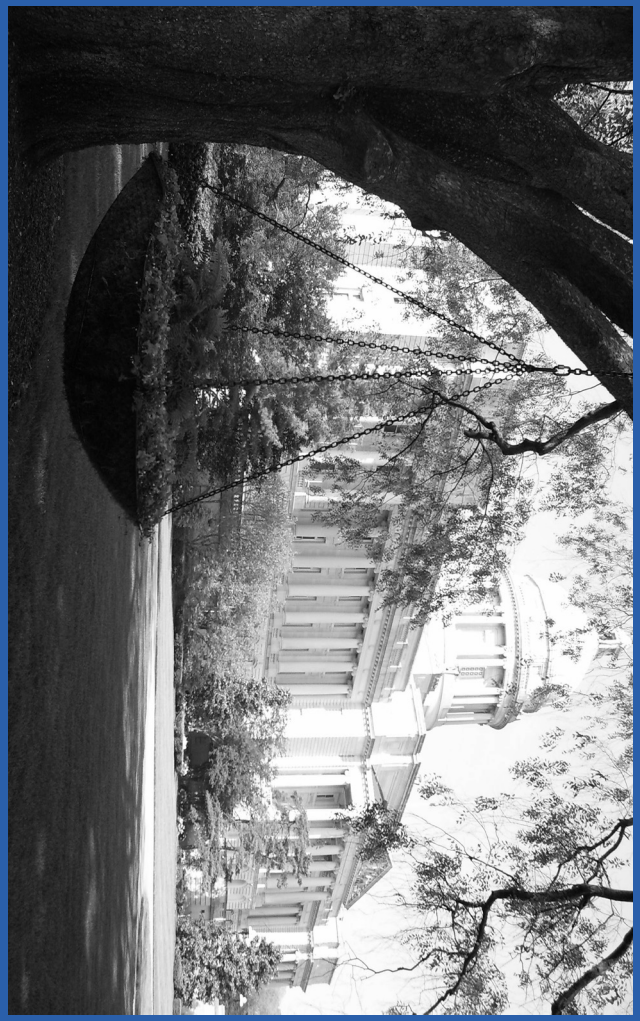
Life Insurance and Annuity Buyer's Guide

Kentucky Office of Insurance



Introduction

The Kentucky Office of Insurance is pleased to offer this "Life Insurance and Annuity Buyer's Guide" as an aid to assist you in determining your insurance needs and the products that will fill those needs. This guide contains only a brief description of various life insurance and annuity products. For specific information about a particular type of life insurance product, you should consult an agent. This guide is not meant to offer legal, financial or tax advice. You may want to consult independent advisors for those specific questions. This guide does not endorse any company, agent or policy type.

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What is Life Insurance?

Insurance, by its nature, is a way of pooling risks. Everyone in the pool pays insurance premiums while hoping he will not need to collect. The company bears the risk, hoping that the amount of the premiums paid will cover any losses incurred by the group.

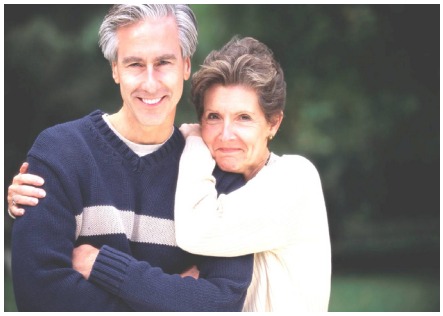
In the case of life insurance, your life is the risk. The insurance company offers a policy to an individual after carefully weighing the likelihood of when he will die while the contract is in force.

Lifespan is an important question to the company that insures you. For example, most life insurance companies assume that everyone will die by the age of 100. In addition, to maintain financial solvency, a company must consider how much premium it must collect before it pays out a death benefit. With that in mind, if you buy a life insurance policy when you are 25 years old, you will pay a lower premium for the same policy than a 65 year old because you will pay the premium for a longer period of time. The 65 year old will pay more because there are fewer years for the company to collect premium before the person reaches 100.

An insurance company agrees to pay your beneficiary a specific amount of money when you die. In most cases, that amount is determined when you apply for life insurance and is specified in the policy you buy. Anyone can be named beneficiary including relatives, friends, organizations, charities, business partners, etc. Generally, you will name a primary and secondary beneficiary. The secondary beneficiary will receive the death benefit only if the primary beneficiary is no longer living at the time of your death.

You pay for the policy by making premium payments. There are numerous payment plans available including monthly, quarterly, semi-annually or annually. You may also pay the entire premium in one lump sum – single premium. The amount of premium you pay depends on a number of factors such as age, gender, health, whether you are a smoker or a non-smoker, how much insurance you are purchasing, type of policy you are purchasing, and your lifestyle such as if you participate in risky activities like race car driving or hang gliding.

Why You May Need Life Insurance



Paying for funeral and burial expenses can be a heavy financial burden. If the person who dies is the primary wage earner for the household, it may be difficult for those left behind to pay the mortgage, utilities, car loans, food and any other expenses. It could be very difficult to maintain the family's same standard of living without that income. Life insurance can make sure your family is not burdened with the debt left behind and can ease the financial hardship associated with the death.

Purchasing life insurance should be considered when you are starting a family, getting married, planning for your children's education, or planning for retirement. These are just a few examples.

Families with young children may have a need for life insurance. If there is a loss of income in the family, the family's future plans may be compromised. A child who will be ready to go to college in a few years may not be able to go. There could be additional expenses, such as childcare, if the surviving spouse has to take on additional work to support the family. Without sufficient income available to the family, other things will have to be considered as well. If you died, would your family be able to afford the house in the community you live in now? Would your children be able to go to the same schools? A life insurance policy can do more than just replace lost income. It can also provide money for unexpected expenses that may arise in the future.

In order to get the best life insurance policy for your family, you need to know what is available to you. It is very important to do some research before you buy a life insurance policy. This does not have to be a long, drawn-out process. However, it is wise to research companies and products to find one that fits your personal situation.

Call local insurance agents and set up appointments to speak with them about the products they offer. They will often fill out a "worksheet" with you to determine how much and what types of insurance best suit your needs. Do your own research on the Internet. If you do not have a computer, go to your local library. Also, friends and family can be very helpful. Odds are, someone you work with, are associated with, or a family member has purchased life insurance.

Buying Life Insurance

When you buy life insurance, you want coverage that fits your needs. It makes good sense to ask a life insurance agent or company to help you. An agent can help you review your insurance needs and provide information about the available policies. If one kind of policy doesn't seem to fit your needs, ask about others. This guide provides only basic information. You can get more facts from a life insurance agent or company or from your public library. Do not purchase any life insurance product if you do not understand exactly what you are purchasing. Be aware that once you have purchased a life insurance policy, you have at least a 10-day period ("free look" period) to review the policy. If you find, for any reason, that you do not want the policy, it can be returned to the company for a full refund of premium during this free look period.

The most important thing you can do is educate yourself about your policy once it has been delivered. ALWAYS READ YOUR POLICY IMMEDIATELY UPON RECEIPT!

How Much Life Insurance Do You Need?

Here are some questions to ask yourself:

- How much of the family income do I provide? If I were to die prematurely, how would my survivors get by? Does anyone else depend on me financially (parent, grandparent, brother or sister)?
- Do I have children for whom I'd like to set aside money to finish their educations in the event of my death?
- How will my family pay final expenses and repay debts after my death?
- Do I have family members or organizations to which I would like to leave money?
- Will there be estate taxes to pay after my death?
- How will inflation affect future needs?

What is the Right Kind of Life Insurance for You?

Typically, life insurance fits into one of two classes - permanent insurance and term insurance. There are, however, many variations within each of these classes. Following are examples of each. This is by no means an exhaustive list, but will give you a good idea about each class.

What is Term Life Insurance?

Term life insurance provides life insurance for a limited period of time. As the name suggests, it is for a specific term, a number of years, or until the insured reaches a specified age. If the insured dies within that period, the beneficiary receives the death benefit. However, if the insured survives the specified term of the policy, the policy simply ends. Term life insurance typically has no cash value; this is the savings element that is present in some policies. Most term policies have a level death benefit for the term of the policy. Although the death benefit remains the same, the premiums normally increase each year. The reason for this is that the age of the person insured is also increasing; age is one of the factors that determine premium.

A couple of important features to consider when researching term insurance policies are renewability and convertibility. Almost all term policies contain the option of renewability. At the end of the term, the policy can be renewed for a limited number of additional years without a medical exam. The premium will normally increase with each renewal, which is expected, because of the insured's increasing age. Renewability may be a very important factor to an insured who has recently had a decline in health status.

If that person had to apply for new insurance after the term expired, he may find himself uninsurable and be without coverage he may need. Fortunately, he can turn to the renewability feature and will have extended coverage without a medical exam. Be aware, as the insured reaches advanced ages, the premiums can become very expensive.

Convertibility is another option on a term policy. It is the option to convert a term policy into a permanent policy without new evidence of insurability, which means no new medical exam. Convertibility is allowed on an "attained age" basis or an "original age" basis. Attained age allows you to purchase a new permanent policy at the premium rate for your current age. Original age allows you to go back to the premium rate you were charged at the age you first purchased the term policy. As you can imagine, the company will charge an additional fee for original age rates. Attained age is the most frequently used convertibility option.

Types of Term Life Insurance

Yearly renewable term – This type of term policy functions as the name suggests. It is issued for a year and the owner can renew annually for future one-year periods. With this type of policy, the insured is normally not required to take a medical exam for renewal. The insured must be allowed to renew, and the increase in premium is based on age and life expectancy.

Renewable terms for other durations – There can be term policies written for different durations, depending on what the company offers, such as 5-year term, 10-year term, etc. In each of these, the premium would remain the same for the duration of the term. The policy may be renewed at the end of the term, but the premium will change due to the age of the insured at time of renewal.

Term to sixty-five – Also acts as the name suggests. It provides coverage to a specified age. The premium stays level throughout the term; however, insurance expires when the term is over.

Decreasing face amount – The face amount, or benefit, decreases over the term of the policy, but the premium remains the same. This type of policy is most commonly used for loan or mortgage protection and can cover a variety of durations, usually 10-30 years. They are typically structured to provide enough benefit to pay off the loan if an insured dies.

Level term – Both the death benefit and the premium remain the same for the entire length of the contract.

Increasing term – Normally issued as a rider to another policy. The face amount, or benefit, increases over the term of the policy.

What is Permanent Life Insurance?

Unlike term life insurance, permanent life insurance remains in force for the full life of the insured as long as premium payments are made in accordance with the policy provisions. Typically, permanent life insurance has a cash value or account value.

Types of Permanent Life Insurance

Whole life insurance – This permanent type of life insurance is different from term insurance in that it provides coverage over the insured's lifetime, not just a portion of the insured's life. Whole life provides coverage to age 100. Since the companies charge premiums based on the assumption that everyone would be dead by age 100, the company pays the policy face amount to those who attain age 100.

In general, premiums can be paid until age 100, or for a portion of the insured's life. Single premium whole life policies are paid with one lump sum payment. Premiums stay level throughout the policy. Since premiums are based on age, the younger a person is when the policy is purchased, the lower the premium will be throughout the life of the policy. In addition to level premiums, the death benefit also remains the same.

It was mentioned earlier that premiums for whole life policies could be paid for a shorter period of time instead of being paid to age 100. This is referred to as limited payment whole life. This allows the premiums to be paid for a shorter time while the death benefit stays in force until age 100. Once the premiums are paid for the chosen period of time, the policy is paid up.

Other forms of limited pay policies are those in which the premiums are paid for a certain number of years or to a certain age. Companies will offer different options such as "Life to 65" or "20 Pay Life." The premiums would be calculated so that the insured would pay until he reaches the specified age or the specified number of years. Then the premiums would no longer be paid. If you choose to purchase one of these limited pay policies, your premiums will be higher than if you paid premiums until age 100. This is because the coverage is until age 100 but the premiums are being paid for fewer years.

A very important aspect of whole life policies is that they have a cash value. This means the policy also has a savings aspect for the insured. A portion of each premium payment goes into the cash value. The policy owner can access this money in a number of ways. Whole life policies have to contain a schedule that shows the owner the minimum value he can receive if he decides to surrender the policy. However, a surrender is not the only way to access the funds. Loans can be taken out up to the cash value; however, interest is charged for this loan, which can be repaid at any time. If the policy is surrendered, the loan is deducted from the cash value. If the insured dies, the loan is deducted from the face amount.

Cash value can also come in the form of dividends from the company. A policy can be "participating" or "non-participating." If the policy does pay a dividend, it is a participating policy. If no dividend is paid the policy is considered non-participating. Dividends may be taken as cash, used to purchase paid up insurance or can be applied to reduce a premium.

The following types of policies (variable life, universal life and variable universal life) are a bit more complicated and can be somewhat confusing. It is very important that you seek out an agent who has experience with these types of policies before you commit to a purchase.

Variable life insurance (variable whole life) – This is another type of permanent life insurance. However, the death benefits and cash account values are determined upon investment options. These investment options are usually in the form of mutual funds. Each company has different investment options and the policy owner is allowed to choose which types of funds to use. Most offer at least a stock fund, a bond fund, and a money market fund. Variable life insurance offers fixed premiums and a minimum death benefit. If the return on the investment options is high, then the account value of the policy will grow. Be aware that the account value can vary from year-to-year and even day-to-day based on the performance of the investments options. The performance of the investment options is not guaranteed. Remember, you as the policy owner are the person responsible for choosing the investment options - not the insurance company.

Flexible premium adjustable life insurance (universal life) – Universal life is a flexible premium life insurance policy that has an adjustable death benefit. This life insurance policy has an initial premium and flexible premiums afterwards. The policyholder can select the future amount and the frequency of his premium payments, within limits, and can also stop and start premium payments. It is very important to be aware of the account value in these types of policies to be sure there are always enough funds to keep the policy in force.

As premium payments are made, they accumulate within the policy at a fixed rate of interest and create an account value. This interest rate is determined by the company, changes periodically (usually each year) and cannot go below the guaranteed minimum interest rate stated in the policy. Each month, policy expenses are deducted from the account value. The difference between the premiums paid in plus the interest credited to these funds, less the policy expenses, equals the account value.

When a policy owner purchases a universal life policy he is given a choice of at least two death benefit options. These are usually referred to in the industry as Option A and Option B or Option 1 and Option 2. Remember, because this is a universal life policy, the policy owner is not locked into either option and the death benefit option can be changed at any time in accordance with the policy provisions. The death benefit can either be a specified amount or a specified amount including the cash value. It is very important that you understand each option before committing and make sure you have a knowledgeable agent to explain each option to you.

As long as the account values are sufficient, you may take out a loan for a certain percentage of your account value. You may also withdraw money permanently, or you may choose to surrender the policy for its surrender value. Be aware that if you surrender your policy in the early years, most companies impose a surrender charge. This charge is a percentage of the account value that the company will deduct from the amount you will receive. These charges vary by company. There is a schedule listed in the policy showing the surrender charge percentages. Normally they decrease over a number of years until they reach zero. Usually, if you surrender the policy in the first few years the account value could be completely eliminated.

Variable universal life – Not to over simplify, but there is one distinct difference between universal life (previously discussed) and variable universal life. The account value in a universal life policy grows at a fixed rate of return. The account value in a variable universal life policy increases (or decreases) at a variable rate. The rate of growth, or lack of as the case may be, is determined by the performance of your investment options. As discussed previously in the variable life insurance section, each company has different investment options from which to choose.

Survivorship life – This is another way to structure a life insurance policy. Policies structured this way are also referred to as Second-to-Die or Last-to-Die policies. Survivorship life insures two or more individuals and pays a death benefit upon the second death or the last death as there may be more than two lives insured. One of the reasons for purchasing survivorship life insurance would be to pay possible estate taxes.

Illustrations

You may be thinking of buying a policy where cash values, death benefits, dividends or premiums may vary based on events or situations the company does not guarantee (such as interest rates). If so, you may get an illustration from the agent or company that will project how the policy may perform. The illustration will show how the values that are not guaranteed will change as interest rates and other factors change. The illustration will also show you the values the company guarantees. Remember that nobody knows what will happen in the future. You should be ready to adjust your financial plans if the policy's value doesn't increase as quickly as shown in the illustration. You may be asked to sign a statement that says you understand that some of the values in the illustration are not guaranteed. If you already own a policy, ask for an "in-force" illustration periodically to see how your policy has actually performed. This is especially important if you own a universal life, variable universal life or variable life policy.

What is an Annuity?

An annuity is an insurance contract where an insurance company promises to make payments to an annuitant over a specified period of time or for life. One of the purposes for an annuity is to make sure a person does not outlive his income. An annuity is a type of insurance to protect against the risk of financial hardship during retirement.

There are three participants in an annuity contract: the owner, the annuitant and the beneficiary. Most of the time, the annuitant and the owner are the same person, but it is not required. The owner is the purchaser of the annuity, pays the premiums and has the right to surrender the annuity. The owner is also responsible for any taxes due upon surrender or payout and is usually the person who names the beneficiary of the contract. The annuitant is the person whose age and life expectancy is going to be used to calculate the benefits of the annuity and who will receive the annuity payments. The beneficiary receives the death benefit upon death of the annuitant or the owner.

Various Types of Annuities

Fixed annuity – This type of annuity accumulates interest on the funds deposited into the annuity on a fixed rate basis. Every fixed annuity has a current interest rate and a minimum guaranteed interest rate. The current interest rate will always be equal to or higher than the minimum guaranteed interest rate. Although this varies from company to company and contract to contract, the current interest rate is declared on an annual basis, usually after an initial guarantee period. With a fixed annuity, the insurance company assumes the risk of paying at least the minimum guaranteed interest rate.

Variable annuity – Different than a fixed annuity, a variable annuity pays varying rates of interest on the funds placed inside the annuity based upon the investment options chosen by the annuity owner. If the investment choices do well, the annuity will do well. If the investment choices do poorly, the annuity will not grow as well or could even lose value. Because the growth of a variable annuity is not guaranteed by the insurance company, the contract holder assumes the risk.

Immediate annuity – This type of annuity begins paying a benefit very soon, usually within 30 days to one year after it is purchased, and usually requires a lump sum payment.

Indexed annuity – This is a fairly new product in the annuity market. Indexed annuities pay an interest rate that is tied to the performance of a common or well-known index such as the S&P 500, the Russell 1000 or the S&P 100. The growth of an indexed annuity is based upon the participation rate of the index it is tied to. For example, if an indexed annuity has a defined participation rate of 70 percent and the index it follows goes up by 10 percent, the annuity's accumulation value will increase by 7 percent (10 percent increase times the 70 percent participation rate). On the downside, most index annuities specify a "floor" that the annuity growth rate cannot go below or offer a minimum interest rate. Typically this minimum rate is 1 percent to 3 percent.

Things Common to all Annuities

There are two distinct phases to an annuity - the accumulation phase and the payout phase. The accumulation phase is the first phase where all the premiums are paid into the annuity and the money grows tax-deferred. The second phase is the payout phase, which is when the annuity actually starts to pay the benefits to the annuitant. There are several payout options; a few of these options will be discussed in the following section. Make sure your agent goes over each option with you thoroughly so that you choose the one most appropriate for your needs. It is very important to understand that once a payout option is chosen and you start receiving payments that option cannot be changed.

Examples of Payout Options (Settlement Options)

Life income (no refund) – Pays an income as long as the annuitant is alive. Payments stop when the annuitant dies.

Life income with period certain (10, 15 or 20 years) – Pays an income as long as the annuitant is alive. If the annuitant dies before the period certain has expired, payments are made to the beneficiary for the balance of the period.

Life income with installments (refund) – This option provides a monthly annuity payment during the lifetime of the annuitant with a guarantee that payments will be made for a certain number of months (not necessarily for the annuitants full lifetime). The number of months is determined by dividing the accumulated amount of the annuity by the amount of the first monthly annuity payment. Only the number of months is guaranteed so there is no guarantee of a full refund.

The following payout options assume there are two individuals that will be receiving benefits from the annuity.

Joint and full to survivor (no refund) – This option pays an income as long as one or more annuitant is living. Payments stop when both annuitants are deceased.

Joint and 2/3 to survivor (no refund) – This option pays an income while both annuitants are alive. When one dies, 2/3 income payments continue during the survivor's lifetime. Payments stop when the second annuitant dies.

Joint and full to survivor with period certain (10, 15 or 20 years) – Pays an income while at least one annuitant is alive. If both annuitants die before the specified period expires, payments of the balance of the period certain continue to the beneficiary.

Joint and full to survivor with installments (refund) – This option pays a monthly payment during the lifetime of the annuitant with a guarantee that payments will be made for a certain number of months. The number of months is determined by dividing the accumulated amount of the annuity by the amount of the first monthly annuity payment. Only the number of months is guaranteed so there is no guarantee of a full refund.

Joint and 2/3 to survivor with period certain (10, 15 or 20 years) – Pays an income while both annuitants are living. When one dies, 2/3 of the income payment continues during the survivor's lifetime. If the second annuitant dies before the period certain expires, the 2/3 payment amount continues to the beneficiary for the balance of the period.

Will You be Penalized if You Withdraw Money From Your Annuity?

In most cases "Yes." However, some annuities have a provision that permits you to withdraw a certain amount each year, usually 10 percent of the annuity value, without having to pay a surrender charge. Please remember, even though you may not have to pay a surrender charge there may still be taxes that have to be paid on some or all of the money you withdraw. It is recommended that you consult a tax advisor or your annuity company regarding the tax consequences before you make the withdrawal.

Important Things to Consider

1. Review your own insurance needs and circumstances. Choose the kind of policy that has benefits that most closely fit your needs. Ask an agent or company to help you.
2. Be sure that you can handle the premium payments. Ask about any possible increases in premium amounts and what may cause an increase.
3. Don't sign an insurance application until you review it carefully to be sure all the answers are complete and accurate.
4. Don't drop one policy and buy another without a thorough study of the new policy and the one you have now. Replacing your insurance may be costly.
5. **Read your policy carefully**. Ask your agent or company about anything that is not clear to you.
6. Periodically review your life insurance program with your agent or company to keep up with changes in your income and your needs.
7. **Do not buy a policy until you have a good understanding of how it works.**

Are You Considering Dropping or Replacing an Existing Life Insurance Policy or Annuity Contract?

If you are thinking about dropping or replacing a life insurance policy or annuity contract, here are some things you should consider:

- If you decide to replace your policy or contract, do not cancel your old policy or contract until you have received the new one. You will usually have a minimum of 10 days to review your new policy or contract to decide if it is what you want.

- It may be costly to replace a policy or contract. There may be substantial surrender charges that you will incur. Remember that if you have held your existing policy or contract long enough and no longer have to pay a surrender charge, purchasing a new contract or policy will start a new period of surrender charges.

- Consider consulting a tax advisor to see if dropping your policy or contract could affect your income taxes.

- If you are older, or your health has changed, premiums for the new life insurance policy will most likely be higher. You will not be able to buy a new policy if you are no longer insurable.

- You may have valuable rights and benefits in the policy or contract you now have that are not in the new one.

- If the life insurance policy you have now no longer meets your needs, you may not have to replace it. You might be able to adjust your existing policy or purchase additional insurance to get the coverage or benefits you now want or need.

- Be aware that the new policy you are considering may only pay a reduced benefit in the early years for some causes of death already covered in the policy you have now.

In all cases, if you are thinking of buying a new policy or contract to replace your existing one, check with the agent or company that issued your existing policy or contract. Before replacing, ask your agent or company for an updated illustration (in-force illustration). Check to see how the policy or contract has performed and what you should expect in the future based on the guarantees.

How Can You Find Missing Policies or Contracts?

- If the deceased's estate went through probate, there is a chance that the policy might have been listed as an asset.

- Begin by contacting insurance companies. Try to narrow your search as much as possible. For example, start with those companies most prominent where the deceased lived or worked. Contact the benefits coordinator at the deceased's place of employment. Remember, unless you are the beneficiary, the company is not required to offer any information. Try to provide as much information as possible, including the deceased's name and any aliases, social security number, date of birth, etc.

- Ask the estate's executor to request copies of all bank statements and other records. If a check has been written or an automatic payment has been made to an insurance company, this might provide a lead.

- Contact the deceased's insurance agent for homeowner's, renters, or auto insurance. Although he may not have sold your friend or relative a life insurance policy or annuity contract, many agents keep records of their client's insurance purchases.

Final Points to Consider

Remember to read your life insurance policy or annuity contract carefully when you receive it. Ask your agent or insurance company to explain anything you don't understand. If you have a specific complaint or can't get the answers you need from the agent or company, contact your state insurance department.

Insurer Rating Organizations

Other sources of information related to the financial strengths of companies are insurance rating organizations. Some of these are A.M. Best, Fitch Ratings, Moody's Investors Service, Standard and Poor's, and Weiss Ratings, Inc. You can use these sources to help you research and determine which companies you would like to contact about your insurance needs. The Kentucky Office of Insurance can provide you with ratings from A.M. Best or you can contact the companies directly to get information about their ratings.

A.M. Best
www.ambest.com
Telephone: 908-439-2200

Fitch Ratings
www.fitchratings.com
Telephone: 800-893-4824

Moody's Investors Service
www.moodys.com
Telephone: 212-553-0377

Standard and Poor's
http://www2.standardandpoors.com
Telephone: 212-208-1199

Weiss Ratings, Inc.
www.weissratings.com
Telephone: 800-289-9222

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