insurance Coverage .................................. 216
Term Riders ................................................................. 216
Family Riders ................................................................. 216
Accidental Death Benefit Riders .......................................... 217
Guaranteed Insurability Option ............................................ 217
Living Benefit Riders ........................................................... 218
Terminal Illness Coverage ................................................... 218
Catastrophic Illness Coverage ........................................... 218
Long Term Care Riders/Combination Plans ................................. 219
Riders Protecting Against Policy Lapse ..................................... 220
Waiver of Premium/Charges Riders ....................................... 220
Overloan Protection Riders .................................................. 221
No-Lapse Guarantee Riders ................................................ 222
Enhanced Cash Value Riders ............................................... 222
Conclusions ........................................................................ 222

PART IV
DETERMINING THE APPROPRIATE POLICY FOR EACH APPLICATION 223

CHAPTER 10
Life Insurance for Family Security ........................................... 225

Introduction ........................................................................ 226
U.S. Family Structures ............................................................ 227
Life Insurance Needs Analysis ................................................ 230
Identify Objectives .............................................................. 230
Gather Information .............................................................. 231
Assets .............................................................................. 231
Liabilities .......................................................................... 232
Income ............................................................................... 232
Analyze Information ............................................................. 233
CHAPTER 11
Life Insurance in Estate Planning

Introduction ................................................................. 241
Overview of Federal Transfer Taxation ....................... 242
Estate Taxation .......................................................... 242
  Calculating Estate Taxes ........................................ 243
  Estate Taxation of Life Insurance ............................... 244
Gift Taxation ............................................................. 244
  Calculating Gift Taxes ........................................... 244
  Annual Gift Tax Exclusion ...................................... 245
  Gift Taxation of Life Insurance ................................. 246
Generation Skipping Transfer Taxation ......................... 247
Common Trusts Used with Life Insurance ..................... 247
  Marital Deduction and Credit Shelter Trusts .............. 248
  Crummey Trusts ................................................... 249
  Irrevocable Life Insurance Trusts ............................. 249
  Charitable Remainder Trusts ................................. 251
  Intentionally Defective Irrevocable Trusts ................... 253
Life Insurance Analysis for Estate Planning .................. 254
  Identify Objectives .............................................. 255
  Gather Information ............................................. 256
  Analyze Information ............................................ 257
  Develop and Implement the Plan: Matching Policies to Goals ... 257
    Nature of Insurance Need Influencing Selection of Policy Types ... 258
    Policy Options for Estate Liquidity with Families Composed of Husband and Wife ... 258
    Policy Options for Estate Liquidity with Other Family and Household Arrangements ... 260
  Policy Options for Other Estate Planning Goals .......... 260
Conclusions ............................................................. 261

CHAPTER 12
Business Uses of Life Insurance

Introduction ............................................................. 263
Forms of Business Organizations ................................. 264
  Sole Proprietorships ........................................... 264
<table>
<thead>
<tr>
<th>PART V</th>
<th>LIFE INSURANCE ILLUSTRATIONS AND THE SUSTAINABILITY OF POLICY VALUES</th>
</tr>
</thead>
<tbody>
<tr>
<td>CHAPTER 13</td>
<td>Life Insurance Policy Illustrations</td>
</tr>
</tbody>
</table>

| Overview of a Policy Illustration | 289 |
| Uses of Policy Illustrations | 290 |
| Non-Guaranteed Nature of Illustrations and Why Important | 290 |
| Content of Policy Illustrations | 292 |
| Non-Variable Life Insurance Illustrations | 292 |
| Tabular Detail | 292 |
| Narrative Summary | 296 |
| Numeric Summary | 298 |
| Supplemental Illustrations | 299 |
| Variable Life Insurance Illustrations | 301 |
| Interest Adjusted Indices | 304 |
| Conclusions | 307 |
Illustration Stress Testing .................................................. 335
Reduce Crediting Rate ...................................................... 335
Increase Policy Charges ..................................................... 335
Death Benefit Protection Stress Testing ............................. 336
Cash Value Accumulation Stress Testing ............................ 336
Cost versus Risk Protection ............................................... 336
Life Expectancy and Probability of Survival ...................... 337
Death Benefit Protection: 10-Pay Examples ....................... 337
Death Benefit Protection: Pay-to-Age 120 Example .......... 341
Cash Value Accumulation: Minimum Non-MEC Death Benefit
Example ................................................................. 343
Special Considerations for Specific Policies ......................... 344
Variable Universal Life ...................................................... 344
Equity Indexed Universal Life ............................................. 345
No-Lapse Guarantee Universal Life ................................. 345
Conclusions .................................................................. 346

CHAPTER 16
Using Policy Illustrations for Competitive Comparison Purposes 349

Why Compare Illustrated Policy Values ............................... 349
Factors to Consider for Illustration Competitive Comparisons 350
Non-Guaranteed Nature of Policy Illustrations .................. 350
Preparing Consistent Illustration Comparisons .................. 351
Rating Categories and Risk Classification Factors .............. 351
Premium Funding Levels, Death Benefits, and Cash Value
Targets ................................................................. 353
Illustrated Assumptions ..................................................... 354
Policy Options and Riders .................................................. 354
Other Considerations for Specific Policies ......................... 355
Variable Universal Life ...................................................... 355
Equity Index Universal Life ............................................. 358
No-Lapse Guarantee Universal Life ................................. 360
Common Measures of Illustrated Policy Performance .......... 362
Premium Measures .......................................................... 362
Death Benefit Measures .................................................... 363
Death Benefit Internal Rate of Return ............................... 364
Death Benefit Solve ......................................................... 365
Surrender Value Measures ................................................ 365
Surrender Value Amount ................................................... 365
Surrender Value to Premium Ratio .................................... 366
Surrender Value Internal Rate of Return ......................... 366
Distribution Measure ....................................................... 367
PART VI
ONGOING POLICY MANAGEMENT

CHAPTER 17
Using Policy Reviews to Sustain Policy Viability and Achieve Insurance Goals

The Importance of Policy Reviews
The Nature of Policy Reviews
Annual Reviews
General Considerations
Considerations Applicable to Particular Policies
Detailed Reviews
Options to Achieve Insurance Goals
When Policy Values are Insufficient
Do Nothing
Make Additional Payments
Reduce Future Death Benefits
Replace the Policy
When Policy Values are Greater than Necessary
Do Nothing
Reduce Future Payments
Increase Future Death Benefits
Take Policy Distributions
Conclusions

CHAPTER 18
Securing Lifetime Values from Life Insurance

Introduction
An Overview of Income Taxation of Cash Values and Dividends
The Effect of Internal Revenue Code Definitions on Life Insurance Income Taxation
<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income Tax Treatment of Cash Values</td>
<td>411</td>
</tr>
<tr>
<td>Income Tax Treatment of Dividends</td>
<td>412</td>
</tr>
<tr>
<td>Policy Surrenders and Maturities</td>
<td>412</td>
</tr>
<tr>
<td>Income Tax Treatment of Surrenders and Maturities</td>
<td>413</td>
</tr>
<tr>
<td>Considerations in Policy Surrenders and Maturities</td>
<td>415</td>
</tr>
<tr>
<td>Policy Withdrawals, Partial Surrenders, and Loans</td>
<td>415</td>
</tr>
<tr>
<td>Income Tax Treatment of Withdrawals, Partial Surrenders, and Loans</td>
<td>416</td>
</tr>
<tr>
<td>Considerations in Withdrawals, Partial Surrenders, and Loans</td>
<td>418</td>
</tr>
<tr>
<td>Policy Replacements</td>
<td>418</td>
</tr>
<tr>
<td>Replacement Procedures</td>
<td>419</td>
</tr>
<tr>
<td>Income Tax Treatment of Replacements</td>
<td>420</td>
</tr>
<tr>
<td>Considerations in Replacements</td>
<td>421</td>
</tr>
<tr>
<td>Accelerated Death Benefits</td>
<td>424</td>
</tr>
<tr>
<td>Income Tax Treatment of Accelerated Death Benefits</td>
<td>425</td>
</tr>
<tr>
<td>Considerations in Taking Accelerated Death Benefits</td>
<td>425</td>
</tr>
<tr>
<td>Sale of the Policy in the Secondary Life Insurance Market</td>
<td>425</td>
</tr>
<tr>
<td>The Process and Economics of Life Settlements</td>
<td>426</td>
</tr>
<tr>
<td>Income Tax Treatment of Selling a Life Insurance Policy</td>
<td>427</td>
</tr>
<tr>
<td>Considerations in Selling a Life Insurance Policy</td>
<td>428</td>
</tr>
<tr>
<td>Conclusions</td>
<td>429</td>
</tr>
</tbody>
</table>

**APPENDICES**

**APPENDIX 1**

Life Insurance Agent Questionnaire                                      433

**APPENDIX 2**

Descriptions of Four Rating Agencies’ Rating Categories                 435

- A.M. Best Company                                                      435
- Fitch Ratings                                                          436
- Moody’s Investors Service                                              438
- Standard & Poor’s                                                      439

**APPENDIX 3**

Attributes of Term and Cash Value Life Insurance Policies                441

**APPENDIX 4**

Example Term Life Insurance Tabular Detail                                447