

Learning Objectives

An understanding of the material in this chapter should enable the student to

1. Define the basic principles of life insurance.
2. Explain the concept of risk pooling and the law of large numbers.
3. Explain how mortality, interest, and expense serve as the building blocks of life insurance.
4. Explain how the premium for yearly renewable term is determined.
5. Describe how the level premium insurance concept works.
6. Explain the concept of human life value and how it relates to the need for life insurance.
7. Identify and explain the expenses commonly associated with death and settling the deceased's estate.
8. List and explain the income needs of family survivors.
9. Explain the post-death cash needs of survivors.
10. Explain the steps in the selling/planning process.

This chapter explores the concept of risk pooling and other principles of life insurance. It defines how life insurance is structured. The human life value concept as the underlying economic principle for the need for life insurance is explained and the basic needs for life insurance are outlined. The chapter ends with a discussion of the selling/planning process applied to life insurance.

BASIC PRINCIPLES OF LIFE INSURANCE

Life insurance is based on several basic principles that apply to all types of insurance, and that form the foundation of the insurance contract. Understanding these principles will help us better understand how life

insurance works as we begin our study of life insurance products. The purpose of this course is to give you a much deeper understanding of life insurance products and related concepts that will help you, as a financial advisor, work with prospects and clients on ways to protect their families against the risk and financial impact of death. It will accomplish this by reviewing the basic principles of how life insurance works, the different financial needs that life insurance can address, the various types of life insurance, ways of comparing policies, the advantages and disadvantages of life insurance illustrations, life insurance policy provisions, the taxation of life insurance and some marketing and ethical concepts applicable to selling life insurance.

The information in this course is largely to educate you, not your clients. You will not necessarily discuss much of this material with clients, since it is largely technical and not relevant to the consumer, but it is important for you to understand it so you can appreciate the concepts and benefits of life insurance, how they work, and explain them correctly and with confidence to others.

The financial advisor can have a significant role in helping individuals and families establish a firm foundation of financial security. They should be able to address the fundamental financial needs and reasons for owning life insurance. He or she should be able to help prospects and clients recognize and accept their financial needs, and encourage them to act to take care of those needs. People face many financial challenges, and the ability to plan and save for the future is often put off for the pressures and pleasures of today.

This is clearly seen in recent research published by LIMRA, a research, consulting and professional development organization that helps insurance and financial services companies increase their marketing effectiveness. A recent LIMRA study (Household Trends in Life Insurance Ownership study, LIMRA, 2010, LL Global, Inc.) found that only 44 percent of U.S. households have individual life insurance, representing a 50-year low in individual life insurance ownership. The number of U.S. households with no life insurance whatsoever is growing. Today, 30 percent of households (35 million) have no life insurance coverage, compared to 22 percent of households in 2004. Despite high unemployment, the study reveals a continuing increase in the proportion of insured households that have only group insurance. Among households with children under age 18, which arguably have the greatest need for life insurance, 11 million have no coverage. Today 77 percent of

husband-wife families with children under 18 have life insurance coverage, compared with 90 percent in 2004. As families have less to fall back on financially in the economic downturn, more families are living on the edge, without the safety net that life insurance provides.

Many Americans say they have not bought more life insurance because they have other financial priorities right now. Among households with children under 18, four in ten say they would have immediate trouble meeting everyday living expenses if the primary breadwinner died today. Another three in 10 would have trouble keeping up with expenses after several months. Half of households feel they need more life insurance than they have—the highest level ever. According to LIMRA's study, life insurance beat out all other sources of financial assets or income that Americans expect to use to help pay bills and to maintain their lifestyle in the event of the primary wage-earner's death. On average, households say they should have enough life insurance to replace their incomes for 6.2 years, but in reality they own enough to replace the household's income for only 3.5 years. Almost eight in 10 U.S. households currently do not have a personal life insurance agent or broker to turn to and most of them say they never did. These facts represent an enormous opportunity as well as a challenge to the life insurance industry and insurance producers.

The Role of the Financial Advisor

There is much to learn to be a competent financial advisor. You must master the core skills of your business including marketing, prospecting, selling, business organization, planning and management, communications, technical and product knowledge, and financial acumen. To be effective, you must know how to help people structure their financial goals. To become a professional and trusted advisor, you must help prospects and clients recognize and accept their financial needs, and encourage them to act to take care of those needs. That is rarely an easy job.

People expect more from financial advisors today than they did in the past. There have been serious violations of trust from financial institutions and those who work for them, and this situation is especially acute today. As an advisor, you are expected to act professionally and give accurate and valuable advice, based on your knowledge, skill and experience.

Financial advisors assist people who are facing the challenges of life such as retirement, disability, long-term care needs, or death. We help people address the problems these life events inevitably create. These are tough

issues. Our task is to focus on these issues, the needs and dreams of our prospects and clients, and to devise the best ways to fulfill their goals and dreams. When we do this, our relationships with clients become meaningful to them and us, and we all benefit.

The financial services industry is very competitive. As you progress in your career, you must develop your knowledge and skills. This must become the difference between you and the competition in some meaningful way. You must ask yourself, how well do you understand your client's financial problems and goals? What ideas do you have to help him or her address them? How skilled are you at carrying out the selling and planning process? You must know your products and how they relate to other financial products that your clients will be offered. How deeply do you believe in the value of your products?

However, just because you want to help people does not mean that they want your help. Many people think they do not need your help because they are “do-it-yourselfers,” or they do not recognize or accept that they have a financial need. You may not have been able to establish a relationship of trust with a prospect that will enable you to start this discussion. Many of those that need your help do not have the money or willingness to pay for it. Success will depend on finding people who want and need your help, and are willing and able to pay for it.

Most people are not looking for help. Most people engage advisors in the midst of or after triggering life events—not proactively, but reactively. Research studies and our own experience point out that people do not like to think about or discuss these topics. Retirement, death, divorce, having children, paying for college, layoffs and unemployment, long-term care events, and disability are critical triggers for prospects to either seek or accept professional financial help. Get in front of this fact with targeted marketing, and seek prospects and markets where you can address these issues with prospects.

How many people you see will determine how successful you become, not how much you know. Knowledge supplements a successful practice; it does not create it. Activity is the key to staying in the business and eventually becoming successful. Make two appointments everyday for some time in the future. Having two appointments every day for the foreseeable future is the path to success.

Selling is a complex, psychological use of questions and statements that motivate people to make a decision and take action. It is neither simplistic nor devious, if done well and professionally. People fail to act in their best interest and tend to stay put, regardless of their discomfort, unless motivated by a fear of loss or hope of gain that is greater than the cost of a solution or doing nothing. No amount of professional knowledge will make a bit of difference to this critical process unless you have someone to talk with. Expertise is useless until the prospect is engaged in the process. Most new advisors will need four or five strategic and repetitive marketing activities to be successful. With time and experience, these activities may be reduced to one or two core activities discovered through actual results over time. Quality comes from experience, and experience comes from repeated activity and many failures.

Insurance Defined

Insurance can be defined from many different points of view. For example, from an economic viewpoint, insurance is a system for reducing financial risk by transferring that risk from a policyowner to an insurer. The social aspect of insurance involves the collective bearing of losses through contributions by all members of a group to pay for losses suffered by some group members.

From a business viewpoint, insurance achieves the sharing of risk by transferring risks from individuals and businesses to financial institutions specializing in risk. The insurer is not in fact paying for the loss. The insurer writes the claim check, but is actually transferring funds from individuals who as part of a pool, paid premiums that created the fund from which the claims are paid.

Lastly, from a legal standpoint, an insurance contract (policy) transfers a risk (the possibility of a loss), for a premium (consideration), from one party (the policyowner) to another party (the insurer). It is a contractual arrangement in which the insurer agrees to pay a predetermined sum to a beneficiary in the event of the insured's death. By virtue of a legally binding contract, the possibility of an unknown large financial loss is exchanged for a comparatively small certain payment. This contract is not a guarantee against a loss occurring, but a method of ensuring that payment is made for a loss that does occur.

The Financial Planning Process

financial planning process

The financial advisor uses a planning approach to marketing insurance and financial products. This course

emphasizes life insurance, but the skills and processes covered can apply to all financial product sales. Financial planning is a process that accomplishes both of the following:

- determines the client's financial problems and/or financial goals
- develops a plan to solve the client's problems and/or achieve the client's goals

Although some people may benefit from comprehensive financial planning, the process of addressing all aspects of one's financial life at one time, most people do not require this approach, and even if they do, they are unwilling to spend the time and money it requires. It is difficult to deal with the totality of one's financial problems and goals all at once. This is also challenging for the financial advisor, who needs specialized education, experience and training to take on this challenging task. In most cases, you will be addressing only one or a few of the most important financial needs for the prospect or client at the initial and subsequent meetings.

At the foundational level of the financial plan, the advisor and client should focus on providing protection against life's uncertainties, those events, such as the death of an income producer or parent, that could have a devastating effect on the financial well being of an individual and his or her dependents. This is the fundamental purpose of life insurance. Life insurance will also be involved in the financial planning process as financial objectives such as wealth accumulation and wealth distribution come into focus.

Life insurance was once considered an isolated financial product designed to protect policyowners from the financial consequences of premature death. Little attempt was made to integrate life insurance planning with the complete array of products sold by all types of financial institutions. In recent years, it has become increasingly difficult to view insurance products in isolation from a comprehensive financial planning process. This is due in part to the growing popularity of the financial planning approach and in part to the integration of the financial services industry, where a broad range of financial products are being made available within one financial services organization.

Risk Management

risk management

Life entails risk, which is defined as the possibility of loss.

People generally seek security and avoid uncertainty.

The risk of death is unavoidable, and is especially an economic threat if premature, when an individual may be exposed to heavy financial

responsibilities, yet has not had the time to accumulate enough savings to offset the financial needs of survivors. Life insurance provides a tool for *risk management*, a process for dealing with the risk of loss of life.

Insurance substitutes certainty for uncertainty, through the pooling of groups of people who share the risks to which they are exposed. Uncertain risks of individuals are combined, making the possible loss more certain, and providing a financial solution to the problems created by the loss. Small, certain periodic contributions (premiums) by the individuals in the group provide a fund from which those who suffer a loss are compensated. The certainty of losing the premium replaces the uncertainty of a larger loss. Life insurance thus manages the uncertainty of one party through the transfer of a particular risk (death) to another party (the insurer) which offers a restoration, at least in part, of relatively large economic losses suffered by the insured individual and his or her dependents.

indemnity

The essence of insurance is the principle of *indemnity*, that the person who suffers a financial loss is placed in the same financial position after the loss as before the loss occurred. He neither profits nor is disadvantaged by the loss. In practice, this is much more difficult to achieve in life insurance than in property insurance. No life insurance company would provide insurance in an amount clearly exceeding the estimated economic value of the covered life. Limiting the amount of life insurance sold to reflect economic value gives recognition to the rule of indemnity. Additionally, only persons exposed to the potential loss may legitimately own the insurance covering the insured's life.

Risk Pooling

risk pooling

Life insurance is based on a concept called *risk pooling*, or a group sharing of losses. People exposed to a risk agree to share losses fairly or on an equitable basis. They transfer the economic risk of loss to an insurance company. Insurance companies collect and pool the premiums of thousands of people, spreading the risk of losses across the entire pool. By carefully calculating the probability of losses that will be sustained by the members of the pool, insurance companies can equitably spread the cost of the losses to all the members. The risk of loss is transferred from one to many and shared by all insureds in the pool.

EXAMPLE

The simplest illustration of risk pooling involves providing insurance for one year, with all members of the group the same age and possessing roughly similar prospects for longevity. The members of this group agree that a specified sum, such as \$100,000, will be paid to the beneficiaries of those members who die during the year, with the cost of the payments being shared equally by the members of the group. In its simplest form, this arrangement might involve an assessment upon each member in the appropriate amount as each death occurs. In a group of 1,000 persons, each death would produce an assessment of \$100 per member. Among a group of 10,000 males aged 35, 21 of them could be expected to die within a year, according to the 1980 Commissioners Standard Ordinary Mortality Table (more on this later). If expenses of operation are ignored, cumulative assessments of \$210 per person would provide the funds for payment of \$100,000 to the beneficiary of each of the 21 deceased persons.

Examples of Risk Pooling**Homeowner's Insurance**

Of 1,000 houses, each worth \$200,000, assume only one house per year is destroyed by fire. Each homeowner could contribute \$200 per year into a pooled fund that could pay out the full \$200,000 value to the homeowner of a destroyed home. Such pooling transfers the risk of bearing the full impact of a potential \$200,000 loss by an owner.

Life Insurance

Ten thousand males aged 35 contribute to a life insurance pool. Twenty-one of them are expected to die this year (based on 1980 CSO Mortality Table). The mortality charge is \$2.10 per \$1,000 of benefit. If each of the 10,000 contributes \$210 to fund death benefits (ignoring costs of operation), a death benefit of \$100,000 could be paid for each of the 21 expected deaths.

Members of the group pay premiums that are measured to be individually and collectively fair based on the risk they impose on the company and the pool. (Each class of policies should pay its own costs.) If all insureds contribute a fair amount to the mortality fund held by the insurance company, there will be sufficient dollars in the fund to pay the death benefits of those insureds that die in the coming year. Individually, we do not know when we will die, but statistically, the insurer can predict with great accuracy the number of individuals that will die in a large group of individuals. The insurance company has taken an uncertainty on any individual's part, and turned it into a certainty on their part.

The Law of Large Numbers

For a plan of insurance to function, the pricing method needs to measure the risk of loss and determine the amount to be contributed to the pool by each participant. The theory of probability provides such a scientific measurement.

Probabilities for life insurance are represented in a mortality table. The *mortality table* is very versatile, developing probabilities of dying over the entire life span. Life expectancy at any age is the average number of years of life remaining once a person has attained a specific age. It is the average future lifetime for a representative group of people at any given age. The probable future lifetime of any individual, of course, will depend on his or her state of health, among other things, and may be much longer or shorter than the average.

law of large numbers

The statistical group that is observed for purposes of measuring probability must have mass—that is, the sample must be large enough to allow the true underlying probability to emerge. The *law of large numbers* states that as the size of the sample (insured population) increases, the actual loss experience will more and more closely approximate the true underlying probability. This means that the insurer's statistical group must be large enough to produce reliable results, and that the group actually insured must be large enough to produce results that are consistent with what probability predicts.

Insurance relies on the law of large numbers to minimize the speculative element and reduce volatile fluctuations in year-to-year losses. The greater the number of exposures (lives insured) to a peril (cause of loss/death), the less the observed loss experience (actual results) will deviate from expected loss experience (probabilities). Uncertainty diminishes and predictability increases as the number of exposure units increases. It would be a gamble to insure one life, but insuring 500,000 similar persons will result in death rates that will vary little from the expected.

A peril is a cause of a loss. In life insurance, the event against which protection is granted, death, is uncertain for any one year, but the probability of death increases with age until it becomes a certainty. If a life insurance policy is to protect an insured during his or her entire life, an adequate fund must be accumulated to meet a claim that is certain to occur.

Some people claim that insurance is a gamble. Insurance is actually the opposite of gambling. Gambling creates risk where none existed. Insurance

transfers an already existing risk exposure and, through the pooling of similar loss exposures, reduces financial risk.

THE BUILDING BLOCKS OF LIFE INSURANCE—MORTALITY, INTEREST, AND EXPENSE

All life insurance products are actuarially created by calculating the relationships of mortality, interest, and expense, and the financial values resulting from each based on time. The assumptions made concerning these three factors will determine the premium at which a policy is sold, the structure of the policy, and over time the performance of the policy and the profitability and solvency of the life insurance company. All life insurance policies, regardless of type, are based on these same elements.

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| mortality | <i>Mortality</i> rates project the cost of covering death claims as they occur. |
| interest | <i>Interest</i> earnings reflect the income the company expects to receive from the investment of premiums over time that will be added to the reserves, held aside to pay future claims. |
| expense | <i>Expenses</i> include the cost of creating, offering, and maintaining the product to pay all promised benefits. These factors must also provide profit to the insurer. |

Different products apply these factors in different ways. Term insurance has a pay-as-you-go structure. Premiums increase as mortality increases and the policy does not build cash value. Interest earnings have a smaller impact on the premium than in permanent policies and expenses are largely covered by the policy fee.

In permanent whole life insurance (WL), the policyowner pays premiums in advance, paying a higher, or excess, premium that can be “reserved,” so that premiums can remain level throughout the insured's life. This higher premium level builds cash value the policyowner can access through loans or cash surrender of the policy. In WL, these factors are “bundled,” meaning they are not itemized or disclosed separately.

On the other hand, in universal life (UL), the costs are unbundled, meaning the components of mortality, interest, and expense in the policy are identified and the values and charges for each are itemized in regular reports to policyowners. Mortality charges are identified as cost of insurance (COI), which are monthly charges based on the insured's issue age, attained

age, net amount at risk, gender, and underwriting class. Interest is paid each month on the cash value at the current crediting rate. Administrative expenses are charged monthly. All of these elements have a current rate, and are subject to maximum and minimum guaranteed charges or interest crediting as stated in the policy.

Because of the unbundled nature of policy costs, UL works like an investment account with term coverage. The mortality charges are similar to those of term, and the interest rates reflect the current market and adjust to changing market conditions. The policyowner accepts more of the investment and mortality risk, with a minimum guaranteed interest crediting rate, and maximum mortality and expense charge guarantees.

Variable universal life (VUL) contains death benefits and cash values that vary with the performance of the subaccounts selected. The death benefit and cash value are not guaranteed, and can fluctuate according to market performance. The life insurance aspect of VUL is essentially the same product as UL with the same features and specifications for the most part. The main difference between UL and VUL is that VUL allows the policyowner to allocate the premiums and cash value of the policy among a group of variable subaccounts.

Mortality

To price insurance products, and ensure the adequacy of reserves to pay claims, actuaries use mortality tables to project the number and timing of future insured deaths. Actuaries study the incidence of deaths in the recent past, and develop expectations about how these events will change over time, allowing them to develop an expectation of the timing and number of such events in the future. A safety margin is built in that increases the mortality rates above what is expected. In participating policies, savings created by these conservative assumptions can be returned as dividends. In nonparticipating policies, the safety margins must be smaller in order for the premium rates to be competitive.

A *mortality table* shows the mortality experience used to estimate longevity and the probability of living or dying at each age, and thus determine the premium rate. Mortality tables may include the probability of surviving any particular year of age, remaining life expectancy for people at different ages, the proportion of the original birth cohort still alive, and estimates of a group's longevity characteristics. Life mortality tables today are constructed separately for men and women, and are created to distinguish individual

characteristics such as smoking status, occupation, health histories, and others.

2001 CSO Mortality Table

With significant improvements in mortality over the last 20 years, mortality rates are decreasing. One resulting change is the extension of the life span in the *2001 CSO Mortality Table* to attained age 120 (compared with age 100 in the 1980 CSO table). The CSO mortality tables represent the most widely used estimates of expected rates of death in the United States based on age. The data used for the CSO tables is taken from data developed by the American Academy of Actuaries, and adopted by the National Association of Insurance Commissioners (NAIC). The CSO mortality tables are used to calculate reserves and minimum cash values for state regulatory purposes, as well as life insurance premiums. Larger insurance companies use their own mortality statistics to calculate their pricing of products, based on their own selection and underwriting practices. Because 1980 CSO mortality represents the vast majority of in-force policies, it is, and will be, relevant for years to come, even though newly issued policies will be using 2001 CSO rates. As of January 1, 2009, all new products must use the 2001 CSO table to calculate nonforfeiture and reserve values for state regulatory purposes.

Interest

Insurers invest the premiums they receive and accumulate them for future claims and other obligations, such as policy loans and surrenders. Life insurance company portfolios are traditionally long-term and emphasize safety of principal and predictable rates of return, to accommodate their long-term obligations. Typically, two-thirds or more of this capital is invested in bonds and mortgages, which meet the above criteria. A smaller percentage is invested in common stocks, due to their volatility. Today, common stocks represent less than 10 percent of the average life insurer's general account portfolio.

Since recently issued policies have low claims experience as a whole until years later, there is an adjustment in the calculation of the premium for the *time value of money* (compound interest). If the investment results exceed the guaranteed minimum, policyowners benefit from either participating dividends or excess interest crediting to the policy's cash value.

Expense

Life insurance companies incur acquisition and administrative expenses in the course of doing business. Acquisition expenses include the costs incurred in obtaining business and placing it in force, such as advertising and promotion fees; commissions; underwriting expenses; costs associated with medical exams and attending physicians' statements, inspection report and credit history fees; home office processing costs; and an addition to the insurer's reserve, surplus, and profits. Administrative expenses include the costs associated with collecting premiums and distributing dividends, continuing producer compensation, investment expenses, and home office overhead. Any costs the insurer incurs must be recovered through mortality savings, expense charges, and (or) reduced interest crediting.

Determining the Premium

The 1980 CSO Mortality Table lists different rates for men and women of different ages. The rate per \$1,000 of benefit for women aged 35 is \$1.65 in the 1980 CSO table. Companies that issue policies to only the healthiest applicants will have rates significantly lower than those in the CSO tables. Even insurance companies issuing policies to applicants in average health usually offer rates lower than those listed in the CSO tables.

yearly renewable term (YRT)

To demonstrate how the tables are used, we will first examine how the premium for a *yearly renewable term (YRT)* insurance policy is calculated. YRT is the simplest form of insurance offered by life insurance companies. It provides insurance for a period of one year and allows the policyowner to renew the policy for successive periods of one year each, paying just the mortality charges and administrative expenses for one year at a time, and no more. The interest component is minimal.

The mortality charge for YRT insurance is determined by the death rate for the attained age of the individual involved. Each premium purchases only one year of insurance protection. Each group of policy owners of a given age is considered to be a separate class for premium purposes; each group must pay its own death claims, with the burden shared equally by the members of the group. Because the death rate increases with age, the premium for yearly renewable term insurance normally increases each year.

EXAMPLE

For a group of 100,000 women aged 25

- The average mortality rate, according to the 1980 CSO Mortality Table, is 1.16 per 1,000.
- Expected deaths from the group for the year are 116.
- A \$1,000 death benefit per deceased results in \$116,000 in claims.
- Each woman contributes \$1.16 to cover the death benefits (ignoring costs of operation).

Because premiums are paid to the life insurance company in advance, the cost of the anticipated death claims would be distributed pro rata over the 100,000 policy owners, and a premium of \$1.16 would be collected from each policyowner. Note that:

- the premium is precisely the same as the death rate applicable to those insured
- those policyowners who, according to the mortality projection, will die during the year, contribute on the same basis as those who will survive

Each policyowner pays a share of his or her own death claim. This is a principle that underlies all life insurance contracts. The proportion, however, varies with the type of contract, age at issue, and duration of the protection.

If the 99,884 survivors of the original group of 100,000 policy owners was insured for another year, they would be exposed to the death rate for persons aged 26, or 1.19 per 1,000, which would theoretically produce 119 deaths and claims totaling \$119,000. That sum divided equally among the 99,884 participants would yield a premium of \$1.19 per person. If the 99,765 women who survived the first and second year should desire insurance for another year, provision would be made for \$122,000 in death claims, requiring a premium of \$1.22 per person.

For the first several years, the premium would continue to increase slowly, being \$1.35 at age 30, \$1.65 at age 35, and \$2.42 at age 40. Later, however, the premium would rise sharply, reaching \$3.56 at age 45, \$4.96 at 50, \$7.09 at 55, \$9.47 at 60, and \$14.59 at 65. If the insurance is continued beyond age 65, the cost becomes prohibitive, soaring to \$22.11 per \$1,000 at age 70, \$38.24 at 75, \$65.99 at 80, and \$116.10 at 85. The premium at 90 would be \$190.75 per \$1,000; at 95, it increases to \$317.32. Finally, if a woman

aged 99 should want \$1,000 of insurance on the YRT basis, she would have to pay a premium of \$1,000, since the 1980 CSO table assumes that the limit of life is 100 years and that a person aged 99 will die within the year, or at least the policy period will end.

LEVEL PREMIUM INSURANCE

Level premium insurance is a plan of insurance under which premiums do not increase from year to year but remain constant throughout the premium-paying period. It does not imply that the insured must pay premiums as long as he or she has insurance protection, only that all premiums required will be of equal size.

If premiums that increase each year are leveled out, the premiums paid in the early years of the contract will be more than adequate to meet current death claims, while those paid in the later years will be insufficient to meet incurred claims. This is a simple concept, but it has many consequences and far-reaching significance.

reserve With the level premium technique, the excess premiums in the early years of the contract create an accumulation fund that is held by the insurance company for the benefit and to the credit of the policyowners. This is not a trust fund in the legal sense, which would require the insurance company to establish separate investment accounts for each policyowner and render periodic accountings. This accumulation is called a *reserve*, which is an amount that must be accumulated and maintained by the insurance company to meet definite future obligations.

legal reserve Because the manner in which the fund is to be accumulated and invested is strictly regulated by law, the reserve is usually referred to as the *legal reserve*. The reserve is a composite liability account of the insurance company, not allocated to individual policies, but an aggregate of individual accounts established to the credit of the various policyowners. In practice, each policy is credited with a cash value or surrender value, which is not the same as the reserve, but is based on the excess premiums paid during the early years.

Term Policies

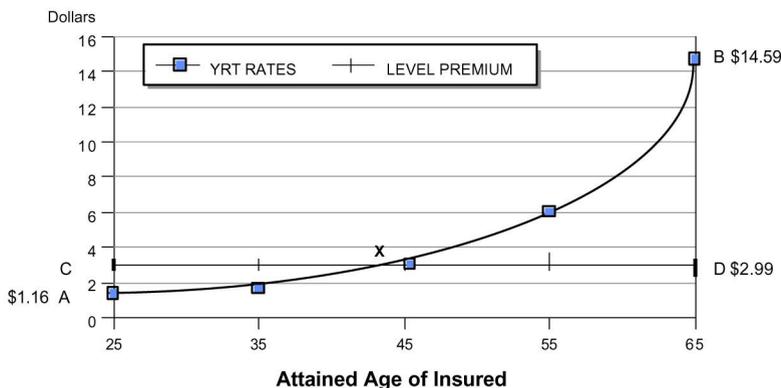
From the standpoint of an individual policy, the excess portions of the premiums paid in the early years of the contract are accumulated at

compound interest and subsequently used to supplement the inadequate premiums of the later years. This process can be explained most simply in connection with a contract that provides protection for only a temporary period, as opposed to one that provides insurance for the policyowner's whole life.

Figure 1-1 shows a level premium term policy issued at age 25, remaining in force to age 65, based on the 1980 CSO female table with an interest assumption of 4.5 percent. It is assumed, in calculating the level premium, that the reserves are invested at 4.5 percent, and that the YRT premiums earn 4.5 percent each year before being disbursed for any death benefits paid. In this example, for the sake of simplicity, no allowance is made for expenses, which makes it easier to understand.

In Figure 1-1 the curve *AB* represents the premiums at successive ages that would be required to provide \$1,000 of YRT insurance from age 25 to age 65. The premium ranges from \$1.16 at age 25 to \$14.59 at age 65. The line *CD* represents the level premium that would be required to provide \$1,000 of insurance from age 25 to age 65 on the *level (premium) term* basis. The level premium to be paid each year through age 64 is \$2.99. This amount exceeds the premiums that would be required on the YRT plan prior to age 44, but is smaller than those payable thereafter.

Figure 1-1
Annual Premium Comparison Level Term to Age 65 and Yearly Term



The area *AXC* represents the excess portions of the level premiums paid prior to age 43; the area *BXD* represents the deficiency in premiums after that age. The second area is much larger than the first. The disparity in the size of the two areas is attributable to the fact that the sums represented by the area *AXC*, which represent the reserve under the contract, are invested

at compound interest, and the interest earnings are subsequently used along with the principal sum to supplement the premium deficiency in the later years.

The reserve is completely exhausted at age 65 (the end of coverage), having been used to pay the policy's share of death claims submitted under this group of policies. The reserve, including the investment earnings derived from them, is gradually used up after age 44 in the process of supplementing the deficient level premium. The reserve under this particular contract—term to 65, issued at age 25—reaches its maximum size at age 53, diminishing thereafter at an accelerating rate until exhausted at the expiration of the policy.

Ordinary Life Policies

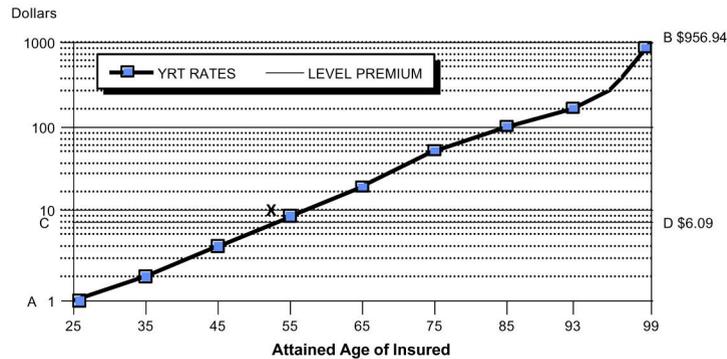
The functioning of the level premium plan is even more striking when applied to a WL policy. A comparison of the level premium required under an ordinary life policy (WL) with that required on the YRT basis is presented in Figure 1-2. An *ordinary life policy* is a type of WL for which level premiums are paid until the insured's death, or the policy termination date of age 100 or 120 (the end of the mortality table used), whichever comes first. The terms ordinary life and WL are interchangeable. Today we more commonly use the term whole life (WL).

| Yearly Term versus Level Premium for Life Female Aged 25 |
|--|
| <ul style="list-style-type: none"> • Annual level premium of \$6.09 per \$1,000 of coverage • Exceeds yearly term cost of \$1.16 per \$1,000 coverage at age 25 • Level premium exceeds the yearly term premium until the insured reaches her mid-50s • Beyond age 55, the level premium of \$6.09 per \$1,000 of coverage is less than the cost of yearly term coverage per \$1,000 • By age 99, the yearly term premium of \$956.94 per \$1,000 of coverage greatly exceeds the \$6.09 cost per \$1,000 |

As in the case of Figure 1-1, the age of issue is 25, and the premiums are based on the 1980 CSO female table and 4.5 percent interest, with no allowance for expenses. In this case, an annual level premium of \$6.09 per \$1,000 paid as long as the insured lives would be the mathematical

equivalent of a series of premiums on the YRT basis, ranging from \$1.16 per \$1,000 at age 25 to \$956.94 at age 99.

Figure 1-2
Annual Premium Comparison Whole Life and Yearly Term



The 1980 CSO Female Table assumes that everyone who survives to age 99 will die during the year, producing a net premium on the yearly renewable term basis equal to the face of the policy, less the interest that will be earned on the premium during the year. In Figure 1-2 line *CD* bisects the curve *AB* between the ages of 53 and 54.

The disparity between the areas *AXC* and *BXD* is very much greater in this case than in Figure 1-1. Excess premiums (area *AXC*) in the early years of an ordinary life contract (or for any type of insurance contract) will offset the deficiency in the premiums of the later years when the term premium is in the hundreds of dollars. With the aid of compound interest, the policy will accumulate a reserve equal to the policy face amount by the time the insured reaches the policy maturity (termination) date.

This is in contrast to the level premium term contract, under which the reserve is completely used up at the expiration of the contract (maturity date). The difference is because the risk (probability of occurrence) under a whole life contract providing protection for the life of the insured is one "converging into a certainty," while the risk under a term policy is a mere contingency—one that may or may not occur. Under a whole life contract, provision must be made for a death claim that is certain to occur, the only uncertainty being the time it will occur.

By the time an insured has reached 99, the reserve under his or her policy must have accumulated to an amount that will equal the face amount of the policy, supplemented by the final annual premium and the interest on the

combined sums for the last 12 months of the contract. A whole life contract will either pay a death claim, or it will endow at the maturity date and the policyowner will receive the face amount. This must be the case if each class of policyowners is to be self-supporting, meaning there are no other funds for the payment of the claims of the last members to die. In effect, such policyowners pay off their own death claims, in addition to paying their share of the death claims of all other members of the group.

Net Amount at Risk

amount at risk Under a level premium contract, the accumulated reserve becomes a part of the face amount payable upon the death of the insured. From the standpoint of the insurance company, the effective amount of insurance is the difference between the face amount of the policy and the reserve. This is called the *amount at risk*, and is the amount the insurer must be able to collect from the reserve to pay the claim. As the reserve increases, the amount at risk decreases. The significance of this relationship is that as the death rate increases, the amount at risk (the effective amount of insurance) decreases, producing a *cost of insurance* within practical and affordable limits.

| Year | Attained Age at Beginning of Year | Reserve End of Year Even Dollars | Net Amount at Risk | Death Rate per 1,000 | Cost of Insurance |
|------|-----------------------------------|----------------------------------|--------------------|----------------------|-------------------|
| 1 | 25 | \$ 5 | \$995 | 1.16 | \$1.15 |
| 5 | 29 | 22 | 978 | 1.30 | 1.27 |
| 10 | 34 | 55 | 945 | 1.58 | 1.49 |
| 20 | 44 | 139 | 861 | 3.32 | 2.86 |
| 30 | 54 | 252 | 748 | 6.61 | 4.94 |
| 40 | 64 | 397 | 603 | 13.25 | 7.99 |

cost of insurance The *cost of insurance* is an actuarial term referring to the sum obtained by multiplying the death rate at the insured's attained age by the *net amount at risk*. This is the amount of actual insurance and determines the amount a policyowner must pay for protection. It is the sum that each policyowner contributes as his or her share of death claims in any particular year. This process is illustrated in Table 1-1.

net level premium

The *net level premium* is the premium based on mortality and interest, and disregards expense. For example, the net level premium for an ordinary life contract on a female issued at age 25, based on the 1980 CSO table and 4.5 percent interest, is \$6.09. Since the death rate at age 25 is 1.16 per 1,000, about \$5 of the first premium is excess and goes into the policy reserve. If the policyowner should die during the first year, the company would use the \$5 in settling the claim and would have to draw only \$995 of the \$1,000 face amount from the premiums contributed by the other policyowners in the age and policy classification of the deceased. This would mean that each member's pro rata share of death claims in the first year would be only \$1.15 (1.16×0.995), instead of \$1.16, the YRT premium for \$1,000 of insurance at age 25 (with no allowance for interest).

By the end of the 5th year, the reserve, or accumulation of excess payments, will have increased to \$22 per \$1,000, which sum would be available for settlement of a death claim under the policy. The net amount at risk would have decreased to \$978, which would necessitate a contribution from the other policyowners (and the deceased) of only \$1.27, instead of the YRT premium of \$1.30. The reserve will have grown to \$139 per \$1,000 by the end of the 20th year, which would reduce the cost per \$1,000 from \$3.32 to \$2.86. By the time the insured reaches 65, the reserve under the policy will have accumulated to \$397, and the actual amount of protection will have shrunk to \$603.

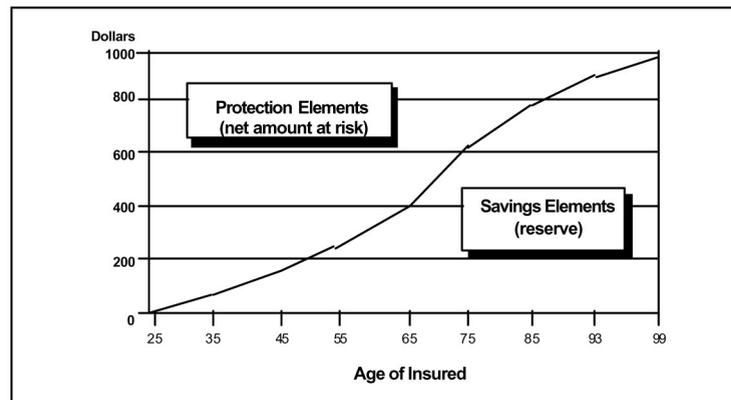
A death claim in the 40th year of the contract would be settled by payment of the \$397 in the reserve and \$603 from the current year's premium payments (of all the policyowners). The pro rata share of each policyowner for all death claims during the year would be only \$7.99, as compared to \$13.25 if no reserve had been available. The influence of the reserve on the COI is even more significant at the advanced ages.

Under the level premium plan, a \$1,000 policy does not provide \$1,000 of insurance. The company is never at risk for the face amount of the policy—even in the first year. The amount of actual insurance is always the face amount, less the policyowner's own accumulated excess payments. The accumulation is the reserve for insurance company purposes, and it is the cash value (slightly less in early years) for policyowner purposes. Because the excess payments may be withdrawn by the policyowner at any time through the cash surrender or loan privileges, they may be regarded as a savings or accumulation account. Thus, a level premium policy does not provide pure insurance but a combination of decreasing insurance and

increasing cash values, so that in any year their sum is equal to the face amount of the policy. This is illustrated in Figure 1-3 for an ordinary life policy of \$1,000 issued at age 25, based on the 1980 CSO Female Table and 4.5 percent interest.

The area below the curve represents the reserve under the contract or the policyowner's equity in the contract. The area above the curve represents the company's net amount at risk and the policyowner's amount of protection. As the reserve increases, the amount of protection decreases. At any given age the two combined will equal the face amount of the policy. By age 95, the protection element of the contract has become relatively minor, and by age 100—the end of the contract—it has completely disappeared. At age 100, the policyowner will receive \$1,000, composed entirely of the cash value element.

Figure 1-3
Proportion of Protection and Savings Elements in Ordinary Life Contract, Issued at Age 25; 1980 CSO Female Table and 4.5 Percent Interest



This combination of protection and accumulated cash values is characteristic of all cash value plans. Fundamentally, one contract differs from another only in the proportion in which the two elements are combined. This basic truth should be kept in mind as you study the types of life insurance policies.

Yearly term insurance is all protection and has no cash value, while single premium life insurance is at the other end of the spectrum with the highest cash values and lowest proportion at risk. Accumulated cash values should be thought of as some degree of prefunding. Single-premium policies are fully prefunded, and lower-premium policies that develop cash values are only partially prefunded. The shorter the premium-paying period, the higher the proportion of cash value to death benefit, and the higher the premium.

The impact of the level premium plan affects all operations of a life insurance company. The investment of these funds has presented the life insurance industry with one of its most challenging problems, but at the same time has enabled insurance companies to contribute to the dynamic expansion of the American economy.

The level premium plan underlies the system of cash values and other surrender options that has made the life insurance contract one of the most flexible and valuable contracts in existence. The greatest significance of the plan is that it is the only arrangement under which it is possible to provide insurance protection to the policyowners at life expectancy ages and beyond without the cost becoming prohibitive.

HUMAN LIFE VALUE

The economic values of a human life are the basis for the need for life insurance, and can help determine the amount of life insurance needed by an individual or a family. A human life has an economic value only if some person(s) or organization depends upon or expects to receive some monetary benefit through that life. The following discussion explains how human life value is determined, and lists and describes the specific needs for life insurance. The methods used to calculate the amount of life insurance needed by individuals and families are discussed later.

The Concept of Human Life Value

A human life possesses many values, most of them irreplaceable and not easily measured. These values are founded on religious, moral, and social relationships. From a religious standpoint, for example, human life is regarded as immortal and endowed with a value beyond the comprehension of mortal man. In a person's relationship with other human beings, a set of emotional and sentimental attachments is created that cannot be measured in monetary terms or supplanted by material things.

Such values, however, are not the foundation of life insurance. Although not oblivious to these values—in fact, the life insurance transaction has strong moral and social overtones—life insurance is concerned with the human life value, or the economic value of a human life, which is derived from its earning capacity and the financial dependence of others on that earning capacity.

The Economic Value of the Human Life

In terms of its physical composition, the human body has a limited dollar value. In terms of earning capacity, however, it may be worth millions of dollars. Yet, earning power alone does not create an economic value that can logically serve as the basis of life insurance. A human life has an economic value only if some other person or organization expects to receive an economic advantage through its existence.

If an individual is without dependents and no other person or organization depends financially on that person, either now or in the future, then that life, for all practical purposes, has no monetary value that needs to be insured. Such an individual is rare. Most income producers either have dependents or can expect to acquire them in the normal course of life. Even those income earners with no family dependents often provide financial support to business or charitable organizations. In either case, a basis exists for life insurance.

Preservation of Family's Economic Security

In many cases, an income producer's family is completely dependent on his or her personal earnings for survival and the comforts of life. In other words, the "potential" estate, or the earnings and savings that may be received and accumulated in the future, is far more substantial than the existing estate—the savings that the family has been able to accumulate. The family's economic security lies in the earning capacity of each income earner, which is represented by his or her "character and health, training and experience, personality and power of industry, judgment and power of initiative, and driving force to put across in tangible form the economic images of his mind," said Solomon Huebner in 1950.

Over time, this economic potential are gradually converted into income, a portion of which is devoted to self-maintenance, a portion to support of dependents, and if the income is large enough, a portion to savings to meet future needs and contingencies. If the individual lives and stays in good health, the total income potential will eventually be realized, for the benefit of the family and others who receive benefits from his or her efforts. If an income earner dies or becomes permanently and totally disabled, the unrealized portion of his or her total earnings potential will be lost, and in the absence of other measures, the family will soon find itself destitute or reduced to a lower income than it previously enjoyed.

This need not happen, however, since there are life insurance contracts that can create a fund at death to at least partially, and possibly fully, offset the lost income of the insured. By means of life insurance, an individual can ensure that the family will receive the monetary value of those income-producing qualities that lie within him or her, regardless of when death occurs. By capitalizing this life value (creating a fund large enough to generate investment income approximating the salary or wages of the individual), an income earner can leave the family in the same economic position that they would have enjoyed had he or she lived.

These concepts are the basis of a sales presentation that was commonly used 30 years ago, and is still valid today, called “live, quit or die”. The concept was that life and disability insurance can protect the economic values of a working person, and that in a way one cannot lose by purchasing these insurance contracts. Only one outcome can ultimately occur in life. A person will

- live, and the cash values of the life insurance policy will be available as living benefits
- die, and the death benefits will provide for survivors
- surrender the policy (quit), and much if not all of the premiums paid can be recovered

An additional condition was sometimes added—become disabled—to demonstrate the waiver of premium provision, or the use of a disability policy, that can provide income in the case of disability.

The Moral Obligation to Provide Protection

Most people assume major responsibility for the support and maintenance of their dependent children during their lifetime. In fact, they consider it one of the rewarding experiences of life. In any case, the law attaches a legal obligation to the support of a spouse and children. Thus if there is a divorce or a legal separation, the court will normally decree support payments for dependent children and possibly alimony for the dependent spouse. In some cases such payments, including alimony, are to continue beyond the provider's death, if the children are still dependent or if the alimony recipient has not remarried. In such event, the parent and ex-spouse are required to provide life insurance or to set funds aside in trust.

It takes a high order of responsibility for a parent to voluntarily provide for continuation of income to dependents after his or her own death. It virtually always involves a reduction in the individual's own standard of living. Yet, few

would deny that any person with a dependent spouse, children, or parents has a moral obligation to provide them with the protection afforded by life insurance, as far as his or her financial means permit.

In his book *Life Insurance*, Dr. Solomon Huebner said the following concerning the obligation to insure:

From the family standpoint, life insurance is a necessary business proposition that may be expected of every person with dependents as a matter of course, just like any other necessary business transaction which ordinary decency requires him to meet. The care of his family is man's first and most important business. The family should be established and run on a sound business basis. It should be protected against needless bankruptcy. The death or disability of the head of this business should not involve its impairment or dissolution any more than the death of the head of a bank, railroad, or store. Every corporation and firm represents capitalized earning capacity and goodwill. Why then, when men and women are about to organize the business called a family should there not be a capitalization in the form of a life insurance policy of the only real value and goodwill behind that business? Why is it not fully as reasonable to have a life insurance policy accompany a marriage certificate as it is to have a marine insurance certificate invariably attached to a foreign bill of exchange? The voyage in the first instance is, on the average, much longer, subject to much greater risk, and in case of wreck, the loss is of infinitely greater consequence.

The growth of life insurance implies an increasing development of the sense of responsibility. The idea of providing only for the present must give way to recognition that a person's responsibility to his family is not limited to the years of survival. Emphasis should be laid on the "crime of not insuring," and the finger of scorn should be pointed at any man who, although he has provided well while he was alive, has not seen fit to discount the uncertain future for the benefit of a dependent household. . . . Life insurance is a sure means of changing uncertainty into certainty and is the opposite of gambling. He who does not insure gambles with the greatest of all chances and, if he loses, makes those dearest to him pay the forfeit.

The Many Uses of Life Insurance, The Swiss Army Knife of Financial Products

You can use life insurance to:

- Provide a death benefit
- Provide income to survivors
- Secure a line of credit
- Fund a buy-sell agreement
- Guarantee future insurability
- Equalize an inheritance
- Pay estate taxes
- Create an estate
- Give to charity
- Supplement college, retirement, and other expenses
- Pay funeral and last expenses
- Pay mortgages and debts
- Provide an employee benefit
- Protect a business from financial loss

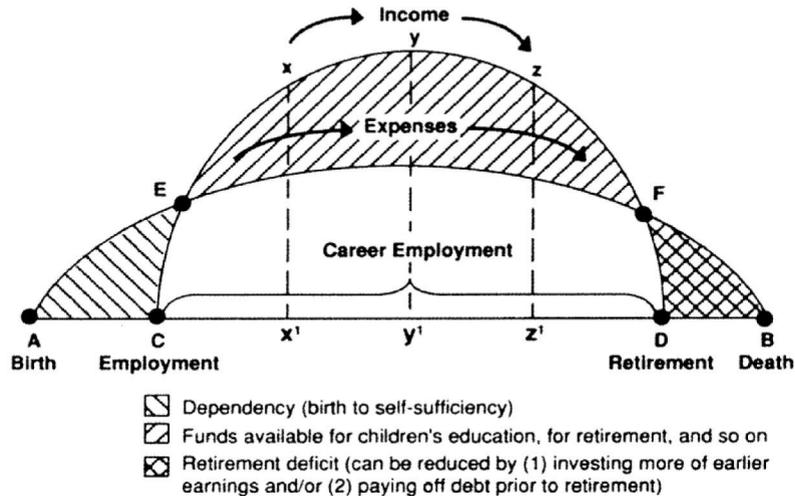
Diminishing Nature of the Human Life Value

The economic value of an income earner tends to diminish with the passage of time. His or her earning level may continue to increase for a certain period or indefinitely, but with each passing year, the remaining period of income production becomes shorter. Each year of income that is realized means that there is one year less that remains to be earned. Because an individual's economic value is the unrealized earning capacity represented by his or her ability and skills, his or her economic value must diminish as potential income is converted into actual income. This principle is illustrated by the diagram in Figure 1-4.

The line AB represents the lifetime of an individual born at point A and dying at point B . The line AB also represents the cost of maintenance and, during his or her productive years, the individual's income tax liability. The arc CD represents earning capacity. During the period A to C , there are no earnings, but there are costs of maintenance represented by the triangle AEC . Earnings commence at C . The area of arc CD that extends above arc AB represents earnings in excess of taxes and the cost of self-maintenance. Point D marks the age of retirement, and the area DFB symbolizes the second major period

in the individual's life, during which the cost of self-maintenance exceeds his or her income.

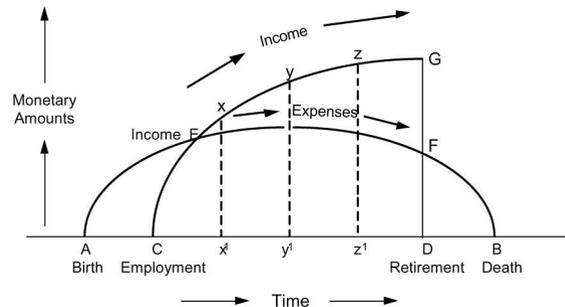
Figure 1-4
Hypothetical Illustration of Economic Value of a Human Life



In Figure 1-4 the monetary value of the individual is at its peak at point *E* when net earnings are just beginning. At the point where xx' intersects the arcs, the earnings rate has increased, but potential future earnings have declined. The earnings potential shows further decreases at yy' and zz' ; at point *F*, it has shrunk to zero.

Figure 1-4 is illustrative and conceptual. Neither earnings nor maintenance expenses follow a symmetrical curve. For example, the childhood period starts with a highly unsymmetrical outlay for maternity costs. Income is also likely to commence earlier than at point *C*, and is unlikely likely to decline so gradually to the age of retirement. In most occupations people reach their maximum earnings in their 40s and 50s, and earnings increase or decline only slightly to retirement, when they terminate abruptly. Figure 1-5 shows a typical pattern of earnings among clerical and professional groups.

Figure 1-5
Typical Pattern of Earnings



Life Cycle of Life Insurance Needs

These diagrams roughly illustrate the economic foundation of three broad categories of life insurance. The first is childhood, represented by the area *AEC*. During this period, an individual's needs are met by the parents or other persons responsible for their care. If the child dies before becoming a producer, the investment in nurturing, maintenance, and education is lost. This can be a sizable sum, especially if the child has been educated at private schools. Various studies have shown that the cost of rearing a child to age 18 ranges from 1.5 times to 3.25 times the parents' average annual income. At today's prices, those costs are even higher. While most parents regard these expenditures as one of the duties and privileges of parenthood, and resist labeling them as an investment to be recovered in the event of the child's death, such costs do create a substantial insurable value. This value can logically serve as one of the bases for juvenile insurance, or insurance on children.

The second category of insurance is portrayed by the area *EGF* in Figure 1-5. The surplus earnings in this area are the source of support for the individual's dependents and a broad measure of the economic loss to the family if the producer(s) should die. A portion of these earnings will go toward insurance premiums, and for both spouses' retirement needs, but the share that is needed for the care and maintenance of the family should be capitalized and preserved for the family through life insurance.

Finally, the individual's retirement needs are represented by the area *DFB*. Although the income vacuum may be partially filled by federal Old Age, Survivors, and Disability Income (OASDI or Social Security) benefits, pension plans and other tax-qualified plans (such as profit sharing, income deferral,

and thrift or savings), and individual investments, the most realistic sources of funds to cover any income shortage are through investment income, life insurance and annuities. This remaining need can be satisfied with group life insurance through employment and/or a personal insurance program. For long-term planning purposes, however, individuals should not rely on group life insurance for any more than the funds that can—and will—be kept in force after an unforeseen job loss. Individuals should check their employer's plan to find out how much of the group life insurance they can convert to individual insurance after termination of employment.

LIFE INSURANCE NEEDS

Why have life insurance? Ben Baldwin gets to the heart of this question in his book, *The Complete Book of Insurance* (Irwin Professional Publishing, 1996). Mr. Baldwin says to answer this question, a person needs to ask two more questions. The first is, "In the event of my death, will anyone experience an economic loss?" If the answer is yes, then the second question is, "Do I care?" If the person does not have anyone who will experience a financial loss at his or her death, or if he or she does not care that those people will experience an economic loss, then that person is not a prospect for life insurance.

This comment beckons a few axioms from the archives of life insurance selling. The first is that "life insurance is sold, it is not bought". Because so many people find reasons not to take the initiative to purchase life insurance, or in many cases do not understand the need for life insurance, the insurance advisor takes the initiative to discuss this important risk management tool.

As suggested by Mr. Baldwin's approach, an old axiom in the life insurance business says that life insurance is only sold when somebody loves somebody. As the Life and Health Insurance Foundation for Education (LIFE) advises, "Life insurance isn't for the people who die. It's for the people who live." This is a major shift of perspective for many prospects. (It's about them, not you.) The following discussion addresses the needs that may result from the death of a breadwinner and should be your foundation for educating a prospect regarding the needs for life insurance.

human life value approach

needs analysis approach

The *human life value approach* produces a value for a person's economic worth at a given point in their life. This method does not anticipate actual dependent needs that may arise with the death of a person. An estimate of these needs is obtained through a needs analysis approach,

which addresses the question: How much life insurance is enough? The *needs analysis approach* is a way to determine how much life insurance a person should carry by analyzing the needs his or her family and other dependents would experience if that individual died.

It would be difficult, if not impossible, to prepare a list of all needs that might possibly arise after the death of an income producer. Family circumstances differ, and a list of needs that would be appropriate for one family might be quite unsuitable for another. Even within any particular family, the needs picture changes from time to time.

Life insurance is the best way to address the financial impacts of death, regardless of when or why it occurs. Life insurance benefits individuals, families, businesses, and their communities, because it delivers tax-free money without administrative hassles and settlement costs. It does so from the inception of coverage until its eventual fulfillment. The following section outlines the general categories of needs that are likely to be found in a typical family situation.

Cleanup Fund (Final Expenses)

cleanup fund

A *cleanup fund*, or funds for final expenses, is a fund set aside for those expenses associated with the death of an individual. Burial or cremation expenses are by no means the only expenses associated with death. The final expenses depend very heavily on the individual circumstances of each death. Some people undergo a lengthy period of hospital treatment and incur large medical bills. Home or convalescent care is rarely covered by private insurance and Medicare offers limited coverage for those over 65. Prolonged medical care and rehabilitative treatment may leave a family's finances devastated even before death occurs. Following death there are usually substantial bills, including funeral expenses, transportation expenses, and cemetery or mausoleum charges.

Many of the expenses associated with a death occur after the funeral. The costs of settling financial and property matters in closing the deceased's estate are examples. Also included are court fees related to the appointment of an executor or administrator to manage and settle the estate, fees charged by the executor or administrator, attorneys' fees, and court costs for probate.

Managing the estate prior to final property disposition may be extremely complex. This may require the services of specialized investment and/or real estate managers to safeguard the property until it is sold or distributed. The

provisions of the will and the nature of the property involved may require a long period of management before the estate is closed. Some assets may be hard to sell due to prevailing economic conditions following death. The terms of the will may require the establishment of trusts and other legal work that may be expensive as well as time consuming. Even the task of locating heirs or other beneficiaries of the estate may require a lengthy search to obtain death certificates for potential recipients who predeceased the insured or are estranged from the family. The longer this process takes, the more costly it becomes.

The administrator or executor has responsibility for settling the outstanding debts and closing the financial affairs of the deceased. These duties include filing tax returns and paying tax liabilities. This process is much more easily addressed when there is adequate cash available, life insurance policy proceeds often being the only source of funds. It is usually not advisable to have life insurance proceeds payable directly to the estate. Rather, they should be paid to a trust or to an individual with an interest in the estate. Cash can then be made available by purchases of assets from the estate or loans to the estate.

The size of the estate and the nature of the assets it contains heavily influence the optimal planning strategies for minimizing taxes and accomplishing individual objectives. Paying policy proceeds directly to the estate is less of a problem for small estates with no federal estate or gift tax liability than it is for large estates. The most important point is that any planning must be done prior to death to achieve the best results. For sizable estates in which there are transfers of life insurance policy ownership, it is better if the planning is done at least 3 years prior to the death. Tax treatment will be governed by policy ownership, beneficiary designations, and trusts in effect at the time of death. The estate may be subject to greater expenses in the absence of proper planning. Even if an administrator or executor knows how to minimize taxes, his or her hands will be tied unless assets have been properly positioned and the necessary documentation, trusts, and other instruments are in place before the insured's death.

The death of an insured family member usually terminates an income stream that the family has relied upon. The costs of daily living for survivors, final expenses for the deceased, emergencies, repairs, and replacements, death taxes, and the cost of estate administration create an immediate need for funds. Mortgages might well be included in the list, but in view of their size

and the special problems associated with them, they are usually treated as a separate need.

One of the goals of good planning is to make sure the emergency fund is adequate to meet the survivors' needs until life insurance proceeds and other potential sources of funds become available. Families having an adequate source of emergency funds in liquid holdings, such as money market funds, mutual funds, bank balances, cash management accounts, and life insurance cash values may easily meet any need for immediate cash following the death. However, the need for additional funds becomes urgent if the family does not have an emergency fund or has depleted it prior to the death.

Estate Clearance Fund

estate clearance fund

An *estate clearance fund* represents money needed to pay any administrative and estate settlement costs, such as attorney and executor fees, appraisers and accountant fees, probate expenses, and state and federal inheritance and estate taxes. Individuals who acquire a sizable net worth during their lifetime may be subjected to taxes on that net worth at their death. The tax is progressive in nature with a lower rate applicable to smaller estates, increasing to 35 percent for large estates. With the estate tax credit set at five million dollars in 2011 and 2012, estates of wealthy individuals will be subject to the federal estate tax. These estate tax rates and exemption amounts can be expected to change as the political climate changes.

Federal estate taxes must normally be paid within 9 months of the owner's death. This presents a real problem for individuals or families whose most important and largest assets are illiquid forms of investment, such as family-owned businesses and investment real estate. Often, these assets cannot be quickly converted to cash without a significant decrease in value. In some cases, the family would prefer to retain the asset and its future income-generating potential. Life insurance proceeds can provide the necessary cash to pay the tax liability and to preserve the assets being taxed for the benefit of family survivors.

Federal gift taxes can also be a sizable tax liability at death. The rates are the same as those for federal estate taxes. They apply to all nonexempt gifts on a cumulative basis. In other words, the aggregate amount of gifts made since 1976 is taken into consideration in determining the applicable gift-tax rate for the gifts currently being taxed. For donors in the highest tax brackets the gift tax can equal 35 percent of the value of the gift itself.

The gift tax triggered by the donor's death often involves gifts that were completed because of that person's death. Examples include jointly owned property after one of the joint owners dies, and life insurance proceeds under some policy ownership and beneficiary designation situations. Settlement of the estate may also result in gift taxes due on gifts made shortly before death.

Most states impose death and/or inheritance taxes in addition to the federal estate taxes. These taxes, like the federal taxes, are due within a relatively short period after death and must be paid with liquid funds. Careful planning is required to provide for these state and federal taxes, especially if life insurance is to be the funding mechanism. If they are not properly structured, the policies themselves may be subject to the tax, further increasing the tax liability of the estate. Good estate planning can avoid unnecessary taxes, and provide the optimal tax-saving strategy for the heirs of the decedent.

Income Needs

income needs

Surviving family members will be faced with the financial demands of maintaining the household and meeting the needs of household members. There will be continuing costs for food, transportation, and utilities. Mortgage payments may have to be continued, and even if they are insured, will have to be paid temporarily. It often takes time for the survivors to determine if there is current life insurance on the mortgage and to file a claim if coverage exists. In the absence of coverage, the surviving family members will have to continue making mortgage or rent payments. *Income needs* are the ongoing needs for income of the surviving dependent family members that continue until those members are self-supporting. They include readjustment period income, dependency period income, and income for the surviving spouse and other dependents.

Readjustment Income

readjustment income

The surviving family members often, at least temporarily, continue their established lifestyle and experience the same level of expenses they incurred prior to the supporting wage earner's death. This means a continuation of bills for cable TV services, magazine subscriptions, newspapers, club memberships, entertainment, and miscellaneous costs. *Readjustment income* is an amount closely equivalent to the family's share of the income producer's earnings at the time of his or her death.

If the surviving family members are aware of their financial situation and they have planned for the death contingency, they will know whether they can afford to maintain the same standard of living or if cost cutting will be necessary. Even if the household budget does have to be trimmed, it is unrealistic to expect the survivors to cut back on their expenses immediately after the death. Changes in a family's living standard are usually accomplished through a certain amount of trial-and-error adjustment over a period that often exceeds one year.

Few individuals are able to leave an estate, including life insurance, substantial enough to fully replace the standard of living that their dependents enjoyed while the income earner was still alive. This means that an adjustment will have to be made to the family's standard of living following the wage earner's death. To cushion the economic and emotional shock, however, it is desirable to postpone that adjustment for a period following the income earner's death. The length of the period depends largely on the magnitude of the change that the family will have to make in living standard. If the surviving spouse must refresh or acquire skills to gain employment, a longer period may be needed. Whatever the duration, the income during this readjustment period should be approximately equivalent to the family's share of the deceased's earnings at the time of his or her death.

| Life Insurance Shoppers' Motivations for Buying Insurance | |
|--|-----|
| Final Expenses | 78% |
| Income Replacement | 53 |
| Mortgage protection — pay off mortgage | 32 |
| Transfer wealth | 20 |
| Pay estate taxes or estate bills | 19 |
| Children's education — college funding | 10 |
| Tax savings | 6 |
| Business purposes | 1 |
| Charitable gift | 1 |

The above table presents the results of a LIMRA survey (2010 U.S. Life Ownership Study, LIMRA International, Inc.), taken to establish prospects' motivations for purchasing life insurance.

The emotional turmoil following the death of a close family member usually lasts about one year. As survivors cope with the death, the grieving process often distracts them from concentrating on financial issues. They may forget to pay important bills, which could worsen their financial position. Creditors who insist on being paid immediately can be an additional source of emotional stress at this time. Survivors who are able to convince these creditors that adequate life insurance will be available are usually not pressed for collection until proceeds have been received.

Dependency Period Income

**dependency
period income**

After the expiration of the readjustment period, *dependency period income* should be provided in a reduced amount until the children, if any, are able to support themselves. Two concepts are involved: how much income should be provided and for how long. As a minimum, there should be sufficient income to allow the family to remain intact, and to allow the surviving spouse to devote adequate time to the care and guidance of the children during their formative years.

The financial needs of family survivors do not end at the closing of the deceased's estate. Minor children and other dependents may need support for a lifetime or at least for many years until they become self-supporting. Life insurance and other accumulated assets can provide that necessary financial support. With proper planning, a surviving spouse can be supported during this dependency period as well, rather than being forced to prematurely enter the labor market. If the surviving spouse lacks training, or is disabled, reentering the workforce may not be an option.

When planning the income needs for surviving family members, it is important to include all persons who depend on the income of the person to be insured. Such planning is important for each member providing income to the family unit. This often includes both husband and wife, and it could include children living at home who contribute income to support the family.

In today's world of multiple marriages and divorces, it is common to have more than one group of minor children to be supported. The husband and wife may have children from previous marriages, in addition to the children of the current marriage. This situation could involve the finances of three or more separate households, if all of the dependent children do not live in the same household with the newly married husband and wife. The sources of support available to children from previous marriages obviously

affect the children's financial needs. The income needs of the youngest children—usually the children of the current marriage and those with the longest remaining period of dependency—should be given top priority.

The most important determinants of the duration of the income needed are the present ages of the insured's children and the type of education they will receive. Generally, income should continue until the youngest child is 18. If there are several children, the income can be reduced somewhat as each reaches the age of self-sufficiency. If the children are to receive a college education, income will have to continue for a longer period. For planning purposes, the immediate death of the income producer is assumed. The needed income is projected for a period equal to the difference between the present age of the youngest child and the age at which the child is expected to become self-supporting.

Children with physical disabilities or mental impairments that will prevent them from ever becoming self-supporting may need lifelong financial support. Their dependency can continue many years beyond the deaths of both parents. Planning for the financial support of children with special needs can be very complex. Severely handicapped children may require institutional care, which can be extremely expensive in private facilities. Care for handicapped children may be available through public institutions only if the family withdraws financial support, allowing the child to qualify for welfare programs. In some states this is very difficult, because minor and disabled children are deemed to be "forced heirs." Any inheritance, asset or trust established for the support of these children must be very carefully structured. The rendering of public institutional support often gives the government the right to be reimbursed from assets inherited by, or set aside for the benefit of the child receiving the institutional care. In some cases, the government has even been able to invade trusts.

Life Income for Surviving Dependent Spouse

After the children have become self-sufficient, the widow(er) may still require an income for support. If the surviving spouse is a full-time homemaker until the children finish at least part of their education, he or she may subsequently be able to obtain employment. However, the surviving spouse's earning power will likely have declined substantially as the result of having been out of the workforce for a period of time. After the birth of children, for example, a wife sometimes gives up her job. As the years pass, she may lose many of the occupational skills she once possessed and would have to return to

the labor market as a middle-aged woman with deficient skills. Under such circumstances, employment opportunities are limited. Many individuals feel a moral obligation, therefore, to provide their spouses with incomes that will continue throughout the remaining years of their lives. The income may be modest, but it can be the difference between complete dependency on welfare services and reasonable self-sufficiency.

EXAMPLE

The death of a nonincome-earning spouse can greatly increase the costs of the surviving household. A single parent has to pay for essential services, such as childcare, transportation, and domestic chores that were previously performed by the deceased spouse and cannot be done by the survivor.

Parents and Other Dependents

Other family members who may have a period of dependency are the husband and/or wife's parents. The financial demands of providing parental support can be minimal—providing room and board in the home for example. At the other end of the spectrum, support of a parent in an institution can be very expensive. Care for an elderly parent in an upscale institution often costs more than two times the median family income.

EXAMPLE

Elderly parents can instantly lose their independence and self-sufficiency by means of an accident or sudden change in health. They may be hospitalized after a fall or a stroke and never be able to live by themselves again. Adult children are often overwhelmed by the demands of seeking or providing care for a parent.

The voluntary assumption of financial support for another individual often implies a willingness to provide that support as long as it is needed. That need may extend beyond the death of the supporter. Careful planning and adequate amounts of life insurance can assure extended parental support even if the supporting child predeceases that parent. Otherwise, the supporting child's death may force the parent to drastically change living arrangements and lower his or her standard of living.

Financial dependence is not restricted to children, spouses, and parents. In some cases, distant relatives and current or ex-in-laws may have to be

supported for one reason or another. Some families take in foster children and develop emotional bonds that are as strong as those between natural parents and their children. Many of these foster parents extend financial support beyond that required by the foster parent program.

Cash Needs

cash needs

Cash needs require some amount of money be set aside to pay an obligation in a lump sum, or as another ongoing income need, depending on family circumstances and preferences.

Funds to Repay Debt

Many personal debt agreements have a clause specifying that the full remaining balance will become due and payable upon the death of the debtor. This clause may be present whether or not there is any credit life insurance covering the loan agreement. Although lending institutions regularly offer credit life insurance at the time the loan is initially created, such coverage is not mandatory and is often refused by the borrower. When credit life insurance is in force, the remaining loan balance will be repaid to the lender by the credit life insurance company when a death claim is filed. However, there is always the possibility that credit life insurance benefits will not be collected if the survivors, executor, or administrator are not aware of the insurance. Credit insurance information, therefore, should always be noted in files pertaining to the insured's debt.

Credit life insurance is not the only way of repaying debts that become due and payable at death. All types of life insurance policies provide death benefits that are suitable for repayment of debts. A single large policy can provide enough funds to liquidate many or all debts. Moreover, the standard types of individual life insurance policies may be lower in costs than credit life policies.

There are some debts that do not become due and payable upon the death of the borrower. This is more likely to be the case when both husband and wife are liable for the debt. Adequate amounts of individual life insurance will give the survivor the option of either paying off the debt or continuing to repay it according to schedule. That option is not available under credit life insurance, because benefits automatically cancel the debt once a claim has been filed and approved for payment.

Mortgage Redemption Needs

Homeownership is usually burdened with a mortgage and it is highly probable that a balance will still be outstanding upon the death of a person with dependent children. In some cases, of course, the widow(er) may want to sell the house and move into a smaller one or into an apartment. Assuming the house can be sold for an amount that exceeds the remaining mortgage balance, it may not be essential to provide funds for the liquidation of the mortgage. In many cases, however, it is preferred that the survivors will continue to occupy the family residence, and funds to pay off the mortgage may be needed. If the family can remain in the home, free of a monthly mortgage payment, the family's income need will be greatly reduced.

Educational Needs

The income provided for a surviving spouse during the period when the children are dependent should normally be adequate for secondary school expenses, as well as for general maintenance. However, if a college education for one or more of the children is a goal, additional income will be needed. A college or professional education is beyond the means of many dependent children who lose an income-earning parent.

Minor children need uninterrupted support for their education—from their first day in the classroom to young adulthood. The funding requirements for educating children vary widely from one family to another. A public school education that ends at high school has relatively modest costs compared to the costs of a private school education including preschool, prep school, private university, and professional school. The factors influencing parents' educational goals and decisions for their children involve a complex mixture of family history, family philosophy toward education, family income, and the abilities and personality of the child. Planning for an ivy-league education, for example, will be for naught if the child does not have adequate financial resources to enable him or her to attend a school of that caliber.

For very young children, the planning horizon for education may exceed 20 years. Adjustments for inflation must be made for educational costs to be incurred more than a decade into the future. Choosing the appropriate inflation factor involves estimation, but it is safe to assume that the rate will be as great or greater than general inflation. Some authorities on the subject recommend a planning assumption of 7 percent to 8 percent annual inflation in education costs.

Educational needs of the family are not restricted to the children. A surviving spouse may need further education to increase future income potential to help support the family. The spouse may need a refresher course or training to return to a prior occupation. On the other hand, the spouse's need may be extensive, such as to prepare to enter the job market for the first time or to upgrade to a higher-paying career.

One important consideration in providing education or training to the surviving spouse is whether the survivor will be able to earn any income while pursuing his or her education or training. Funding spousal education on a full-time basis usually requires prefunding family support while the spouse is a full-time student and prefunding the educational or training costs as well.

In some cases, the surviving spouse may be able to pursue the education on a part-time basis while he or she is employed in the workforce. This is an emotional and challenging avenue for a surviving spouse who is now also a single parent. Pursuing education on a part-time basis may greatly lengthen the period needed to complete the educational program. This will delay any significant increases in earned income for the surviving spouse and family members. If the potential increase in income because of further education is large enough, it may actually be less costly to prefund a full-time educational program.

Emergency Needs

From time to time in the life of a family, unforeseen needs for money arise because of illness, surgery, major dental work, home repairs, or many other reasons. It is unrealistic for the family income providers to leave only enough income for the family to subsist if everything goes well and not to plan for unusual expenditures. Therefore, a liquid fund should be set up from which additional income can be provided if and when it is needed. Some financial planners suggest that the emergency fund often warrants a higher priority than income for dependents. The actual setting of priorities is properly the responsibility of the income earner(s). A 3 to 6 month fund of average spending amounts is normally suggested, but this will vary by family.

Funding Trusts at Death

Trusts are contractual arrangements for the ownership and management of assets by a trustee according to the trust agreement. The trustee manages trust assets on behalf of and for the benefit of the trust beneficiaries. There are many different motivations for the establishment of a trust. One is to get

professional management from a corporate entity, such as a trust company or a bank trust department, so that the trustee will not predecease any of the trust beneficiaries. Tax considerations may also justify the creation of a trust.

Life insurance is often an integral part of the trust funding. The trust itself often owns life insurance on the grantor, who names the trust as beneficiary of that insurance. Trusts can also be beneficiaries of insurance policies not owned by the trust. Those insurance proceeds provide the funds necessary for the trust to carry out its objectives. Some trusts are set up specifically for the purpose of funding life insurance premiums and receiving proceeds. If estate tax minimization is the objective of the trust, the trust is subject to more stringent requirements that can change many times during the existence of the trust.

Trusts have always been an important means of extending family financial management by the parents beyond their lifetime. In these arrangements, the trust is often used to distribute funds periodically rather than in a lump sum. The objective is usually to protect a child from spending funds frivolously. By spreading out the distribution, the child is unable to get access to and squander the entire sum immediately after the parents' death. Final distribution from such trusts is often based on the beneficiary's attainment of a specified age and is usually the parents' decision as to when the child will be mature enough to handle the funds responsibly.

Trusts can be set up for the benefit of children with mental impairments or other problems that would prevent them from ever becoming capable of managing their own finances. The nature of the trust depends very heavily on the type of care being provided to such children, especially on whether the care is private or public.

| Trusts |
|---|
| <ul style="list-style-type: none">• Contractual agreement created by trustor• Managed by trustee• For benefit of trust beneficiaries, such as child or spouse• Can own and manage assets• Can be funded with life insurance• Can own life insurance policies |

Trusts can also be an important tool for keeping assets from a spouse to prevent the assets from being directed to a stepchild or to an unforeseen

family member if the surviving spouse were to remarry after the insured's death.

Life insurance and trusts are often combined in creative ways to fund charitable gifts. Sometimes the entire arrangement is for the exclusive benefit of the charity. In other arrangements, the trust is set up for a combination of family objectives and gifts to charitable institutions. Such arrangements usually involve a stream of income payments and subsequent distribution of the trust corpus. The charity or the family member can be the recipient of the income payments, the corpus, or both.

Charitable Donations

Life insurance policies are often used to increase the value of gifts to charities. This can be accomplished either by giving the policy itself to the charitable organization or by naming the charity as the beneficiary on the existing life insurance policies. Where federal estate tax considerations are important, a new life insurance policy may be purchased by the charity itself at the request of the donor, who would give the necessary permission and information to complete the policy application and would provide the funds for premium payments.

Life insurance can also be used for charitable giving even if the charity is not a beneficiary of the insurance policy. The donor can use adequate amounts of life insurance to fund the needs of surviving family members and thereby free up personal property and other assets for lifetime gifts to the charities.

Gift tax and estate tax considerations are often strong motives for making charitable gifts. Because tax laws can—and probably will—change, tax planning should be carefully coordinated by a knowledgeable tax adviser.

Funding for Gifts to Individuals

The use of life insurance is not limited to benefiting family members and related trusts and charities. Life insurance can be used to benefit anyone the donor specifies. The motivation could be friendship, long-term loyalty, respect for another's accomplishments, support of a common endeavor, or any other commitment about which the individual feels strongly. The intended recipient can be made beneficiary of a life insurance policy or a beneficiary of a trust funded by life insurance proceeds.

One of the important factors favoring life insurance policies is that the proceeds do not generally go through probate and are not a matter of public

record. The proceeds are payable quickly and directly to the beneficiary. Complications of settling or managing the estate have no bearing on nor do they delay the payment of proceeds under a life insurance policy unless the proceeds are payable directly to the insured's estate. In estates large enough to have a federal estate tax liability, therefore, it is generally not a good idea to have life insurance proceeds payable to the insured's estate.

Funding Home Health Care or Nursing Home Care

The cash values of life insurance policies can be used for home health care or nursing home care if that is deemed desirable or necessary. Access to the cash value is available through policy loans, partial withdrawals of the cash value, or outright surrender of the policy.

Long-term-care riders are available with some life insurance policies to provide for home health care or nursing home care needs. In some cases, the rider is available without any additional charge; in other cases, there is a nominal charge. In essence, these riders make a portion of the death benefit, usually 1 percent or 2 percent of the face value of the policy, available each month that the insured qualifies for the benefit. The subsequent death benefit payable is reduced dollar-for-dollar for each accelerated benefit payment made under these riders. Their pre-death benefit payments are usually subject to an aggregate limitation of 50 percent of the face value of the policy, although a few insurance companies have increased the aggregate limitation to 70 percent or 80 percent of the policy face value.

Long-term-care riders allow life insurance policies to do double duty. They make benefits available for both the insured's lifetime objectives and the survivors' objectives. This can create a complication, however, in that lifetime uses directly reduce the residual benefit payable upon death. It is important to recognize and evaluate the potential conflicts when planning for these needs.

Retirement Needs

Retirement is a planning need that the financial advisor must anticipate. This contingency determines the type of insurance the prospect should purchase. If the family needs are met with cash value life insurance (assuming adequate funds for premiums), the cash values under this insurance can supplement other retirement income sources to take care of the postretirement needs of the insured and his or her spouse.

I AM A LIFE INSURANCE POLICY

I am a piece of paper, a drop of ink, and a few pennies of premium.

I am a promise to pay.

I help people see visions, dream dreams, and achieve economic immortality.

I am education for the children.

I am savings.

I am property that increases in value from year to year.

I lend money when you need it most, with no questions asked.

I pay off mortgages so that the family can remain together in their own homes.

I allow people to dare to live and to die responsibly.

I create money where none existed before.

I am the great emancipator from want.

I guarantee the continuity of a business.

I conserve the employer's investment.

I am tangible evidence that a man is a good husband and father, and that a woman is a good wife and mother.

I am a declaration of financial independence and economic freedom.

I am the difference between an old man or woman and an elderly gentlemen or lady.

I provide cash if illness, injury, old age, or death cuts off the breadwinner's income.

I am the only thing that can be bought on the installment plan that a family doesn't have to finish paying for.

I am protected by laws that prevent creditors from assessing the money I give to loved ones.

I bring dignity, peace of mind, and security to the family.

I supply investment capital that makes the wheels turn and the motors hum.

I guarantee the financial ability to have happy holidays and the laughter of children—even though father or mother is not there.

I am the guardian angel of the home.

I am life insurance.

Life insurance policies can be an important source of supplemental retirement income funds for the insured and for the surviving spouse. These funds can supplement any other source of retirement income available from corporate pensions, IRAs, qualified plans, investments, and Social Security. This

can be accomplished by utilizing the cash value of the life insurance prior to the insured's death. Some policies, such as UL policies, allow partial withdrawals of cash value amounts without terminating the policy. Under any life insurance policy having a cash value, the policyowner can always gain access to the funds by either taking out a policy loan or surrendering the policy for the entire cash surrender value. Surrendering the policy, of course, terminates any death benefit protection.

THE SELLING/PLANNING PROCESS FOR LIFE INSURANCE

There are two sides to every purchase—something is bought and something is sold. In the professional selling/planning process, it is essential that the advisor understand the buyer's side of the situation. Because of the intangible nature of life insurance and a general aversion to the concept of personal mortality in our society, the advisor typically takes the initiative in the sales process. But sales do not happen without the buyer's cooperation and participation. In the client-focused sales process, the buyer's realization and acceptance of his or her needs and goals is of utmost importance. By understanding the buying cycle, the advisor can appreciate the process the buyer is going through, and how the buyer views the process. Empathy and client-focused behavior on the part of the advisor play a key role.

The Selling/Planning Process

A thorough understanding of the selling and buying process will help you achieve sales success and produce satisfied clients. Working with the prospect means guiding that person through each step of the selling/planning process. If any step is omitted or inadequately completed, the result will be that a sale is not made, or the sale will be on an unstable foundation that may end in disappointment. By following the selling/planning process systematically, better results will be obtained for both the client and the advisor, because a more complete process will be achieved. If the sale is not successful, it provides you with an opportunity to analyze what took place between you and the prospect, and identify the areas that need strengthening and improvement.

selling/planning process

The *selling/planning process* involves eight steps that move a prospect through a procedure that culminates in satisfying the needs and wants of the buyer. These needs

and wants must be matched with the appropriate product or service. This matching, plus your own creativity, may convince the buyer to act and buy now to fill the needs.

LUTC has adopted the phrase, the selling/planning process, to emphasize that financial services advisors need sales skills, that the client-advisor relationship typically involves a selling process, and that financial advising and counseling have sales elements. On the other hand, the financial planning movement has gained prominence in recent years and has influenced the client/advisor relationship. This has advanced client-focused selling and the total-needs approach to selling. The industry and the public recognize the comprehensive nature of our financial lives and the need to take an integrated approach to planning our financial security.

The Eight Steps of the Selling/Planning Process

1. *Identify the prospect.* Identify whom you are going to approach and why. Effective selling begins with getting in front of prospects who have a probable need for your products and who can afford them. They appreciate you and your services and may be a source for repeat business and referrals. You need a system to consistently find potential clients in target markets. The key to successful selling is prospecting and marketing.

2. *Approach the prospect.* Contact the prospect by telephone, by mail, or face to face and ask for an appointment, stating the reason why you are interested in meeting. As telemarketing and direct mail become less effective, referral prospecting is becoming more critical than ever.

3. *Meet the prospect.* In the initial interview, establish rapport and explain your business purpose. Make positive statements about yourself, your company, and the services you offer. Ask thought-provoking and challenging questions, and encourage agreement to proceed with the gathering of relevant information about the prospect. Impress upon the prospect what makes you different from other advisors and what you offer that is of added value. Establishing the prospect's interest in pursuing solutions to uncovered needs is essential for the selling/planning process to proceed.

4. *Gather information and establish goals.* Using a fact-finder, ask questions that will help you gain information about the prospect's situation.

These questions should seek to uncover information about goals, attitudes, and priorities, in addition to facts about the prospect's personal and financial life. Ask the prospect what his or her expectations are for your relationship. What results does he or she want? This will help you understand what you should plan to deliver and how to deliver it.

Information is required to define the prospect's current situation, determine what his or her desired future situation is, and when it is to be achieved. Establish what the prospect is willing and able to do to achieve these goals. This information must be accurate, complete, up to date, relevant, and well organized. Financial plans based on erroneous or incomplete information, will be deficient, inappropriate, inconsistent with the prospect's other goals, and perhaps even dangerous to his or her well being.

Goal setting is important to creating a successful financial plan. By guiding the prospect through the goal-setting exercise, the advisor not only helps to establish reasonable, achievable goals, but also sets the tone for the entire selling/planning process and the advisor-client relationship.

5. Analyze the information. Once the relevant information about the prospect has been gathered, organized, and checked for accuracy, consistency, and completeness, you need to analyze the prospect's present financial situation. The objective is to identify where the prospect is now in relationship to the goals that were established in the previous step. You must identify real problems and needs to which your products and services will provide real solutions.

Although the prospect's situation may reveal a number of strengths, more than likely your analysis of the prospect's present situation will reveal a number of weaknesses, or conditions that are preventing achievement of the prospect's goals. The prospect may have excellent fringe benefits at work, including good life, medical, and disability insurance benefits. He may have just recently updated his will and installed a living will that includes provisions that legally carry out his wishes in the case of death or catastrophic illness. On the other hand, the prospect may be using debt unwisely, amassing credit card and other debt, paying unnecessarily high federal income taxes, or be inadequately insured. A prospect's investment portfolio may be inconsistent with her investment objectives or risk tolerance.

It may be that the prospect cannot realistically attain the goals stated, and they need to be revised. For example, the prospect's income and resources

may prevent reaching a specified retirement income goal or retirement starting age. In this case, the advisor should help the prospect revisit the goal and revise it, or discuss what needs to be done to achieve that goal. Postponing retirement, saving more money, seeking higher returns, or deciding to deplete principal during retirement are four possible ways to help the prospect achieve the retirement goal. Presented as alternatives, the advisor can help the prospect restate the original goal in terms that will make it more achievable.

6. Develop and present the plan. After the information has been analyzed and the objectives to be achieved confirmed, and if necessary revised, the next step is to devise a realistic plan for bringing the prospect from his or her present financial position to the attainment of those objectives. A good plan must reflect the prospect's needs, attitudes, and goals. The plan must be the prospect's plan, not the advisor's plan.

It is not likely that any individual advisor can maintain an up-to-date familiarity with all the strategies that may be available and appropriate for a given prospect's situation. Based on his or her education, experience, training and specialization, the advisor is likely to rely on a given number of proven strategies and products that typically work when encountering similar prospect circumstances. When additional expertise is needed, the advisor should always consult with another advisor who is a specialist in the field in question.

There is usually more than one way to achieve a prospect's financial goals. When this is the case, the advisor should present alternative strategies for the prospect to consider and should explain the advantages and disadvantages of each strategy. Your presentation should provide an answer to the problems and needs discovered in your analysis of the prospect's situation. You support the decision to buy now because your product is the best available solution. Of course, your prospect must agree with this conclusion. You want to anticipate client concerns and provide answers for them.

After the plan is presented and reviewed with the prospect, the "moment of truth" arrives. The advisor must ask the prospect to approve the plan, or some compromise alternative, and commit to purchasing any products that may be part of the plan's implementation. Planning involves selling, and good selling is based on good planning.

7. Implement the plan. You must motivate the prospect to act and help him or her acquire the financial products necessary to put the plan into action. You must answer concerns that may prevent him or her from implementing the plan. Then, you must support the decision to buy the products you recommend. Complete the application(s) and all required forms, explain the process to the prospect, and verify that everything that is being done is understood. Perform or order all field underwriting requirements as needed. If the plan is limited in scope or complexity, it may be within the advisor's ability to implement the plan entirely. Otherwise, it may be necessary to call upon additional specialized professional expertise where needed. For example, legal instruments, such as wills and trusts, may need to be drawn up and executed. It is typically part of the advisor's responsibility to motivate and assist the prospect in completing each of the steps necessary to implement the plan.

8. Service the plan. This may be the most important step in preserving your hard work and expanding on it. Deliver the policy and reaffirm the decision to buy, citing the problems that can be solved by having this product. Restate the benefits you are providing. Get referrals. Service will help you build your long-term career as a financial services professional. Through service, you enhance and cement your relationship with each new client, make additional sales, and set the stage to obtain quality referrals to new prospects.

The relationship between the advisor and client should be ongoing. Normally, the advisor meets with the client once a year, or more or less frequently as agreed upon, to review the performance of the vehicles selected to implement the plan. The advisor should also review the client's personal and financial situation, as well the tax and financial environment around him or her, to establish if anything has changed that would warrant making changes to the plan.

Figure 1-6
Steps of the Selling/Planning Process:



CHAPTER REVIEW

Key terms and concepts are explained in the glossary. Answers to the review questions and the self-test questions are found in the back of the book in the Answers to Questions section.

Key Terms and Concepts

financial planning process
 risk management
 indemnity
 risk pooling
 law of large numbers
 mortality
 interest
 expense
 2001 CSO Mortality Table
 yearly renewable term (YRT)
 reserve
 legal reserve

amount at risk
 cost of insurance
 net level premium
 human life value approach
 needs analysis approach
 cleanup fund
 estate clearance fund
 income needs
 readjustment income
 dependency period income
 cash needs
 selling/planning process

Review Questions

1. Define the basic principles of life insurance.
2. Explain the concept of risk pooling and how it relates to life insurance.
3. Explain how mortality, interest, and expense serve as the building blocks of life insurance.
4. Explain how the premium for Yearly Renewable Term (YRT) is determined.
5. Explain how the level premium insurance concept works.
6. Explain the concept of human life value and how it relates to life insurance.
7. Identify and explain the expenses commonly associated with a death and settling the deceased's estate.
8. List and explain the income needs of surviving family members.
9. Explain the post-death cash needs of survivors.
10. Explain the steps in the selling/planning process.

Self-Test Questions

Instructions: Read the chapter first, then answer the following 10 questions to test your knowledge. Circle the correct answer, then check your answers in the answer key in the Answers to Questions section in the back of the book.

1. The newest mortality tables introduced by the NAIC are called the
 - (A) 1980 CSO Tables
 - (B) 2001 CSO Tables
 - (C) 2003 CSO Tables
 - (D) 2007 CSO Tables
2. In a level premium ordinary life policy, the net amount at risk
 - (A) increases each year
 - (B) decreases each year
 - (C) remains the same over time
 - (D) could increase or decrease based on investment returns
3. Which of the following is a characteristic of an ordinary life (WL) policy?
 - (A) It is the most expensive form of cash value insurance.
 - (B) It matures at age 65.
 - (C) It has an increasing cash value and decreasing risk amount.
 - (D) Both the cash value and amount at risk increase annually.

4. The reserve is
 - (A) a plan of insurance under which premiums do not increase from year to year
 - (B) the same as the policy cash value or surrender value
 - (C) an amount that must be accumulated by the insurer to meet definite future obligations
 - (D) an asset of the company allocated to individual policies

5. The step in the selling/planning process where you establish rapport, explain your purpose, ask some questions, and get agreement to proceed is called
 - (A) meeting the prospect
 - (B) analyzing the situation
 - (C) presenting the solution
 - (D) selecting the prospect

6. At the end of the term period of a term life insurance policy, if death has not occurred, the company will
 - (A) pay a living benefit
 - (B) pay a refund on premiums
 - (C) pay a portion of the death benefit
 - (D) pay no benefit as premiums are considered fully earned

7. Which of the following statements is (are) correct about level premium insurance plans?
 - I. The \$1,000 policy does not provide \$1,000 of pure insurance.
 - II. The company is never at risk for the face amount of the policy.
 - (A) I only
 - (B) II only
 - (C) Both I and II
 - (D) Neither I nor II

8. Which of the following statements concerning the readjustment period for survivors after a wage earner's death is (are) correct?
- I. The length of the period should be less than one year, ideally 3–6 months.
 - II. The income during this period should be approximately equivalent to the insured's earnings at the time of death.
- (A) I only
(B) II only
(C) Both I and II
(D) Neither I nor II

READ THE FOLLOWING DIRECTIONS BEFORE CONTINUING

The questions below differ from the preceding questions in that they all contain the word EXCEPT. So you understand fully the basis used in selecting each answer, be sure to read each question carefully.

9. In calculating insurance needs, cash needs would include all of the following EXCEPT
- (A) income for a surviving spouse.
 - (B) education fund for children
 - (C) emergency fund
 - (D) cleanup fund or final expenses
10. All of the following statements concerning risk pooling are correct EXCEPT
- (A) It involves combing risks by persons exposed to loss from a particular source.
 - (B) It involved sharing losses on some equitable basis.
 - (C) It is one important element that must be present in any sound insurance plan.
 - (D) It is used only when the insurance is issued by a mutual company.