MARKETS AND SOCIAL SECURITY

LEARNING OBJECTIVES
Upon the completion of this chapter, you will be able to:

1. Compare the Master Policy with the Certificate of Insurance under a group insurance plan
2. List the characteristics of a group insurance plan
3. Define group conversion
4. Explain the purpose of credit life insurance
5. Differentiate between contributory and noncontributory
6. List the business uses of life insurance
7. Define fully insured and currently insured under Social Security

OVERVIEW
The purpose of this chapter is to acquaint the student with the many different markets in which life insurance may be sold. The characteristics and features of each of these markets are discussed. This chapter will wind up with an overview of Social Security.

6.1 Group Insurance Market

Group life insures a group of people under a single contract. State and federal laws restrict the insurer’s underwriting criteria for group policies. The purpose of group life is to underwrite the combined risk of a group of individuals as a single policy. It allows the insurer to write a bulk amount of insurance at an appropriate rate. The group sponsor benefits both from the standpoint of employee retention, but also because costs are lowered because the sponsor takes on some of the tasks of marketing and administration.

Group Risk Selection
Risk selection may have several aspects, such as size, stability, and industry. For example, group life insurance products may require a minimum number of participants in order to avoid higher claims because of a few individual substandard risks.

Underwriters are also concerned about stability. It is important to know how long the group has existed, how often the group switches providers, and what is the group’s unifying characteristic. Individual turnover is less important.

Unlike in an individual plan, the departure of an individual does not mean the policy is cancelled. Instead, the sponsor may drop one employee and pick up another. Also, the sponsor is doing some of the administration.
Characteristics of Group Insurance Plans

In a group insurance plan, the insurer issues a **Master Policy** to the plan sponsor and each participant receives a **Certificate of Insurance** covering the participant; and if offered, his/her spouse and dependents. Participants in the plan do not have personal control of the policy or policy changes as with an individual policy. Group insurance is a contract between the sponsor and the insurance company.

The sponsor may set the terms and determine which classes of employees qualify, such as full-time vs. part-time employee. The plan cannot discriminate so all members of the eligible class of employees must be eligible for predetermined benefits based on a single formula, such as the same percentage of annual income. The sponsor can elect to discontinue the plan and the insurance company can increase the rates it charges. To be eligible for a group plan, the group must be a **natural group**, meaning it was formed for a purpose other than for procuring or reducing the cost of insurance. Group plans must also have a **grace period** of typically 31 days and is usually written as **Annual Renewable Term**. Evidence of insurability is not required if the individual enrolls when eligible.

Types of Group Plan Sponsors

Group plans may be sponsored by employers, associations, debtors, labor unions, or trusts. The most common type of plan sponsor is an employer group. Employer plans have the following characteristics:

- The employer may be a partnership, a corporation, or a sole proprietorship.
- There are two legal employer-employee groups fitting one of the following definitions:
  - **Contributory** – Employees must contribute to the premium payments and at least 75% of all eligible employees must participate.
  - **Noncontributory** – Employer pays the entire premium with a mandatory 100% of the eligible employees participating. The percentage participation requirements are used to reduce adverse selection.
- An employee must be a full time employee in the immediate group, a subsidiary firm or an employee of any active partner to be eligible for coverage.

Group Underwriting

The underwriter’s greatest concern when underwriting a group plan is adverse selection. To help protect against preexisting conditions and immediate claims, group plans can have a **probationary period** set by the group sponsor. This is a waiting period between when an individual is hired and when they become eligible to enroll in the group plan. As long as the individual enrolls during the **open enrollment**, coverage is guaranteed and evidence of insurability is not required. Individuals who do not enroll during the initial enrollment period are considered late enrollees and must provide evidence of insurability unless they wait until the next open enrollment period.

Open enrollment periods are offered on an annual basis which allows individuals to enroll without evidence of insurability or to make changes. An individual can make changes at any time if they have a change in status, such as adding an eligible dependent or change in employment status such as going to or from full time to part time employment.

The cost of the plan is determined by the average age of the group, size, industrial classification (nature of the work involved), experience rating (the group’s claims) and the personnel turnover history. These factors are more important than the actual overall health of the group.
Group Conversion

There is a conversion period of **31 days** in which the employee may, upon termination of eligibility and without evidence of insurability, convert his/her group life insurance benefit to an individual permanent policy. The premium will be at a higher than normal rate to include the insurer’s guaranteed convertible surcharge, since the majority of all conversions are on persons that would otherwise be uninsurable. Premiums will also be higher because the conversion policy will be issued at the attained (current) age of the insured and the policy will build cash values.

The conversion period is also a grace period. In the event a terminated or ineligible employee dies during the conversion period, whether they were going to elect individual coverage or not, a death claim will be paid by the group policy, less the premium due for the benefit.

Franchise (Wholesale)

This group insurance is unique in that a Master Policy is not issued since underwriting is on an individual basis and individual policies are issued. Therefore, evidence of insurability may be required. The employer may be the premium payor or the premium costs may be shared by the employer and employee. The grace period is typically 31 days, with the employer being responsible for the plan administration making it less expensive than individual policies. The insurer requires a minimum number of participants before underwriting and the group must be together for reasons other than to purchase insurance.

Retention Question 1

**In a group life insurance plan, the employee has control over which of the following?**

a. Choice of insurance company
b. Type of policy
c. Choice of beneficiary
d. Mode of premium payments

Retention Question 2

**The Master Policy for a group life plan goes to the employer. What does the employee receive?**

a. Certificate of Insurance
b. Change of beneficiary form
c. Copy of the Master Policy
d. Claim form package

Retention Question 3

**When a group insurance plan is identified as contributory, it means all of the following, EXCEPT:**

a. Employees pay a portion of the cost of their benefit
b. Employers must enroll 100% of eligible employees
c. Employees must be eligible to participate
d. Employers are responsible for collecting the premiums employees pay
6.2 Specialized Plans

Credit Life Insurance (Individual and Group)

Credit Life Insurance is either a form of individual coverage on the life of a debtor, or group insurance issued to a creditor providing coverage on debtors for the benefit of creditors. Both types of plans are normally a form of Decreasing Term and the amount of insurance reduces as the amount of obligation reduces.

Usually the individual debtor pays the premium. A few dollars of a monthly payment are credited toward premiums for the insurance and the debtor is entitled to cancel the insurance if and when the loan is prepaid or refinanced. The premiums are based on a flat amount. The amount of insurance benefit must not exceed the total amount of indebtedness.

The coverage begins when the debtor becomes obligated to the creditor. The creditor (who normally is both policyowner and the beneficiary) must apply the insurance proceeds to discharge the loan.

Industrial (Home Service)

Individual policies are issued to low-income workers without a medical examination requirement. The premiums are collected weekly or monthly by the insurance agent servicing that particular area or paid directly to the insurer.

Industrial policies normally have a face amount of $1,000 or less and are written to reduce funeral costs. These policies are marketed house-to-house by a Debit Agent, also known as a Home Service Agent. The grace period is 4 weeks in length with the method of settlement upon death being lump sum.

Facility of Payment Clause – The insurer may pay to a relative or anyone it deems entitled to the benefits in the absence of a designated beneficiary.

Retention Question 4

In a credit life plan, who is the beneficiary?

a. The wife of the insured
b. The husband of the insured
c. The children of the insured
d. The creditor

Retention Question 5

Industrial life insurance is typically sold in face amounts of:

a. $1,000 or less
b. $5,000 multiples
c. $10,000 to $20,000
d. Up to $50,000
6.3 Business Uses of Life Insurance

In addition to personal uses of life insurance, the business market also benefits from the purchase of life insurance. Business uses of insurance often mirror individual needs—to cover the unexpected death of business partners, executives, and key employees by providing funds for the continuation of the business, not for the heirs of the decedent.

**Buy-Sell Agreement**

This agreement contractually establishes a price with the intent to purchase, at a predetermined value, the assets of a business should one of the contract participants predecease the others. It may be used with a sole proprietorship, a partnership or with stockholders of a closed corporation.

**Some of the advantages of having such an agreement:**

- It is legally enforceable.
- The value of the business is previously agreed upon.
- It is an immediate and automatic method of transferring the deceased’s interest.

**Some disadvantages of NOT having an agreement:**

- Income to surviving family members stops.
- Surviving business owners may suffer a loss of income.
- Asset reduction due to forced liquidation may occur.
- The estate transfer may be delayed due to forced business liquidation.
- Shares of ownership transfers to surviving relatives.

Any type of life insurance may be used to provide funds for the Buy-Sell Agreement. Premiums are not deductible, and policy proceeds are received income tax-free.

**Types of Buy-Sell Agreements**

- **Cross Purchase Plan** – Used when the partners of a business purchase life insurance on each other. At the death of one of the partners, policy proceeds are used to purchase that person’s interest in the business from his/her heirs. Each partner owns insurance on each of the other partners.

  For example, if there are 3 partners in a company valued at $300,000, then each would have a $100,000 interest in the company. Each partner would purchase a policy on the other partners, providing for a total of 6 policies (3 x 2 = 6). Each policy would be valued at $50,000 (6 x $50,000 = $300,000).

- **Entity Plan** – Under this plan, a business entity enters into an agreement in which it is obligated to purchase the deceased owner’s interest. The entity typically buys life insurance policies on each of the owners. The entity would then name itself as the beneficiary of each policy. The death benefit of the policy would be equal to the pre-agreed upon purchase price which would be spelled out in the buy-sell agreement. Upon death of one of the owners, the entity would use the death proceeds to purchase that owner’s interest.

  For example, if ABC Enterprises is worth $300,000 and each shareholder is an equal owner of the company, then the company would buy three $100,000 life insurance policies, one on the life of each owner. The policy would be owned by the company. The company would be named as the beneficiary. At the death of one of the owners, the company would have the funds necessary to buy the deceased’s stock in the company.
- **Stock Redemption Agreement** – An agreement between the shareholders and a close corporation. Each shareholder agrees to sell their shares upon death to the corporation according to the price, terms and circumstances specified in the agreement. This type of buyout is structured so the corporation buys the shares with corporate dollars.

**Key Person (Key Employee)**

Key persons are employees whose contributions have a significant impact on the revenue and profitability of the company, especially in small businesses.

The key employee contributes substantially to the success of a company. They are typically:

- Part of the management team
- More highly paid
- Respected by customers, creditors, suppliers, and vendors
- Have direct responsibilities for sales, production, or service

The life insurance proceeds from a key person life insurance policy provides the necessary funds to recruit, hire, and train a replacement employee, restore lost profits, and reassure customers that the business operations will continue. Either term or permanent coverage can be used to fund the plan.

**Retention Question 6**

*One of the purposes of a Buy-Sell Agreement is which of these?*

a. To provide the business with funds in the event of the death of a key person who is not an owner
b. It describes which relatives of a business owner have the right to purchase that person’s interest in the business
c. It acknowledges the commitments of the partners to each other and to their heirs to assure the continuation of the business in the event one of them dies unexpectedly
d. It describes the conditions that will force a sale of the business, as well as the requirements to be met if the business wants to buy the assets of a competitor

**Retention Question 7**

*A primary purpose of key person life insurance is to do which of these?*

a. Provide the family of the deceased employee with up to ten years of the employee’s lost future income
b. Provide the business with money to recruit and train a replacement employee
c. Provide the business with money to pay vested retirement benefits to the heirs of the employee as a lump sum
d. Protect the business against the death of any employee earning at least $50,000 per year
6.4 Third-Party Ownership

A policy owned by one person insuring the life of another person. The three parties involved in a third-party ownership are the policyowner, insured and insurer. Examples of third-party ownership policies are:

- A husband buying a policy on a wife
- A parent buying a policy on one of their children
- A business buying a policy on a key employee
- A business partner buying a policy on another business partner

6.5 The Social Security System

Funding

Funding is provided by both employee and employer through the Federal Insurance Contributions Act (FICA) tax. The employer withholds the employee’s tax and pays it along with the employer’s portion. Self-employed individuals pay an amount equal to the total of an employer and employee payment.

Based on one’s taxable income and number of years in the workforce, each covered employee earns credits toward the eligibility of Social Security benefits. The credits are based on annual income and allow a worker to accumulate up to four credits, or quarters of coverage, per year.

Once eligible, the amount of monthly Social Security benefits is based on a basic formula which determines each covered worker’s Primary Insurance Amount (PIA).

Insured Status

Fully Insured – Fully insured status requires an individual to have earned a minimum of 40 quarter credits, or approximately 10 years of employment. A fully insured worker has permanent coverage under Social Security and cannot lose this status. Benefits that may be received monthly under a fully insured status are:

- Retirement starting at age 62, or older
- Spousal retirement at age 62 or older
- Widows and widowers can begin receiving Social Security benefits at age 60

Currently Insured – A worker must earn at least 6 quarter credits during the full 13-quarter period ending with the quarter in which the worker dies, becomes disabled, or is entitled to retirement benefits.

Types of Social Security Benefits

Retirement – At Full Retirement Age, a retired worker is eligible to receive monthly income equal to his/her PIA. The Full Retirement Age (FRA) varies based on year of birth but is up to age 67. Covered workers may begin receiving retirement benefits as early as age 62, however benefits will be permanently reduced. Delaying benefits beyond FRA will increase future benefits. Social Security retirement benefits are modified each year for Cost-Of-Living Adjustments. Retirement benefits are also payable to qualified dependents of a covered or deceased worker.

Death Benefits – A one-time lump sum payment of $255 in total may be made after the taxpayer’s death. This death benefit is only payable to a surviving spouse or minor children.
Survivor Benefits

A monthly Survivor Benefit is payable to eligible dependents of a fully insured deceased worker. A **surviving spouse** with a dependent child under age 16 is entitled to monthly income until the youngest child reaches age 16 (or a disable child reaches age 22). Once the youngest child reaches age 16, the surviving spouse’s benefits stop. An unmarried surviving spouse may start receiving retirement benefits at age 60. The **blackout period** is the time between when the youngest child reaches age 16 and the spouse is eligible for retirement benefits at age 60.

**Surviving children** of a deceased worker are eligible for benefits and covered to age 18 or 19 if still enrolled in high school.

Beginning at age 62, **surviving parents** are also eligible for monthly survivors benefits if being at least one half supported by the deceased worker.

**Retention Question 8**

*In order for a worker to be qualified for all of the benefits available from Social Security how many credits must be earned?*

- a. 30 credits
- b. 6 credits in the last 13 quarters
- c. 1 credit for each year of work between age 20 and age 40
- d. 40 credits

**CHAPTER SIX — LIGHTNING FACTS**

1. A “natural group” is one formed for a purpose other than procuring or reducing the cost of insurance. 6.1

2. Employer-sponsored group life insurance has the largest share of all group policies in force. The employer receives the Master Policy, and employees receive a Certificate of Insurance as their evidence of coverage. 6.1

3. Individual evidence of insurability is not normally required to be eligible for group insurance. 6.1

4. A noncontributory plan provides the employers pay the entire cost of their employees’ premiums. 100% of eligible employees must be enrolled. 6.1

5. A contributory plan provides the cost may be shared with or paid for entirely by the employees. 75% of eligible employees must be enrolled. 6.1

6. If an employee is no longer eligible for the group insurance (termination or change in classification), there is a 31-day conversion period in which the employee may elect to obtain an individual policy with the same insurance company without underwriting. The cost will be based on the employee’s attained age. 6.1

7. The conversion period is also a grace period. In the event a terminated or ineligible employee dies during the conversion period, whether they were going to elect individual coverage or not, a death claim will be paid by the group policy, less the premium due for the benefit. 6.1

8. The majority of group life policies are written as Annual Renewable Term (ART). 6.1

9. Group insurance is available to individual employers, to labor union groups, debtors, associations or trusts. 6.2

10. Credit life insurance is issued as a group policy to the creditor for the outstanding balance on the debtor’s account. It is normally a decreasing term policy, with the premiums being paid by the debtor. The amount of insurance must not exceed the total indebtedness amount. 6.2

11. Business uses of insurance often mirror individual needs—to cover the unexpected death of business partners, executives, and key employees by providing funds for the continuation of the business, not for the heirs of the descendant. 6.3
12. Buy-sell agreements often establish a price to purchase the assets of a deceased participant. They may be used in closely held corporations, sole proprietorships or partnerships. 6.3
13. The primary forms of buy-sell agreements which may be funded by life insurance are “cross-purchase” plans, “entity-purchase” plans, and “stock redemption” plans. 6.3
14. In a cross-purchase plan, each partner owns a policy on each of the other partners. 6.3
15. In an entity-purchase plan, the business is the owner and beneficiary of the life insurance policy of each principal. 6.3
16. A stock redemption plan is an agreement between the shareholders and a close corporation. Each shareholder agrees to sell their shares upon death to the corporation according to the price, terms and circumstances specified in the agreement. 6.3
17. Key person life insurance is purchased to protect a business against the unexpected loss of a valuable employee. Such an employee brings critical knowledge, experience, or skills to the business, or is responsible for a significant share of company revenue. 6.3
18. The premiums for a key person life insurance plan cannot be deducted by the business as a business expense. The business receives the entire death benefit income tax-free. 6.3
19. A life insurance policy is under “third-party ownership” when the owner and insured are not the same persons, such as a husband buying a policy on a wife. 6.4
20. To be eligible for all Social Security, a person must be “fully insured” (or the spouse of a fully insured person). To become fully insured, a person must earn 40 “credits”. 6.5
21. A spouse or minor child of a deceased worker (or deceased retired worker) may be eligible to receive Survivor’s Income benefits and may also receive a one-time $255 lump sum death benefit from Social Security. 6.5
22. Income benefits for a surviving spouse are paid if the spouse is caring for the minor children of the disabled or deceased worker who are under age 16. 6.5
23. The period when no survivor benefits are payable to a spouse or former spouse is known as the “blackout period.” 6.5