

# Concepts, contracts, and basics

## General insurance concepts

- **Risk types**
  - **Pure:** Only loss possible; insurable. Insurance restores, it does not create profit (principle of indemnity).
  - **Speculative:** Loss or gain possible; not insurable (e.g., gambling, investing).
- **How to manage risk**
  - **Avoid:** Eliminate the risk entirely (e.g., don't drive).
  - **Reduce:** Lower the chance or severity of risk (e.g., healthy habits).
  - **Retain:** Accept and pay for the risk yourself (e.g., deductibles).
  - **Share:** Spread the risk with others (e.g., business partners).
  - **Transfer:** Shift the risk to another party (e.g., buying insurance).
- **Law of large numbers**
  - The larger the group, the more accurately insurers can predict losses and set premiums. It's the statistical foundation of insurance.
- **Insurable interest**
  - Must have a financial or personal stake in the insured at time of application (e.g., self, family, business).
- **Free look period:** Policy owners have 10 days (or as required by state law) to cancel a new policy and receive a full refund.

## Insurance contracts

- **Four elements of a valid contract**
  - **Offer:** An offer is made when the applicant completes the application; it's accepted when the insurer issues the policy.
  - **Acceptance:** Acceptance occurs when the insurer agrees to the offer as written or with counter-offers.
  - **Consideration:** Consideration is the exchange of value – the applicant's premium for the insurer's promise to pay claims.
  - **Legal capacity and purpose:** Both parties must be legally able to enter the contract, and the purpose must be legal (no fraudulent intent).
- **Key features**
  - **Adhesion:** "Take it or leave it", the insurer sets terms.
  - **Aleatory:** Unequal value exchange (small premium for large benefit).
  - **Unilateral:** Only the insurer makes a binding promise (the insured does not promise anything in return).
  - **Conditional:** Terms and conditions must be met to receive benefits.
- **Utmost good faith**
  - Both parties must act honestly and rely on each other's representations.
- **Representations vs. warranties**
  - **Representation:** Statements believed to be true to the best of the applicant's knowledge.
  - **Warranty:** Guaranteed truth; false = void policy.
  - **Misrepresentation:** Knowingly false information may void the contract.
- **Doctrine of adhesion**
  - If contract terms are ambiguous, they are interpreted in favor of the insured.
- **Principle of indemnity**
  - Insurance restores the insured to their financial position before the loss; no opportunity for gain.

## Life insurance basics

- **Types of policies**
  - **Term life:** Pure protection, no cash value, less expensive, premiums rise over time.
  - **Whole life:** Permanent, builds cash value, level premium.
  - **Universal life:** Flexible premiums and death benefit, builds cash value.
  - **Variable life:** Investments tied to a separate account. Policyholder bears the investment risk. Requires securities license to sell; regulated by SEC/FINRA. Cash value and death benefit can fluctuate based on investment performance.
- **Beneficiaries**
  - **Revocable:** Can be changed at any time.
  - **Irrevocable:** Cannot be changed without beneficiary's consent.
  - **Per stirpes:** Deceased beneficiary's share goes to their heirs.
  - **Per capita:** Proceeds divided only among surviving named beneficiaries.
- **Premium factors**
  - **Mortality:** The likelihood of death; higher for older individuals, increasing premium costs.
  - **Interest:** Insurer invests premiums to earn interest, which helps reduce the required premium.
  - **Expenses:** Operational costs (commissions, administration, profits) added to the premium.
- **Policy riders**
  - **Waiver of premium:** Waives premiums if the insured becomes disabled and cannot work.
  - **Guaranteed insurability:** Allows purchasing more insurance later, without proof of insurability.
  - **Accidental death benefit:** Pays extra if the insured dies due to an accident.
  - **Return of cash value:** Pays back the cash value of the policy in addition to the death benefit at death.
  - **Payor benefit:** Waives premiums on a juvenile life insurance policy if the parent or guardian paying the premiums dies or becomes disabled before the child reaches a certain age (usually 21 or 25). This keeps the child's policy in force without requiring further payments.
- **Policy provisions**
  - **Contestability period:** Insurer can void the policy for misrepresentation within the first 2 years.
  - **Suicide clause:** Suicide within 2 years results in premium refund only.
  - **Reinstatement:** Lapsed policies can be reinstated (typically within 3 years) with proof of insurability and back premiums plus interest.
  - **Misstatement of age:** If an insured misstates their age, the policy remains valid, but the face amount will be adjusted based on the correct age.
- **Group life insurance**
  - **Applicants:** Employers, METs, labor unions, creditors.
  - **Policy issuance:** One policy for the group, participants get certificates.
  - **Underwriting:** No medical exams for most groups; rates based on size, age, and claims.
  - **Cancellation:** Group policies may be canceled by the insurer or policyholder with 31 days' notice.
  - **Participation:** 100% for non-contributory, 75% for contributory.
  - **Conversion:** Members can convert to individual policy within 31 days without proof of insurability.
- **Annuities**
  - **Purpose:** Protects against outliving financial resources, provides guaranteed payments (often for life).
  - **Premiums:** Not tax-deductible but grow tax-deferred.
  - **Purchase:** Can be single premium (immediate) or periodic payments (deferred).
  - **Accumulation:** Flexible contributions, but withdrawals are taxable and subject to 10% penalty (if under 59½).
  - **Annuitization:** Converts the annuity to guaranteed periodic payments; irreversible.
  - **Payout options**
    - **Life income:** Guaranteed for life, ceases at death.
    - **Period certain:** Payments for life, but beneficiary continues if annuitant dies early.
    - **Refund:** Payments continue to beneficiary if the total payments are less than the contract value.
    - **Joint life:** Payments continue until the last annuitant dies.
  - **Taxation:** Payments taxed based on growth portion; no 10% penalty once annuitized.
  - **1035 Exchange:** Tax-free transfers allowed between life insurance and annuity contracts (e.g., life → life, life → annuity, annuity → annuity). Not allowed from annuity → life.
    - **ERISA:** ERISA governs retirement plans. Life insurance and annuities can work alongside retirement strategies but are not ERISA-qualified unless used in specific employer-sponsored plans.
- **Taxation basics**
  - **Premiums:** Not tax-deductible.
  - **Death benefits:** Usually tax-free to the beneficiary.
  - **Cash value:** Grows tax-deferred.
  - **Withdrawals:** Taxable only if they exceed the premiums paid (cost basis). In standard life insurance policies — as long as they are not MECs — premiums come out first, and interest is taxed only after the basis is withdrawn.
  - **Policy loans:** Not taxable if policy remains in force.
  - **Dividends:** Not taxable (considered return of excess premium).
  - **Modified Endowment Contract (MEC):** A life policy that fails the 7-pay test; taxed like an annuity (LIFO, 10% penalty if under 59½).