

Keir Digest
with
Assessment Questions

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Chapter 1

Economic Bases of Life Insurance

Learning Objectives

1-1. The Role of Insurance. Life insurance plays a critical role in preserving a family's economic security by replacing the economic value lost due to the death of a person. The economic value of a human life is the person's unrealized earning capacity that will go to the support of his or her dependents if he or she survives to generate that earning power. The economic value of a human life usually arises out of family relationships, but it should be noted that such value may also arise out of certain business relationships.

Note that earning power alone is not sufficient to create an economic value for a human life that can logically serve as the basis for life insurance. Only if there are some individuals or organizations that are dependent upon the person's earning power in a financial sense can there be a logical basis for life insurance. For example, it could be argued that an individual who has earning power but has no dependents and is unlikely to have anyone dependent upon him or her for financial support in the future has no economic value that needs to be preserved through life insurance; this, of course, is not the norm.

Dr. Solomon S. Huebner, who originally developed the concept of the economic value of the human life, believed that the individual has a strong obligation to provide protection for his or her family members. He pointed out that most people willingly assume financial responsibility for the support and maintenance of their dependent spouse and children while alive. He stressed, however, that it takes a higher order of responsibility for an individual to voluntarily provide for continuation of income for the benefit of dependents after his or her own death. In fact, Dr. Huebner's views

were so strong that he felt that one who dies without having provided an adequate amount of life insurance for his or her dependents does not merely die, but rather, he or she absconds!

1-2. The five steps in the procedure to compute a person's monetary value for purposes of life insurance are as follows:

(a) Estimate the average annual earnings of the individual from personal efforts over the remaining years of his or her income-producing lifetime.

(b) Deduct from those average annual earnings the anticipated federal and state income taxes, life insurance premiums, and annual costs of self-maintenance of the individual.

(c) Determine how many years remain between the person's present age and the anticipated age of retirement.

(d) Select a reasonable and conservative rate of interest at which future earnings are to be discounted in order to reduce them to their present value.

(e) Multiply the net annual earnings as found in the first two steps by the present value of \$1 per annum for the number of years determined in the third step, discounted at the rate of interest selected in the fourth step.

For example, assume that a person age 25 expects to retire in 40 years and expects to earn an average of \$80,000 per year during that period. Also assume that about 50% of those earnings will go toward taxes, life insurance premiums, and the cost of self-maintenance, leaving a net of \$40,000 per year for the dependents. If a 6% interest rate is selected, the present value of \$1.00 per year at the start of each of 40 years is \$15.95. The present value of \$40,000 at the start of each of those years would be \$40,000 x \$15.95, or \$638,000.

Chapter 1

Economic Bases of Life Insurance

1. Life insurance is primarily concerned with which of the following aspects of the human life value?

(C 1.3)

- (A) The religious value
- (B) The social value
- (C) The economic value
- (D) The moral value

2. A human life may have an economic value that can logically serve as the basis for life insurance in which of the following situations?

(C 1.3)

- I The individual is age 23 and unmarried and has no children.
- II The individual has only one dependent, an aged father.
- III The individual has no dependents but makes sizeable periodic gifts to a favorite charity.

- (A) II only
- (B) I and III only
- (C) II and III only
- (D) I, II, and III

3. Which of the following is an element of the technically accurate method of calculating the economic value of an individual's human life?

(C 1.6)

- (A) Deduct the cost of the individual's self-maintenance, life insurance premiums, and personal income taxes.
- (B) Discount for the contingency of the individual's death, but not for the contingencies of his or her disability or unemployment.
- (C) Reduce the residual income of the individual to its future value.
- (D) Calculate the size of a fund whose investment earnings will be sufficient to replace the dependents' share of the individual's income.

4. All the following are steps in the five-step process of estimating a person's economic value for purposes of life insurance, EXCEPT:

(C 1.7)

- (A) Estimate the person's average annual earnings from personal efforts during the remainder of the person's working years.
- (B) Deduct the cost of the person's self-maintenance, life insurance premiums, and income taxes.
- (C) Select a reasonable rate of interest to use in discounting future earnings.
- (D) Determine the remaining number of years in the person's life expectancy.
- (E) Multiply the person's net earnings by the present value of \$1.00 per year, based on the selected interest rate and the remaining number of years until the person's planned retirement date.

Chapter 1

Economic Bases of Life Insurance

1. C is the answer. Although life insurance is not oblivious to the various values of the human life, such as its religious value, its artistic value, its value in life insurance is with the economic value of a human life, which depends upon the earning capacity of that life and the fact that other people are financially dependent on those earnings for their support.

2. D is the answer. A human life has an economic value if there is some other person or organization that will benefit financially from the continuation of that individual's life. Clearly, then, II and III are correct. As for I, although the individual at present does not have any dependents, it is not unreasonable to expect that the individual will have dependents at some time in the future, so this person may still be an economic value that is the basis for life insurance.

3. A is the answer. B is incorrect because all three contingencies should be taken into account in the discounting process. C is incorrect because the technically accurate method entails reducing the residual income of the individual to its present value. D is incorrect because the fund does not need to be so large that the investment earnings alone will be sufficient to replace the lost income. Rather, both investment earnings and principal can be liquidated to meet this objective.

4. D is the answer. The number of years that is relevant for this calculation is the remaining years until the person's planned retirement date, not the number of years remaining until the individual lives out his or her life expectancy. Thus, the correct procedure is that summarized in E, in which the net earnings, as

calculated in A and B, are discounted at the rate of interest chosen in C.