CHAPTER TWO

THE LIFE AND HEALTH INSURANCE INDUSTRY

CHAPTER OUTLINE

Insurance Companies as Business Organizations
Types of Insurance Company Organizations
Organizational Operations

Insurance Companies as Financial Institutions

Overview of Life and Health Insurance Products
Group and Individual Insurance
Life Insurance
Annuities and Investment Products
Health Insurance

Other Providers of Life and Health Insurance
Fraternal Benefit Societies
Banks
Governments
Medical Care Plans

LEARNING OBJECTIVES

After reading and studying this chapter, you should be able to:

- Distinguish between the three types of business organizations and explain why insurance companies must be organized as corporations.
- Distinguish between stock insurers and mutual insurers.
- Describe the financial services industry and how insurance companies function in that industry.
- Identify the major providers of life and health insurance.

In this chapter, we look at insurance companies as business organizations—how they are organized, how they fit within the larger context of the economy, and the types of products that life and health insurance companies sell. We also describe some other life and health insurance providers that operate in the United States and Canada.

Insurance Companies as Business Organizations

A *business* can be defined as an organization established for the purpose of producing goods or services that consumers want or need and then selling those goods or services, typically for a profit. *Profit* is the money, or revenue, that a business receives for its products or services minus the costs it incurred to produce the goods or deliver the services. It is important to remember that, as a business, an insurance company typically has a responsibility to its owners to operate profitably.

Each business organization is structured in one of three ways: (1) as a sole proprietorship, (2) as a partnership, or (3) as a corporation. A **sole proprietorship** is owned and operated by one individual. The owner reaps all profits and is responsible for all the debts of the business. If the business fails, the owner's personal property may be used to satisfy the debts of the business. If the owner becomes disabled or dies, the business usually closes its doors.

sole proprietorship A business that is owned and operated by one individual.

A **partnership** is a business that is owned by two or more people, who are known as the *partners*. The partners reap the profits and are personally responsible for the debts of the business. If one of the partners dies or withdraws from the business, the partnership generally dissolves; although the remaining partners may form a new partnership.

partnership A business that is owned by two or more people who are known as the partners.

For our discussion, we're primarily concerned with the corporate form of business. A **corporation** is a legal entity created by the authority of a government. A corporation has two major characteristics that set it apart from a sole proprietorship and a partnership. First, a corporation is a legal entity that is separate from its owners. As a result, a corporation can sue or be sued, can enter into contracts, and can own property. The corporation's debts and liabilities belong to the corporation itself, not to its owners,

corporation A legal entity, separate from its owners, that is created by the authority of a government and continues beyond the death of any or all of its owners.

who are not *personally* responsible for the corporation's debts. The second difference is that the corporation continues beyond the death of any or all of its owners. This second characteristic of the corporation provides an element of stability and permanence that a sole proprietorship and partnership cannot guarantee. It is this stability that makes the corporation the ideal form of business organization for an insurance company. Because insurance companies must be permanent and stable organizations, laws in the United States and Canada require insurance companies to operate as corporations.

Types of Insurance Company Organizations

Even though they must be corporations, life and health insurance companies have some flexibility in how they are organized to do business. Most insurance companies are organized as either stock companies or mutual companies.

Stock insurance companies

stock insurance company *An insurance company that is owned by people who purchase stock in the corporation.*

The majority of life and health insurance companies are established and organized as stock companies. A **stock insurance company** is formed as a corporation, and the *capital*—the funds—the corporation needs to begin operations come from investors who purchase *stock*—ownership shares—in the corporation. A stock company, then, is owned by the individuals who hold shares of stock in the company, known as the *stockholders*. From time to time, a portion of the company's operating profits may be distributed to these stockholders in the form of *stockholder dividends*.

Mutual insurance companies

mutual insurance company *An insurance company that is owned by its policyowners.*

Life and health insurance companies can also be organized as mutual companies. A **mutual insurance company** is an insurance company that is owned by its policyowners, and a portion of the company's operating profits are from time to time distributed to these policyowners. When operating profits are distributed to the owners of a mutual company, they are distributed in the form of *policy dividends*. We describe policy dividends in more detail later in the text.

Before a mutual company can be formed, a certain number of policies must be sold in advance to provide the funds the company needs to begin operations. Because most people are reluctant to purchase a product from a company that does not yet exist, most mutual companies begin as stock companies and later convert to mutual companies. This process of converting from a stock company to a mutual company is called *mutualization*. One advantage that a stock company gains from the process of mutualization is that it cannot be bought by another company since a mutual company has no stock to sell.

In the past 25 years in the United States, at least 16 mutual companies have *demutualized*—reorganized as stock companies. The primary reason a mutual insurer might wish to demutualize is that, as a stock company, it can more easily raise operating funds because it can sell shares of stock. Stock insurers also have greater flexibility than mutual insurers in buying and operating other types of companies. In today's highly competitive financial services marketplace, some mutual insurers are reorganizing as stock companies in order to enhance their ability to raise capital *and* to enable them to purchase other organizations.

Even though stock insurers greatly outnumber mutual insurers, mutual insurers provide a significant amount of the life insurance in force in the United States and Canada. (See Figure 2-1, which depicts the concentrations of stock, mutual, and fraternal companies in the insurance industry. We describe fraternal companies later in the chapter.) Mutual insurers account for a significant amount of life insurance in force because they are generally older and larger than stock insurers.

CHECK POINT 2A ✔

1. Which form of business organization do U.S. and Canadian laws require for insurance companies? Why?
2. Describe how ownership of a stock insurance company differs from the ownership of a mutual insurance company.
3. Are most insurance companies in the United States and Canada organized as stock companies or as mutual companies? Why is this form more advantageous to the insurance company?

You will find the answers to the Check Point questions in the Prep Pak for this course.

Organizational Operations

As a final topic in our look at insurance companies as business organizations, we'll define some terms that are commonly used to refer to the physical or geographic aspects of an insurer's operating structure. The headquarters of any insurance company is generally referred to as the company's **home office** or *head office* and is often located in the state or province in which the company was incorporated to do business. It is also usually the location of all the company's executive offices.

home office The headquarters of an insurance company, where all the company's executive offices are usually located.

Because insurance companies vary significantly in size, the geographic arrangement of their office locations also varies. For example, very large insurance companies may have regional offices in addition to the home office. A **regional office** is generally charged with many of the same functions and operations as the home office but is geographically closer to the market it serves and generally reports to the home office.

regional office An insurance company office that provides many of the same functions and operations as the home office but is geographically nearer to the market it serves and generally reports to the home office.

field office An insurance company's local sales office.

Within each geographic region, a company may have field offices. A **field office** is an insurance company's local sales office out of which its field force or sales agents work. The home office and regional office typically provide support services to the field office. Some field offices are classified as *branch offices* while others are classified as *agency offices*, depending on how they are organized and what the working relationship is with the home office.

These structural aspects of insurance organizations vary widely from one company to another, depending on the size of the company's operations and the geographic markets it serves.

Insurance Companies as Financial Institutions

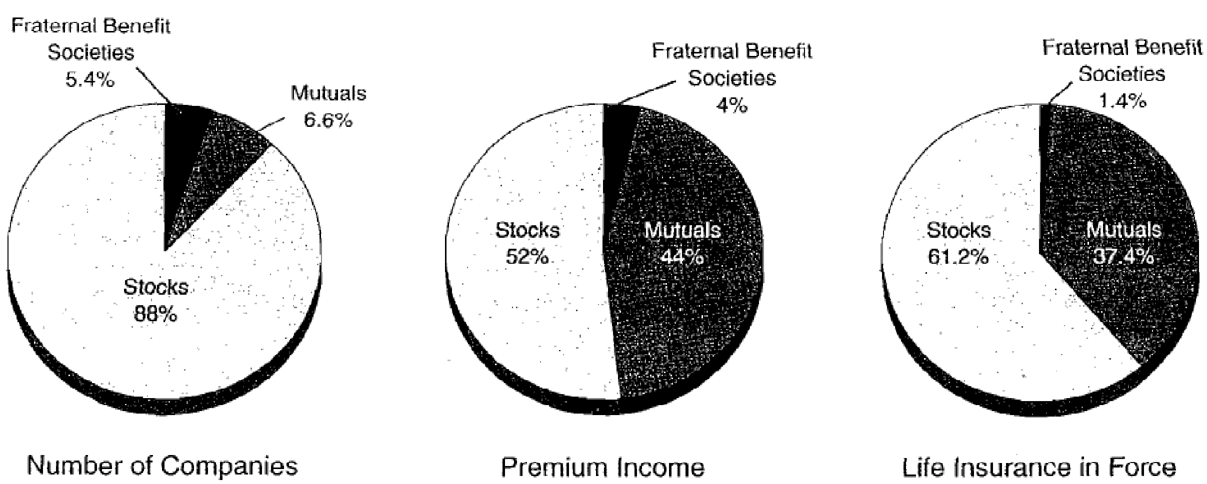
financial institution An organization that channels funds through the economy by accepting the surplus money of savers and supplying that money to borrowers, who pay to use the money.

financial services industry The financial institutions that help consumers and business organizations save, borrow, invest, and otherwise manage money.

Insurance companies are financial institutions that function in the economy as part of the financial services industry. A **financial institution** is an organization that helps to channel funds through an economy by accepting the surplus money of savers and supplying that money to borrowers who pay to use the money. The **financial services industry** is made up of financial institutions that help consumers and business organizations save, borrow, invest, and otherwise manage money.

Insurance companies are among the most important financial institutions in North America. They make a significant contribution to the economic growth of the United States and Canada, both as investors in their economies and as employers. Life and health insurance companies invest their assets in other businesses and industries, as well as in

Figure 2-1 Concentrations of stock companies, mutual companies, and fraternal benefit societies in the United States and Canada in 1994



Sources: American Council of Life Insurance; Canadian Life and Health Insurance Association, Inc.; Fraternal Congress of America.

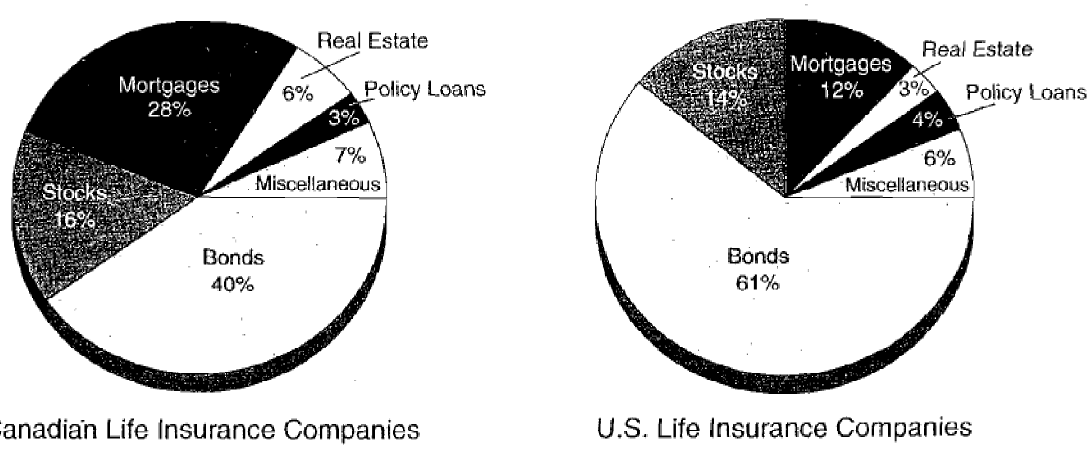
mortgage loans. These investments help provide the funds that other businesses need to operate and grow and that individuals need to purchase homes. (See Figure 2-2, which illustrates how insurance companies invest their assets.) The life and health insurance industry is also a major employer in the United States and Canada, employing several million people.

In addition to providing funds for economic growth, insurance companies also invest in social programs that help improve the quality of life for all people. For example, life and health insurance companies invest money to further AIDS research and education and to provide support to charitable organizations, such as the United Way. For some real-life examples of the insurance industry at work to improve the quality of life, see Insight 2-1.

The financial services industry has undergone profound changes in the past few decades. Historically, financial services were provided by various types of financial institutions, and the activities of each type of financial institution were distinct. In fact, legal restrictions separated the activities of financial institutions. Banks, as well as U.S. savings and loan institutions and Canadian trust companies, accepted customer deposits and made consumer loans. Investment products were offered by investment companies. Insurance companies provided insurance products.

Today, however, the distinctions between these financial institutions have blurred. In both Canada and the United States, laws have been changed so that each type of financial institution can now offer a wider variety of products. Banks now may offer investment products and insurance

Figure 2-2 Distribution of investments by Canadian and U.S. insurance companies in 1993



Source: ACLI 1994 Life Insurance Fact Book, *p. 126.*

products, in addition to the usual checking and savings accounts. Insurance companies have begun to offer a wider variety of insurance, as well as noninsurance products, such as savings plans, mortgage loans, and mutual funds. In short, financial institutions are competing with one another to provide a wide range of financial services to today's sophisticated consumers.

Insight 2-1 Insurance Companies and Improved Quality of Life

Many insurance companies contribute corporate funds and encourage employee volunteerism to benefit society or to assist those in need. The following examples illustrate some of the many ways insurance companies have used their resources to improve the quality of life within their own communities and beyond.

- London Life in Canada makes an annual $300,000 medical research grant ($100,000 a year for three years); the recipient is chosen by a company committee from among submitted proposals. The 1994 award was granted to the University of Ottawa's Neuroscience Research Institute for research into the effects of stroke on the human brain.[1]
- The Prudential Foundation awarded a $1,200,000 grant to the Children's Television Workshop and the National Safety Environmental Health Center to develop and implement the Lead Poisoning Awareness and Prevention Project. The nationwide campaign uses Sesame Street characters to educate children ages three to six, along with the families and caregivers of children from birth to age six.[2]
- In 1995, AFLAC donated $3,000,000 to the cancer unit of Egleston Children's Hospital in Atlanta, marking the beginning of a planned long-term commitment to the hospital.[3]
- INSURE is a national charitable foundation funded by member companies of the American Council of Life Insurance (ACLI) and the Health Insurance Association of America (HIAA). By the end of 1993, through INSURE and the Insurance Industry AIDS Initiative (an industrywide program), insurers had given approximately $36,000,000 to support AIDS education and service programs. As part of two three-year initiatives, begun in 1989, INSURE gave $3,500,000 in grants to community-based AIDS education and service programs for the purpose of assisting people with AIDS and those at high risk of becoming infected with HIV.[4]
- Many insurance companies got involved in volunteer efforts to help victims of the Midwest Flood of 1993, ranging from employee donations of food, water, and clothing to countless people-hours spent sandbagging and cleaning up. Some companies also committed corporate funds to match the fundraising efforts of their employees. For example, Lincoln National Corporation matched $50,000 of the $52,948 raised by company employees and retirees, bringing the total contribution for flood relief to $102,948. Lutheran Brotherhood made a matching corporate contribution of $100,000 in response to the $2,700,000 raised by company employees to be distributed to flood relief organizations in nine states.

Numerous other insurance companies (Business Men's Assurance Company of America, The Reliable Life, Preferred Risk Group, and The New England, to name just a few) gave corporate gifts to the American Red Cross and other relief agencies. Many companies also offered policyowners in flood-affected areas extended deadlines for premium payment. Some insurers gave their employees extra vacation time to enable them to assist in relief efforts.[5]

- Other insurance companies actively involve their employees in volunteer work on an ongoing basis. Pacific Mutual's "Good Guys" participate in environmental programs, fundraising activities for health and local interest issues, and other community interest projects.[6] Each year Pacific Mutual selects several employees active in volunteer work and donates $1,000 to one or two charities in the employee's name. Equitable encourages its agents to become involved with local chambers of commerce, sponsoring community education programs and volunteer events. Northwestern Mutual Life has established a national Agent Community Service Award, which channeled $100,000 to nonprofit organizations around the country in 1995.[7]

Overview of Life and Health Insurance Products

Life and health insurance companies market a variety of insurance and investment-type products. Throughout this text, we'll describe many of these products in detail. In this section, we give you a brief overview of life and health insurance products so that you can begin to understand how those products differ.

Group and Individual Insurance

Life and health insurance companies market insurance products to both individuals and groups. An **individual insurance policy** is an insurance policy that is issued to insure the life or health of a named person. Some individual policies also insure the person's immediate family or a second named person. We'll describe how both individuals and businesses can benefit from the purchase of individual life and health insurance.

individual insurance policy An insurance policy that is issued to insure the life or health of a named person or persons.

A **group insurance policy** is a policy issued by an insurance company to an organization that is purchasing insurance coverage for a specific group of people. For example, a group insurance policy is usually purchased by an employer to provide life or health insurance coverage to its employees and, sometimes, to the dependents of covered employees. Life and health insurance companies provide group insurance to various types of groups in addition to employer-employee groups. We describe later in this text the types of group insurance products that life and health companies market.

group insurance policy An insurance policy that is issued to an organization that is purchasing insurance coverage for a specific group of people.

Life Insurance

A **life insurance policy** is a policy under which the insurance company promises to pay a benefit upon the death of the person who is insured. The benefit is usually paid to an individual, known as the *beneficiary*. Life insurance is provided on both an individual and a group basis and is available under a variety of types of policies. We describe the following three major types of life insurance policies.

life insurance policy A policy under which the insurance company promises to pay a benefit upon the death of the person who is insured.

- **Term life insurance** provides a death benefit if the insured dies during a specified period. We describe term life insurance in Chapter 7.
- **Permanent life insurance** provides life insurance coverage throughout the insured's lifetime and also provides a savings element. As premiums are paid for these policies, an accumulated savings amount—known as the policy's *cash value*—gradually builds. A policy's cash value is a valuable asset that the policyowner can use in a number of ways. We describe permanent life insurance, including its savings element, in more detail in Chapters 8 and 11.

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- **Endowment insurance** provides a policy benefit that is paid either when the insured dies or on a stated date if the insured lives until then. Endowment insurance has some characteristics of both term life insurance and permanent life insurance. Like term insurance, endowment insurance provides life insurance coverage for only a stated period of time. And like permanent life insurance, endowment insurance provides a savings element. We describe endowment insurance in Chapter 8.

In each case, the policy benefit is paid only if the policy is in force when a covered loss occurs. In addition, each of these three types of life insurance is available in various plans. In other words, each basic insurance product is available in a variety of forms.

Annuities and Investment Products

annuity (1) A series of periodic payments. (2) A policy under which an insurance company promises to make a series of periodic payments to a named individual in exchange for a premium or a series of premiums.

In addition to providing life insurance coverages, life insurance companies market various products that are designed to provide consumers with a way to invest their money and to provide themselves with periodic income benefits, especially retirement income benefits. An **annuity** is a series of periodic payments. For example, when the insured of a life insurance policy dies, a relatively large sum of money is often payable. Life insurance policy beneficiaries can receive the policy proceeds in the form of an annuity, payable over a period of time, rather than in a lump sum. An **annuity** can also be a policy under which an insurance company promises to make a series of periodic payments to a named individual in exchange for a premium or a series of premiums.

In addition to annuities, many insurance companies market various investment products to individuals and to groups. In Chapter 10, we describe individual annuities and investment products. We describe group retirement and pension plans in Chapter 17.

Health Insurance

Health insurance provides protection against the risk of financial loss resulting from the insured person's sickness, accidental injury, or disability. The two major forms of health insurance coverage are (1) **medical expense coverage**, which provides benefits to pay for the treatment of an insured's illnesses and injuries, and (2) **disability income coverage**, which provides income replacement benefits to an insured who is unable to work because of sickness or injury. Health insurance coverage is available to both individuals and groups and is provided by a variety of organizations and governmental programs in addition to being provided by commercial life and health insurance companies. We'll describe individual and group health insurance in Section 3 of this text.

health insurance A type of insurance that provides protection against the risk of financial loss resulting from the insured person's sickness, accidental injury, or disability.

medical expense coverage A type of health insurance that provides benefits to pay for the treatment of an insured's illnesses and injuries.

disability income coverage A type of health insurance that provides income replacement benefits to an insured who is unable to work because of sickness or injury.

CHECK POINT 2B ✔

1. Which life insurance product provides both life insurance coverage throughout the insured's lifetime and a savings element?
2. Which life insurance product provides a death benefit only if the insured dies during a specified period?
3. Which life insurance product provides a policy benefit either when the insured dies or on a stated date if the insured survives to that date?
4. What insurance product provides a series of benefit payments?

Other Providers of Life and Health Insurance

Most of our discussions in this text will relate to commercial life and health insurance companies. By that we mean corporations that are organized as stock or mutual insurance companies to provide life and/or health insurance coverages. But, in addition to insurance companies, an array of other organizations—public and private—provide life and health insurance.

Fraternal Benefit Societies

A **fraternal benefit society** is an organization formed to provide social, as well as insurance, benefits to its members. The members of such societies often share a common ethnic, religious, or vocational background, although

fraternal benefit society An organization formed to provide social, as well as insurance, benefits to its members.

membership in some societies is open to the general public. One of the legal requirements of being a fraternal benefit society is that the fraternal must have a representative form of government—the members must elect the officers of the fraternal society. Additionally, fraternals must operate through a lodge system whereby only lodge members and their families are permitted to own the fraternal society's insurance. In fact, applicants for insurance often become members of the society automatically once the society issues them a policy. Today, fraternal insurers in the United States and Canada hold more than $200 billion of in-force life insurance. (See Figure 2-1 for a graphic depiction of how fraternal benefit societies compare to stock and mutual insurers.)

Banks

FAST FACT By the end of 1993, the assets, or financial resources, of Canadian and U.S. life insurance companies totaled over $2 trillion.[8]

Most people in the United States do not think of banks as being providers of insurance. In certain instances, however, banks in the United States can offer insurance products. For example, U.S. banks have traditionally marketed mortgage or loan protection insurance to their loan customers. In addition, federal laws allow national banks to sell life insurance if they are located in a town of fewer than 5,000 people. Finally, in the states of Connecticut, Massachusetts, and New York, savings banks are permitted to sell what is known as *savings bank life insurance (SBLI)* and annuities to individuals and groups. These insurance products are generally sold over the counter by bank employees. The maximum amount of SBLI that may be purchased by one person is defined by the laws of each state, and only persons who live or work in one of these states are eligible to purchase SBLI.

Governments

Federal, state, and provincial programs provide various health insurance and retirement income coverages to residents of the United States and Canada. We describe these government-sponsored programs in more detail later in the text. For now, you should know that in Canada most medical expense insurance is provided by government-sponsored programs, although many individuals are also covered under private plans that supplement the government programs. In the United States, although most health insurance coverage is provided by private health insurance plans, governmental programs provide health insurance coverages to specified individuals.

Medical Care Plans

Various types of medical care plans provide health care benefits to individuals or groups either by (1) assuming coverage for insureds in exchange for a premium or (2) providing health care services on a prepaid basis. For example, *Blue Cross and Blue Shield plans* provide various medical expense coverages in exchange for the payment of premiums. A *health maintenance organization (HMO)* is an example of a health care organization that provides medical care services to their members. Later in the text, we describe the benefits provided by these and other health care organizations. Finally, a substantial number of employers in the United States and Canada serve as health insurance providers through their use of self-insured employee benefit plans.

CHECK POINT 2C

1. What individuals are allowed to own a fraternal benefit society's insurance?
2. Although most life insurance is provided by commercial life insurance companies, what other type of financial institution is allowed to sell some forms of life insurance in the United States?
3. What is the source of most health insurance coverage in Canada? In the United States?

Key Terms

sole proprietorship
partnership
corporation
stock insurance company
mutual insurance company
home office
regional office
field office
financial institution
financial services industry
individual insurance policy
group insurance policy
life insurance policy
term life insurance
permanent life insurance
endowment insurance
annuity
health insurance
medical expense coverage
disability income coverage
fraternal benefit society

Other Important Terms

business
profit
partners
capital
stock
stockholders
stockholder dividends
policy dividends
mutualization
demutualization
head office
branch office
agency office
beneficiary

cash value
savings bank life insurance (SBLI)
Blue Cross and Blue Shield plans
health maintenance organization (HMO)

Endnotes

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3. "AFLAC Gift," *The Atlanta Constitution* (June 21, 1995), p. E1.
4. "Industry News: INSURE Funds AIDS Fight," *Resource* (March 1992), p. 65. ACLI *1994 Life Insurance Fact Book*, p. 115.
5. "Report: Insurers and the Flood of '93," *Resource* (January 1994), pp. 14–37.
6. "Good Guys Make Big Plans," *Wavelength* (Pacific Mutual's employee newsletter) (June 1994).
7. "Insurer Positions Agents Through 'Civic Marketing,'" *National Underwriter* (February 6, 1995), pp. 7, 20–21.
8. ACLI *1994 Life Insurance Fact Book,* pp. 83, 126.