Introduction to Life Insurance

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WHAT SOME ECONOMISTS HAVE dubbed the Great Recession of 2008–09 painfully reminds us of the critical importance of making life insurance purchase decisions only after the most thoughtful deliberations. While life insurers fared far better than banks, most suffered material hits to their balance sheets and net incomes. Consequently, policy values have been negatively impacted either through reduced interest crediting rates or negative equity market earnings in variable contracts. Even so, the life insurance industry in general weathered the financial crisis quite well due to strong financial regulation, with most of the top life insurers still carrying high ratings.

An insurer's financial strength and product selection are more important to buyers than ever before. This *Guide*'s aim is to help advisors ensure that their clients make wise policy purchase (and termination) decisions whatever the economic environment.

This and the following chapter begin this process. This chapter introduces fundamental life insurance concepts and terminology.[1] As it explains, the purchase of life insurance can be a challenging experience because at times there is reluctance to

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[1]This chapter draws in part from Kenneth Black, Jr. and Harold D. Skipper, Jr., *Life and Health Insurance* (13th ed.; Upper Saddle River, NJ: Prentice-Hall, 2000), Chapters 14 and 17, and from Harold D. Skipper and W. Jean Kwon, *Risk Management and Insurance: Perspectives in a Global Economy* (Malden, MA: Blackwell Publishing, 2007), Chapter A6.

discuss death and dying and because the purchase decision is often complex. Chapters hereafter emphasize the importance and means of:

- Assessing advisor quality and life insurance company financial strength;
- Understanding life insurance policy fundamentals;
- Determining the appropriate policy for each application;
- Understanding policy illustrations and assessing their sustainability; and
- Conducting ongoing policy management.

We do not attempt to examine in detail the many ways that life insurance can be used to help solve family and business issues. Nor do we explore how policies should be structured for optimum efficiency and affect, including their structure, ownership, or beneficiary arrangement.

Psychological Aspects of Death and Planning

It can be helpful in the consultative process if the advisor understands some of the psychological aspects of death and planning. We offer a short introduction here.

The way a society and a family view death—whether it is celebrated, dreaded, or somewhere between the two extremes—influences how individuals plan for it. Death is intertwined with our culture, including religious beliefs and convictions. An intimate relationship between religious commitment and security can reinforce the view that we are not dealing solely with an economic problem.

Many individuals do not wish to discuss their own mortality. Often, there are psychological reasons for this reluctance, and understanding their source might help ameliorate reluctance.

Anxiety

Humans throughout history have exhibited a desire to reduce uncertainty. Uncertainty can cause anxiety. **Anxiety** is a collection of fears resulting in unpleasant uneasiness, stress, generalized pessimism, and risk averse attitudes. An individual's capacity to tolerate and manage anxiety is considered to be a measure of the degree to which the person is well adjusted. Also, the different roles (e.g., child, parent, etc.) and corresponding responsibilities that individuals assume throughout their lives can create anxiety.

Anxiety is not an absolute condition. It ranges from extreme neurotic anxiety with an overreaction to a perceived threat, to normal anxiety in which our reactions are proportionate to a perceived threat. Normal anxiety can be

TABLE 1-1
Rankings and Relative Degrees of Life Change in Selected Life Events

Rank	Life Event	LCU Score
1	Death of spouse	100
2	Divorce	73
4	Death of a close family member	63
6	Personal injury or illness	53
9	Retirement	45
11	Major change in health of a family member	44
16	Major change in financial state	38
17	Death of a close friend	37

Source: Richard H. Rahe, "Life Change and Subsequent Illness Reports," in *Life Stress and Illness*, E.K. Eric Gunderson and Richard H. Rahe, Eds. (Springfield, Ill.: Charles C. Thomas, 1974), pp. 60–61.

dealt with constructively at the level of conscious awareness, or it can be relieved by various risk management techniques.

Anxiety is often fostered through the financial planning process, especially when the discussion turns to death. In establishing objectives for the family, consideration is given to life changes that are among life's most stressful: death, loss of health and jobs, retirement, and divorce. This can be a reason why some clients wish to avoid or postpone needed financial planning.

A scale to measure the relative degrees of life change inherent in various life events has been developed. Table 1-1 lists several life changing events commonly associated with financial planning and shows their relative ranking and their so-called life change unit (LCU) value (with 100 being the greatest value). Life changes induce stress. Note that the death of a spouse is potentially the most stressful of life's events. Merely speaking about the possibility of death likewise can induce stress.

Financial advisors and life insurance salespersons often use the possibility of such life events and transitions to arouse anxiety within their clients in an effort to motivate them to reflect on the possible financial consequences of the occurrence of the events—and take action. Advisors can then paint a picture of freedom from anxiety that involves planning and products designed to reduce uncertainty.

Emotions

Emotions are a primary determinant of behavior. **Emotions** are learned reactions to a set of experiences or perceptions that have been either very favorable or very distressing. Contact with events or thoughts that recall these experiences can stimulate a desire to remove or satisfy the resulting emotions. For example, individuals who experienced severe financial difficulty as children because of the death or incapacity of a parent might be strongly moti-

vated to avoid recurrence of that status for their families through the purchase of insurance.

Emotions can be learned from the experiences of others. Because emotions can be generalized from one set of circumstances to another, many advisors are successful in communicating to a client the emotional consequences of failing to make provision for adverse events, such as death. The purchase of insurance can provide individuals with an overt and constructive outlet for their emotional concerns.

External sources of additional money at the time of death, such as would be provided by individual life insurance, an employer, or the government, undoubtedly help dependents and loved ones from a financial point of view. Dependents and loved ones may infer something about the extent to which a deceased breadwinner cared about his or her family if the deceased person made thoughtful pre-death arrangements, including ensuring adequate funds for the surviving family. Indeed, one academic coined the term "the love theory" to explain the purchase of life insurance.[2]

Dealing With the Financial Consequences of Death

Death can create not only profound emotional distress but equally profound financial distress for families. If a family's economic livelihood depends on the wages of one person, that person's death could be financially devastating for the family. Having two breadwinners spreads the risk, but usually does not eliminate it. Even if a family is not financially dependent on one person's wages, his or her death could provoke substantial estate taxes, correspondingly reducing residual wealth passed to loved ones. The death of a breadwinner who also has a high net worth subjects the family to the potential of a double financial "whammy."

Businesses can be similarly devastated by the death of key employees, especially in smaller and closely held firms. Perhaps a key employee has special knowledge, skills, contacts, persuasiveness, or other attributes that would be difficult, if not impossible, to replace or could be replaced imperfectly and only at substantially higher costs.

Small and closely held businesses and families alike can fall victim to poor planning in connection with their owners' deaths. Heirs who have no interest in or skills relevant for the business may inherit stock that is illiquid, because no viable market exists for it. To add insult to (financial) injury, they may owe meaningful tax on the inheritance, yet not have the cash to pay it.

[2]Stuart Schwarzschild, "The Love Theory—New Rationale for the Purchase of Life Insurance," *Best's Review,* Life/Health ed., Vol. 73 (1972), pp. 46–48.

Surviving owners may seem to be the logical purchasers, but why should they, at this point, agree to purchase shares except at fire-sale prices. Fortunately for planning, business owners do not know which of them might die first, potentially leaving *their* heirs in such a disadvantageous situation, so all might have a motivation to avoid such an unpleasant situation.

In quantifying the financial consequences of death, as discussed later in this chapter, the advisor concludes either that the client's resources are sufficient to avoid adverse consequences or that they are not. If resources are insufficient, additional resources must be located. These resources can come from:

- Relatives,
- Additional savings/investments,
- Employer-provided death benefits, and
- Individual life insurance.

Relatives

Many individuals rely explicitly or implicitly on wealth transfer from either their relatives or in-laws to protect their families from a meaningful reduction in living standard, if not destitution, brought about because of the individual's death. Transfer may be via inheritance or gifting. In some circumstances, reliance on this strategy might be rational. In others, it can be foolhardy.

Most situations fall between these extremes. Even so, unless any such wealth transfer is a certainty as to amount and optimum timing, relying on it as a basis to fill death-related needs is likely unwise. In any event, reliance on this strategy places the financial well-being of the client's surviving family at risk to a greater or lesser degree. Obviously, each situation is different. Some persons seem to expect that their relatives will "save the day." The earlier discussion about the psychological aspects of death seems especially relevant in such situations.

Additional Savings/Investments

In financial planning, loss exposures can be retained or transferred. Meeting the death exposure via additional savings alone is tantamount to the exposure being retained until sufficient additional resources are accumulated. Retention ordinarily is not desirable. Hence, one of the other resource options typically is combined with this option during that interim period.

We can think of this approach as having near-term and longer-term components. In the near-term, inadequate time exists to accumulate sufficient savings to fill the financial gap. The longer term affords more alternatives. Presumably, sufficient time exists to implement an enhanced savings/investment program to fill the financial gap; in other words, retention becomes feasible.

In theory, the need for life insurance disappears when sufficient savings/investments have been accumulated to cover the gap. This approach is consistent with the view of those who advocate the purchase of term life insurance over cash value insurance, with the idea of saving the excess of the cash value policy's premium over the term premium. In practice, however, few individuals have the diligence to fund the death need through savings.

Employer-Provided Death Benefits

One's employer can be a source of additional death benefits. Most employer-provided death benefits are from group term life insurance provided as an employee benefit. Such plans enjoy favorable income tax treatment for the first $50,000 of coverage. To minimize adverse selection, the amount of group life insurance for which an employee is eligible usually is determined by a system that limits the employee's ability to select the coverage amounts, which are themselves typically modest.

Supplemental life insurance sometimes is made available, subject to the employee meeting the insurer's underwriting requirements. The employee usually pays the entire premium. While available amounts may be larger than those provided under the tax-qualified group life insurance program, they ordinarily are not large.

Each of the above employer-provided death benefit plans can be important components for some individuals' financial plans—typically, those in the lower income category. Most group life insurance amounts are set by the terms of the employer's benefit plan and bear no necessary relationship to the individual's need. For individuals with families or other substantial financial obligations, additional insurance is almost always required.

Two other potential employer-provided death benefit programs are executive bonus plans and split dollar plans. Both of these plans are **nonqualified executive benefit arrangements**, meaning that they do not meet the requirements for preferential tax treatment and nondiscrimination among employees as set out under the Employee Retirement Income Security Act (ERISA) and the Internal Revenue Code (IRC). A detailed discussion of these plans is beyond the scope of this guide, but we offer an idea here of how they function, with slightly more detail offered in Chapter 12.

An **executive bonus plan** is a nonqualified executive benefit arrangement under which an employer pays for individually issued life insurance for selected executives. It is a simple arrangement. The employer agrees to pay the premiums for a policy that is owned by the executive. As a nonqualified benefit plan, the employer is free to discriminate among employees.

The premium payments by the business are compensation and, therefore, ordinarily tax-deductible, provided the death proceeds are not payable to the business. The executive must include the amount of the premium pay-

ment in his or her taxable income. Because the plan provides nonqualified life insurance, the executive cannot exclude any of the payment from taxable income. Some employers pay an additional bonus to executives to cover this income tax obligation.

As the owner of the policy, the executive may name the beneficiary and exercise all other policy rights. Of course, the death proceeds will be included in the executive's gross estate if he or she retains any ownership interest or if proceeds are payable to or for the benefit of the estate.

A **split dollar life insurance plan** is a nonqualified executive benefit arrangement under which the employer assists the employee in purchasing life insurance on the executive's life by sharing (splitting) the premium payments and policy benefits between the employer and employee. Under such arrangements, death benefits are split between the employer and executive's beneficiary, and living values are split between the employer and the executive. The employer's share of the death proceeds is intended as a reimbursement for the premiums that it paid and is equal to the sum of those premiums, with or without interest. The balance of the death proceeds is payable to the executive's designated beneficiary.

Split dollar insurance is a funding method, not a type of policy. It can provide executives with substantial amounts of life insurance protection at an outlay well below that which they would pay for the same policy. The employee can be allowed to purchase the policy from the employer at termination or retirement.

Individual Life Insurance

Perhaps the most widespread means of funding for the financial consequences of premature death is through the purchase of individual life insurance policies. Life insurance with a death benefit equal to the amount needed to fill any financial gap is a perfect hedge against the financial consequences of death. The event that gives rise to the need also gives rise to the solution. If purchased in adequate amounts, life insurance, in purely economic terms, replaces the deceased individual's future earnings, thereby protecting the family or business from suffering adverse financial consequences.

Issuance of individual policies is determined on a policy-by-policy basis. Insurance companies determine whether to issue the requested insurance policy based on an application submitted by the applicant—typically through an insurance agent—and, if the amount applied for is large, based also on results of one or more physical examinations, laboratory tests, and other information. The application contains questions of an administrative nature and those relating to insurability. Besides trying to determine the proposed insured's health status, the underwriter wants to be satisfied that the amount of insurance requested bears a reasonable relationship to the financial loss that

the beneficiary would suffer upon the insured's death. The underwriter also wishes to know the purpose for the insurance and that the policyholder and beneficiary designations seem logical (i.e., insurable interest is present).

Life Insurance in Family, Estate, and Business Planning

Life insurance has an important role to play in most families' financial plans. This is evidenced by the fact that 78 percent of American families own life insurance.[3] It also plays an important and more specialized role in business continuation and estate conservation. In each of these circumstances, making a wise life insurance purchase decision involves five sequential determinations:

1. Whether life insurance is needed;
2. The appropriate amount;
3. The most suitable policy;
4. From whom to purchase the policy; and
5. How best to structure the policy to accomplish the goal.

In providing an overview of each of the five decision points, this section includes introductions to the generic types of insurance policies, to the types of insurance companies, and to how these companies position themselves in the market. This guide's focus, however, is on items 3 and 4 only—the policy and the insurer. Further, while logically these two decisions are separable, they usually are considered together. We begin this section by introducing some terminology that will ensure consistency of usage throughout this guide.

By **life insurance**, we mean a contract under which an insurer agrees to pay a specified sum of money, called the **face amount** (or **insurance amount**, **death benefit**, and a host of other terms by insurers), if the insured dies while the policy is in effect. The **insured** is the individual whose death triggers payment of the face amount. The person who applies for the policy, and usually will be the owner of the policy, is the **applicant**. In most instances, the proposed insured is also the applicant, but sometimes the applicant is someone else, especially when life insurance is being purchased for estate liquidity or business purposes.

The **policyholder** (or **policyowner**) is the person who owns the policy, exercises all contract rights, and with whom the insurer deals. The **beneficiary** is the person or entity designated by the applicant (policyholder) to receive the face amount on the insured's death. Of course, the policyholder must pay a stipulated consideration—called the **premium**—for the policy to become and remain in effect.

[3] *Life Insurers Fact Book* (Washington, D.C.: American Council of Life Insurers, 2008).

Determining Whether Life Insurance is Needed

The starting point of a life insurance needs analysis is an examination of the circumstances under which life insurance is needed. All insurance analyses have two dimensions: (1) the frequency of occurrence of loss-causing events and (2) the events' severity. Frequency of death is measured by **mortality tables** that display yearly probabilities of death by age and gender and sometimes other characteristics. **Life expectancy**, the average number of years of life remaining for individuals of a given age and gender and sometimes other characteristics, is derived from mortality tables.

For insurance planning purposes, probabilities of death or, equivalently, life expectancy, are relevant for large groups of insureds, as with employee benefit plans. They are of little relevance to a particular individual. A given person will either survive the year or not and is highly unlikely to live precisely to his or her life expectancy. Even so, many planners will use life expectancy to give the client some idea of the average remaining lifetime of similarly situated individuals or as an aid in determining the duration of coverage. Some marketing groups use life expectancy calculators derived from the mortality experience of their own clients, not those of the industry as a whole or even of a particular insurer.

Table 1-2 shows probabilities of death within the next year and prior to age 65 for selected ages, as well as life expectancies as of the ages shown, based on aggregate U.S. population data. The probability of death within one year for persons during their working years is small. The likelihood of death prior to age 65 is not. Indeed, approximately one in seven persons now aged 30 is expected to die before age 65. Also, for many persons, death after age 65 creates adverse financial consequences for families, and death probabilities after age 65 are high.

TABLE 1-2
Probabilities of Death

Age	Within One Year	Prior to Age 65	Life Expectancy
0	0.0068	0.1582	77.8
5	0.0002	0.1564	73.5
10	0.0001	0.1558	68.5
15	0.0005	0.1549	63.6
20	0.0009	0.1519	58.8
25	0.0010	0.1479	54.0
30	0.0010	0.1438	49.3
35	0.0013	0.1390	44.5
40	0.0019	0.1322	39.9
45	0.0030	0.1216	35.3
50	0.0044	0.1053	30.9
55	0.0063	0.0812	26.6
60	0.0095	0.0450	22.7

The key to planning for the death contingency is to focus on its financial consequences to the family or business, irrespective of its probability of occurring. One commonly accepted approach to beginning the process is to have the client answer a question akin to the following: *Will my death result in financial consequences that I find unacceptable for anyone?* If death would not create financial hardship on anyone—as is often the situation with children and single adults—there typically is no need for life insurance. Similarly, if death gives rise neither to estate taxes nor to business continuation issues, there likely is no need for life insurance for this purpose.

Note that the question's answer is from the perspective of what the *client* finds unacceptable. The client might, for example, find it perfectly acceptable *not* to provide financial support for one or more family members. If the client does not much care what happens to them, he or she is unlikely to buy life insurance for their benefit. We are reminded that we are not dealing with economic matters alone.

Determining the Appropriate Insurance Amount

Assuming a "yes" answer to the preceding question, the next question is: *How much life insurance is needed to address the financial consequences created by death?* The answer to this question gets to loss severity.

The possibility of a loss of earnings occasioned by the death of the family breadwinner is the major financial loss faced by most families. A business can suffer a parallel financial loss from the death of a key executive. As explained in Chapters 11 and 12, death can give rise to still other financial needs, including a desire to avoid having estate taxes diminish the estate corpus itself and to arrange for business buyouts. In each instance, advisors ordinarily derive a quantitative value of the need, which becomes the basis for making financial decisions about how most effectively to deal with it. To provide a feel for this process, here we sketch out how an advisor might go about estimating the financial impact on the family of a breadwinner's death. (Chapter 10 offers more detailed explanations for this use of life insurance.)

In such a situation, it would be necessary, first, to gather relevant quantitative and qualitative information to permit a sound identification of financial needs arising from the individual's death. This involves identification and valuation of the individual's assets and liabilities, and establishment of family objectives. For death planning purposes, this means that the family determines the income levels needed were either spouse to die. A commonly stated objective is to allow the family to maintain its current living standard. This might translate, for example, into a survivor income need of 70 percent of the pre-death family income, as the deceased spouse's self-maintenance expenses end. One ordinarily also establishes objectives regarding amounts to:

- Pay off liabilities;
- Cover funeral and other final expenses;
- Establish a family emergency fund;
- Establish a fund to finance children's education; and
- Give to charities or other organizations.

The advisor then determines the assets available to support the preceding objectives. These include existing personal and group life insurance, assets that could be liquidated on death, earnings on investments not to be liquidated, and future income from wages and Social Security survivor income benefits.

In analyzing future needs and resources, the advisor may make simple rough estimates for the value today of such future cash flows or may actually calculate present values at various interest and inflation rates. Such calculations require estimates for future investment returns and inflation rates, rendering them somewhat problematic. This fact is the reason that some advisors are satisfied with rough estimates.

In many instances, the need for the current year only is estimated. An attempt should be made to estimate future needs. This pattern can influence the type of insurance policy purchased. For example, if the future need were to pay off a mortgage loan, the amount of life insurance needed likely will decline with age—suggesting a decreasing term policy.

As for other circumstances, if the insurance need is to provide estate liquidity, a common means of determining the insurance amount is to base it on an estimate of future estate tax obligations. If the insurance need is to arrange for purchase at death of an owner's interest in a closely held business, a common means of determining the insurance amount is to base it on an estimate of the value of that business interest. Similarly, if the insurance need is to indemnify a business for the net income loss associated with the death of a key employee, a common means of determining the insurance amount is to base it on an estimate of that lost net income. These and other circumstances are explained in Chapters 11 and 12.

Numerous websites offer life insurance needs calculators. Additionally, one of the important value-added services of agents and financial planners is assistance in quantifying the need, especially in more complex situations.

Determining the Most Suitable Policy

After deciding on the amount of insurance, the client should decide on the most appropriate policy to buy. Several factors drive this decision, which we cover in detail in Chapter 10. In short, there will be personal and policy factors to consider. Here is a sampling of some of the personal factors to consider:

- The amount of money one is willing to spend on life insurance premiums;
- The likely pattern and duration of future life insurance needs;
- The likely pattern and accumulation of future policy cash values;
- The client's wealth transfer objectives;
- Financial discipline and risk tolerance; and
- Other saving options.

While Chapter 7 discusses in detail the common types of policies found in the market today, all fall into one of two generic categories: term life insurance or cash value life insurance. **Term life insurance** pays a death benefit if the insured dies within a set time period, such as 20 years, and pays nothing if the insured survives the period. **Cash value life insurance** combines term insurance and internal savings—called the **cash value**—within the same contract; that is, it accumulates funds that are available to the policyowner, much as with a bank savings account. Cash value life insurance is also sometimes referred to as **permanent life insurance**.

Virtually every cash value policy falls into one of three categories: (1) universal life insurance, (2) whole life insurance, or (3) endowment insurance. **Universal life insurance** policies are flexible-premium, adjustable death benefit contracts whose cash values and coverage period can be for the whole of life, depending on the premiums paid into them. **Whole life insurance** typically requires the payment of fixed premiums and promises to pay a death benefit whenever the insured dies and, therefore, is life insurance intended to remain in effect for the insured's entire lifetime. For both universal life and whole life policies, the policy values are credited with interest from underlying investments, typically investment grade fixed-income instruments, managed by the insurance company, and supported by a guaranteed minimum credited interest rate.

Endowment insurance makes two mutually exclusive promises: to pay a benefit if the insured dies during the policy term or if the insured survives the stated policy term. Very little endowment insurance is sold in the United States today, because its income tax treatment is no longer favorable. For this reason, we omit further treatment of it in this guide.

Cash value policies are also available as variable life insurance. With **variable life insurance**, the policyholder allocates the premium to investment options offered by the insurance company through what are called separate accounts with the policyholder carrying 100 percent of the investment risk, unlike non-variable policies. Thus, policy values fluctuate with changes in the market value of the investments backing the policy. The death benefit may vary with these changes in market value as well.

The issue of the type of insurance to purchase should not be divorced from the next issue—from whom to buy it. This is especially true for more

complex insurance situations and where the need for cash value insurance is indicated. Chapters 6–18 focus on understanding, assessing, and managing life insurance products.

Determining from Whom to Purchase the Policy

The next decision is from whom to buy the insurance. This decision involves examination of the quality of the advisor and of the insurer. Chapter 2 explores the quality dimension of advisors. In this section, we introduce the two most common organizational structures of life insurers and also discuss the importance of their target markets. Chapters 3–5 explore how to assess the financial strength of life insurers.

Organizational Structures of Life Insurance Companies

The vast majority of life insurance purchased in the United States is sold by commercial life insurance companies organized as either stock or mutual insurers, and selling their products through agents.[4] Other sellers include fraternal benefit societies and certain agencies of the federal government with regard to veterans' insurance. Fraternal benefit societies operate under a lodge system and may sell insurance only to their lodge members and their families. Their share of the U.S. life insurance market has been in slow decline for some years, accounting for only 1.5 percent of all life insurance in force in 2008. Given their small market presence and limited target market, we omit them from further discussion or analysis. We omit government-provided insurance for veterans for the same reason.

At year end 2008, 976 life insurance companies were doing business in the U.S., the number having steadily declined from a 1988 peak of 2,343 companies. This drastic change has been due mostly to vigorous competition which, in turn, drove more mergers and consolidations, as many insurers realized that they were not sufficiently large to compete successfully against larger insurers. Besides consolidation, another recent trend is demutualization and the formation of mutual holding companies, in order to raise capital from the equity market to fund business growth or support business risk. In creating a mutual holding company, a mutual insurer either starts or acquires a stock company.

Many life insurance companies are stand-alone entities, with no insurer affiliate or subsidiary. Others are organized into groups or fleets of affiliates and subsidiaries. Table 1-3 lists the rankings of the 25 largest life insurance groups at year-end 2008 based on direct individual life insurance premiums writings, with stand-alone companies counted as a group of one. The table

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[4]Information for this section is drawn from *Life Insurers Fact Book* (Washington, D.C.: American Council of Life Insurers, 2009).

TABLE 1-3
Largest 25 U.S. Life Insurance Companies by Form and Ownership (Ranked by Individual Direct Life Insurance Premiums Written, 2008)

Ranking	Group Name	Premiums (000s)	Form	Ownership
1	American International Group	$24,201,968	Stock	USA
2	Northwestern Mutual	11,755,258	Mutual	USA
3	MetLife, Inc.	7,922,876	Stock*	USA
4	New York Life	7,388,752	Mutual	USA
5	Prudential Financial	6,507,556	Stock*	USA
6	Manulife Financial	5,686,086	Stock*	Canada
7	Lincoln Financial	4,577,432	Stock	USA
8	Massachusetts Mutual	4,449,165	Mutual	USA
9	AEGON USA, Inc.	3,956,284	Stock	Netherlands
10	State Farm	3,558,336	Mutual	USA
11	AXA Financial	3,534,597	Stock	France
12	Guardian	2,876,099	Mutual	USA
13	Pacific Life	2,450,678	Mutual	USA
14	ING North America	2,306,145	Stock	Netherlands
15	Allstate	2,197,648	Stock	USA
16	Protective Life	2,124,229	Stock	USA
17	Hartford Life, Inc.	1,859,794	Stock	USA
18	Genworth Financial	1,849,336	Stock	USA
19	Primerica	1,828,002	Stock	USA
20	Phoenix Life	1,638,628	Stock*	USA
21	AFLAC	1,600,341	Stock	USA
22	Principal Financial	1,493,701	Stock*	USA
23	Sun Life Assurance	1,441,657	Stock*	Canada
24	Thrivent Financial for Lutherans	1,370,988	Fraternal	USA
25	Torchmark	1,340,049	Stock	USA

*Demutualized to become a stock life insurer.
Source: ACLI 2009 *Life Insurance Fact Book*, as of December 31, 2008.

also shows whether the insurer is a stock or mutual company (and whether it has undergone demutualization) and its country of ownership.

Stocks and mutuals differ from each other based on the nature of their ownership. **Stock life insurance companies** are shareholder owned corporations authorized to sell life insurance products. Stock insurers have access to capital through the equity market to grow the business or to support business risk. They are owned and controlled by their stockholders, with net profits inuring to these stockholders. Stock insurers can be owned by other stock insurance companies, mutual life insurance companies, or companies outside the insurance industry. Stockholders elect the members of the company's board of directors. Policyholders are purely customers of the insurer and have no rights to exercise any control over the insurer.

By contrast, **mutual life insurance companies** are policyholder owned corporations authorized to sell life insurance products. Net profits inure to the benefit of policyholders. Only policyholders can own a mutual company. Mutual companies do not issue stock, which means they do not have direct access to the equity market to raise capital. Instead, to raise additional capital they must (1) grow it internally through accumulated surplus (profits), (2) form mutual holding companies thereby allowing indirect access to the equity market, or (3) issue state-approved surplus notes—which are hybrid promissory notes that regulators allow to be counted as surplus. The ability to raise capital through surplus notes is limited compared to equity capital funding. Policyholders elect the members of the company's board of directors. Policyholders are both customers and owners of the insurer.

Some 75 percent of life insurers are stock companies, 19 percent are mutuals, with the balance being mostly fraternals. Stock companies held 73 percent of life insurance in force and mutuals held 25 percent in 2008. Some 11 percent of all stock insurers are foreign-owned, with Canada, the Netherlands, France, the United Kingdom, and Switzerland accounting for 78 percent of all such companies.

In discussing essential differences between stocks and mutuals, issues of control and cost sometimes are raised, so we address each briefly here. Some proponents of the mutual form contend that it is superior to the stock form as mutuals are controlled by and operate for the benefit of policyholders, whereas the stock company is owned and controlled by its profit-seeking stockholders. While it is theoretically correct that policyholders have ownership and control rights in the mutual company, this is true in reality to a limited extent only.

In fact, very few policyholders in mutual insurers vote for the members of the companies' boards of directors, and when they do vote, they typically give their proxies to existing management. They do this because they (1) do not purchase insurance to be able to control the company, perceiving themselves more as customers than owners; (2) are numerous and widely scattered geographically, with little capacity or inclination for intercommunication necessary for effective control; (3) have comparatively small stakes in the insurer; and/or (4) do not understand or care about their rights to vote. As a practical matter, mutual companies typically are controlled more by their management group through proxy arrangements than by policyholders. This fact is not necessarily bad, provided management diligently works for the best interests of policyholders and does not abuse their capacity for self-perpetuation.

Some proponents of stock companies argue that stockholders take a greater interest in the control of the company, creating more incentive for management to maximize value (as compared to complacency that can occur

with management of mutuals and their disinterested owners). As a practical matter, those stock companies with widespread and diverse ownership are also sometimes controlled more by their management groups through proxy arrangements.

Another issue in the stock versus mutual debate has been the question of relative product cost. Proponents of mutual companies have argued that, since profits flow to policyowners, their policies will be less costly than those sold by stock companies, as stockholders benefit from favored financial results. Conversely, proponents of stock insurers have argued that, being subject to the discipline of the market, their policies can be less costly by virtue of the company operating more efficiently.

Generalizations on the question of cost are not very helpful. Some mutual companies are more efficiently run than some stock companies and vice versa. Even if a given insurer is efficiently operated, there remains no guarantee that policyowners—whether in a mutual or stock company—will benefit from that fact. Stock companies may pay out substantial dividends to stockholders. Mutual companies may elect to restrict policyowner dividend payments in order to build surplus, as they have no direct access to the equity market. Whether a particular policy is low cost usually is not a function of the insurer's organizational form, but rather of its efficiency coupled with the extent to which the insurer passes efficiency gains to policyowners. This can be assessed by the company's history of passing on value to policyowners as measured by policy performance and the company's stated intention for passing on future experience gains. We explore this in Chapter 17.

Importance of a Life Insurance Company's Target Market

Life insurance companies, as with other commercial enterprises, do not try to be "all things to all people." Instead, they will have segmented large, heterogeneous markets into smaller, less diverse submarkets that have relatively similar product or marketing needs. From among these segments, most insurers (and agents) will have selected one or a few on which to focus their marketing efforts, called their **target markets**.

For example, some insurers' target market is the elderly who are not particularly wealthy, such as Colonial Penn Life Insurance Company, which targets the 50–85 age segment, offering modest amounts of cash value life insurance with no underwriting. At the opposite age spectrum, Gerber Life Insurance Company focuses on the juvenile market and sells relatively modest insurance policies directly to consumers, not through agents. Insurance groups that began as property/casualty insurers—such as Allstate, Farmers, and State Farm—typically sell life insurance through their agents as add-on coverage for those who already own homeowners and auto insurance with the group. Their target markets tend to be middle and upper-middle income families.

The selection of target markets strongly influences all marketing and related decisions taken by the insurer (and agent). It influences, if not dictates, what products it should develop, their pricing, and how they should be structured internally; the depth, quality, and quantity of needed actuarial, legal, investment, underwriting, and field support expertise; what reinsurance is needed; needed information systems support; the distribution methods to be adopted and compensation to be paid; and the nature of advertising and promotion—just to name a few.

Life insurers (and agents) select their target markets in a variety of ways. One way is to segment the market by (1) life stage, (2) financial status, (3) buying behavior, (4) affinity group, and (5) health. While shown here as distinct segments, in practice insurers usually combine subsets of each to develop their target markets.

Consider a target market keying off of, among other things, the household's financial status. Insurers could target their marketing efforts on one or more of these sub-segments:

- Households of modest financial means;
- Households of moderate financial means;
- Households of high financial means; and
- Affluent households.

A household's financial status is a function of its income and net worth. Obviously, different combinations of income and net worth exist. So target markets could be further segmented by these variables and others. For example, a further subdivision of the two highest financial categories could be:

- Professionals (perhaps further subdivided by profession; e.g., physicians),
- Non-professionals,
- Business owners (perhaps further subdivided by industry or size), and
- Individuals with inherited wealth.

Unsurprisingly, life insurers targeting the highest income and/or net worth market sell much larger policies on average than those targeting other income and/or net worth segments. Table 1-4 illustrates this point. As cash value policies are predominant in this market, and the need for life insurance typically is for long durations, the table is limited to insurers that sold at least 1,000 cash value policies during 2009 and whose average policy amount issued was at least $200,000, a comparatively modest amount. A minimum of 1,000 policies is used as a proxy for the insurer being a meaningful competitor and having sufficient sales to justify the high costs of providing the necessary personnel infrastructure to support their efforts in this market.

TABLE 1-4
Life Insurance Companies issuing at least 1,000 Cash Value Policies of $200,000 and greater during 2009

Rank	Insurance Company	Corporate Group	Number of Cash Value Policies Issued	Average Face Amount per Policy ($000)
1	Lincoln Life & Annuity Company of NY	Lincoln Financial Group	1,091	1,258
2	John Hancock Life Insurance Company USA	Manulife Financial	27,907	1,104
3	Sun Life Assurance Company of CA (US)	Sun Life Financial Group	1,743	1,085
4	John Hancock Life Insurance Company NY	Manulife Financial	3,321	972
5	Sun Life Assurance Co. of Canada USB	Sun Life Financial Group	4,773	954
6	Security Life of Denver Insurance Co.	ING USA Life Group	5,749	794
7	Penn Insurance and Annuity Company	Penn Mutual Group	2,059	787
8	Lincoln National Life Insurance Co.	Lincoln Financial Group	27,175	755
9	Allianz Life Insurance Co. of NA	Allianz Insurance Group	1,789	736
10	AXA Equitable Life Insurance Company	AXA Financial Group	14,197	730
11	PHL Variable Insurance Company	Phoenix Life Group	1,993	674
12	Minnesota Life Insurance Company	Securian Financial Group	8,630	604
13	MetLife Investors USA Insurance Company	Metropolitan Life and Affiliated Cos	22,244	580
14	Pacific Life Insurance Company	Pacific Life Group	13,122	491
15	Principal Life Insurance Company	Principal Life Group	11,155	478
16	Guardian Life Ins Co. of America	Guardian Life Group	25,845	440
17	Penn Mutual Life Insurance Company	Penn Mutual Group	6,517	434
18	Hartford Life Insurance Company	Hartford Life Group	1,577	416
19	RiverSource Life Insurance Company	Ameriprise Financial Group	11,668	401
20	Federated Life Insurance Company	Federated Life Insurance Company	2,304	400
21	Pruco Life Insurance Company	Prudential of America Group	21,561	387
22	Protective Life Insurance Company	Protective Life Corp	36,965	374
23	Aviva Life and Annuity Company of NY	Aviva USA Group	1,878	367
24	Acacia Life Insurance Company	UNIFI Companies	1,333	361
25	Nationwide Life Insurance Company	Nationwide Life Group	2,880	360
26	Massachusetts Mutual Life Insurance Co.	MassMutual Financial Group	40,968	360
27	MONY Life Insurance Company of America	AXA Financial Group	4,286	359
28	New York Life Insurance and Annuity Corp.	New York Life Group	26,240	359
29	West Coast Life Insurance Company	Protective Life Corp	4,094	352
30	Ameritas Life Insurance Corp.	UNIFI Companies	2,705	340
31	National Life Insurance Company	National Life Group	3,898	329

32	Hartford Life and Annuity Insurance Co.	Hartford Life Group	28,449	321
33	Ohio National Life Assurance Corporation	Ohio National Life Group	3,629	309
34	Aviva Life and Annuity Company	Aviva USA Group	26,404	301
35	National Western Life Insurance Company	National Western Life Insurance Company	8,213	292
36	Union Central Life Insurance Company	UNIFI Companies	4,465	282
37	North American Company for L & H Ins	Sammons Financial Group	6,015	253
38	Columbus Life Insurance Company	Western & Southern Financial Group	1,362	252
39	Western Reserve Life Assurance Co. of OH	AEGON USA Group	26,540	237
40	Ohio National Life Insurance Company	Ohio National Life Group	3,997	232
41	MTL Insurance Company	MTL Insurance Company	3,256	220
42	American General Life Insurance Company	AIG Life Group	10,916	215
43	Lafayette Life Insurance Company	Western & Southern Financial Group	4,805	213
44	Northwestern Mutual Life Ins Co.	Northwestern Mutual Group	144,188	210
45	Midland National Life Insurance Company	Sammons Financial Group	19,239	208

Source: A.M. Best Statement File.

It can be seen from Table 1-4 that, for several insurers, the average policy issue size was well above $200,000 and, for a few insurers, in excess of $1.0 million. Worth noting is the group affiliation of each insurer. In most instances, the group is composed of several other life insurers, each of which has its own target market, often focused on a geographical region, product type (e.g., variable), marketing method (e.g., brokerage), or other market segment.

It can be extremely important that each client's specific needs and circumstances match well with the target market of the insurer or insurers and agent being considered. Consider the client who requires complex estate planning and advice. Ordinarily, agents and insurers that do not specifically target this market would not be expected to bring much added value to the life insurance purchase, even if their products were priced competitively with those that did so specialize, which usually is not the case. Indeed, they could bring the very opposite if they were merely "order takers."

Evaluation of Life Insurance as a Financial Instrument

Life insurance is perhaps the most common financial instrument for dealing with death's adverse financial consequences. It offers several advantages not enjoyed by other instruments or techniques. It also carries some disadvantages.

Advantages of Life Insurance

Aside from the macro-advantages of life insurance to society, life insurance offers specific advantages to individuals. *First*, as noted earlier, life insurance can be the perfect hedge against the adverse financial consequences of death. The event that gives rise to the need also gives rise to the solution.

Second, life insurance enjoys tax treatment under the IRC not enjoyed by other comparable financial instruments. The tax that otherwise would be due on the interest earned on life insurance cash values is either deferred or avoided altogether, provided the policy qualifies as "life insurance" under the IRC (see Chapter 7). The tax is avoided altogether if the policy is retained until death. Because interest accrues on a tax-deferred basis, the cash value is greater than the after-tax value of equivalent taxable savings media for a term-plus-side-fund arrangement.

If the policy is terminated during the insured's lifetime, income tax will be due to the extent that the cash value and any other amounts received under the policy exceed the premiums paid, which is the cost basis. Even in this case, the tax will have been deferred for many years. Additionally, the IRC does not require a deduction from the tax basis for the economic value of the death benefit protection (i.e., the internal cost of insurance charges) provided

over the years. This tax advantage can perhaps be seen more clearly by noting that the premiums paid for term life insurance under term-plus-side-fund arrangements cannot be counted as part of the arrangement's cost basis, thus resulting in a higher taxable gain of such an arrangement in comparison to that of an otherwise identical cash value policy.

Life insurance death proceeds are free of income tax to the beneficiary, irrespective of the length of time the policy had been in effect, provided certain minimum precautions are taken. Also, through reasonable planning, the death proceeds can be received free to estate taxes. Thus, every dollar of such a policy's death proceeds in the beneficiary's hands could be the equivalent of two dollars of assets retained in the taxable estate (assuming a combined 50 percent state and federal death tax rate).

Third, many life insurance policies today are exceptionally flexible in terms of being capable of adjusting to the client's changing financial and other circumstances. They are tax-favored repositories of easily accessible funds if the need arises. Yet the assets backing these funds are generally held in longer-term investments, thereby earning a higher return. Also, the policyholder usually can opt to deposit additional funds into the policy, thereby enhancing tax favored interest earnings and lowering the internal mortality charges while possibly extending the length of time that the policy will remain in effect. Likewise, with many policies sold today, the policyholder can change the amount of premium paid to accommodate changed circumstances, sometimes even paying nothing if sufficient policy value exists to sustain the policy.

If changed circumstances suggest a lesser amount of insurance is needed, the policy face amount easily can be reduced, with corresponding reductions in internal mortality charges or premiums. The opposite set of circumstances can be accommodated through an increase in the face amount, subject to satisfactory insurability.

Further, life insurance can prove invaluable for innumerable business and personal purposes. Executive bonus plans are but one example. So, too, is using life insurance to fund the purchase of a closely held business on the death of one of its owners. The owner's heirs receive cash for what might otherwise be an illiquid ownership interest. The surviving business owners enhance their ownership share and avoid the potential for conflict with the deceased owner's heirs.

Disadvantages of Life Insurance

Life insurance is not without its disadvantages. *First,* insurers necessarily incur operational expenses and taxes, and these must be paid for via loadings in the policy. Such loadings vary over time, ranging, for example, from 100 percent or more of the first year premium to 5–20 percent thereafter, depending on the type of policy and the insurer's target market.

Second, buyers of life insurance forego some current expenditure to pay policy premiums for this future hedge. Moreover, the person foregoing current expenditures to pay the policy premium is unlikely to realize the benefit of the hedge directly. Life insurance is purchased for the benefit of others and usually only indirectly for the benefit of the person whose life is insured.

Third, the life insurance purchase decision can be complex. Even the comparatively straightforward decision to purchase life insurance to cover one's family may not be simple. Is insurance needed and, if so, in what amount, what type, and from whom should it be purchased. The decision requires analysis at each stage, and the customer often is not well versed in life insurance.

Complexity can increase by orders of magnitude if the purchase is for estate liquidity or is to be used in business situations or complex family situations. The decision involves the same types of issues as with the family purchase, but others as well, such as: How best to structure the arrangement? How do we minimize income, gift, and estate taxes? How to maximize the possibility of all heirs feeling that they have been treated fairly? How do we go about ensuring that the insurance amount remains adequate over time and that the policy being considered offers needed flexibility for changing circumstances?

Conclusions

The decision whether to purchase life insurance can be entangled with the psychological aspects of death and dying. Anxiety and emotions can be a hindrance to sound planning or can be used as the basis for motivating planning, depending on the client and on how sensitive and effective advisors treat these aspects. The client's setting of objectives with regard to the financial consequences of his or her death is a vital first step in the planning process. Quantification of these financial consequences logically follows, with individual life insurance commonly proving to be the most effective means of addressing these financial consequences.

Life insurance policies can be broadly classified as being either term life insurance or cash value life insurance. Within the cash value classification, universal life and whole life policies predominate. A seemingly endless variety of these policies is found in the market, regrettably abetting confusion.

Stock and mutual life insurance companies are the predominant forms in life insurance markets worldwide. Stock insurers are owned by stockholders, and mutual insurers are owned by its policyholders. Stock insurers are far more prevalent today than in times past, thanks to the demutualization of many large mutual insurers. Both stock and mutual insurers decide on, and

then focus their resources on, one or more target markets. Several insurers (and agents and marketing organizations) target the high income/net worth market, having honed their expertise to provide meaningful added value to clients. Independent advisors such as attorneys, accountants, and financial planners should, if asked, critically consider the target market of any insurer being recommended by a salesperson, as well as the target market of the salesperson.