Life Insurance in a Nutshell

Life insurance protection is one of the important parts of a family's financial plan. Life insurance is an investment that in some cases never pays out. However, the financial protection provided for families in case of the loss of the family breadwinner may save the survivors from financial ruin.

Life insurance is best when purchased at a young age. Insurance companies evaluate factors such as a person's health, age and occupation when calculating premiums. The younger and healthier a consumer is, the less money he will pay for life insurance.

What is Life Insurance?

Life insurance is a contract between an insurance company and an individual. The individual agrees to pay a certain amount of money as premiums to the insurance company, and the insurance company agrees to pay a specified amount of money to a person's beneficiaries upon his death.

A life insurance policy transaction involves the insurer, the policyholder, the insured party and a beneficiary. One life insurance policy might provide coverage for more than one person, and may have more than one beneficiary. Technically, the policyholder, the insured person and the beneficiary can all be the same person.

If an insured person meets an untimely demise, the insurance company agrees to pay the death benefit of the policy to the beneficiary. The life insurance policy must be kept paid up. If the owner allows it to lapse, the policy will not pay anything upon the person's death.

Why Do I Need It?

The main reason people purchase life insurance is to protect the finances of their family or friends in case of the breadwinner's death. Life insurance is also a key component of financial planning in many ways.

A life insurance policy offers both estate and mortgage protection, and a whole life policy can be used to help fund retirement. Life insurance protects businesses in case of the loss of a key employee, and is offered to many workers as an employment benefit.

Life insurance comes in two main types, term life insurance and permanent life insurance.

Term Life Insurance

Term life insurance requires the buyer to pay fixed premiums each month and provides insurance coverage for a set amount of time, such as five or 10 years. The policy pays a death benefit if the insured person dies before the policy term ends. Within the term insurance group, a few different variations exist.

Some policies offer renewals, some offer a conversion to permanent life insurance and some policies have a one-year term with an annual renewal option. A return-of-premium term life policy pays all of the premiums back to the insured once the policy expires, although this type of term insurance is up to three times as expensive as regular term insurance.

Term Life Pros and Cons

Term life insurance works well for families that want protection while they are in the midst of paying financial obligations such as a mortgage or college education. Term insurance will also cover child care, funeral costs and replace the income of the deceased policyholder.

Business owners might choose term life insurance to support financial planning goals of the company, such as protection against the loss of a critical employee or to fund a buy-sell agreement. Additionally, term life insurance is very inexpensive compared to permanent life insurance, and some financial advisors suggest purchasing term insurance and investing the additional money that would have been spent on permanent life insurance.

Term life insurance does have its downside. In most policies, if the policyholder remains alive when the policy expires, the money paid into the policy is lost. Additionally, when the term insurance policy expires, the individual may have a health condition or have reached age 65, in which case a new term life insurance policy will cost substantially more. Some term life policies, such as renewable term life insurance, have a premium escalation built in, making the policy more expensive over time.

Permanent Life Insurance

Permanent life insurance comes in a few variations including whole life insurance and universal life insurance. Within these classifications exist many policy options and features that create many different products for consumers to choose from.

Whole life insurance requires fixed premium payments, carries a cash value that can be liquidated, and pays out a guaranteed death benefit even if the policyholder outlives the insurance policy, although most whole life policies expire at or around 100 years of age.

Universal life insurance allows policyholders to pay any amount they want at intervals they choose, up to certain maximum payments. This type of policy must be paid indefinitely, and it builds cash value and can be liquidated.

Permanent Life Pros and Cons

Permanent life insurance tends to be quite a bit more expensive than term life insurance. One caveat is that an individual who shops for term life insurance when he is older and his health has started declining may pay the same or more for term insurance than he would have for a whole life policy bought when he was younger.

Permanent life insurance has a cash value that earns interest on a tax-deferred basis, and the cash value is available for a loan at any time after the first few years of the policy.

Permanent life insurance builds very little cash value in the first few years, partially because premiums pay for the agent's commission. Additionally, an interest rate floor is guaranteed for the policy's cash value growth, although it is usually set at a low rate, such as four percent. Permanent life insurance makes the most sense for families who prefer to keep the protection of their policy for the rest of their lives and can afford to buy it when they are young and healthy.

Buying the Right Amount of Life Insurance

How much life insurance does a family need? That question depends upon various factors that are unique to each situation. A common benchmark is to set the policy's death benefit equal to approximately six to eight times a person's annual salary. Some important considerations include any other income sources that may need to be replaced, the size of the insured's family, and whether a spouse works and what his or her earning capacity is currently and in future years.

Additionally, consider the number of dependents to provide for and for how many more years. Subtract income from social security death benefits the spouse would receive, and add in costs for special needs such as college education, mortgage payoff and estate planning needs.