What are the principal types of life insurance?

Life Insurance

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Life insurance can be an essential part of financial and legacy planning. When shopping around for coverage, you may come across various products that fall into two main categories: term life and permanent life (also commonly referred to as whole life). Understanding the essential differences between these two main types of insurance can help you make coverage decisions according to your needs and goals.

Remember that insurance products for groups, policies that cover a group of people under a single contract (e.g., coverage offered through an employer), can differ from policies sold to individuals. The following information below focuses on products as typically sold to individuals.

What is term life Insurance?

A term life policy is purchased to last for a specified period, such as 1, 5, 10, or sometimes as much as 30 years. Coverage expires when that period ends?hence the name?and therefore, a payout only happens if the insured's death occurs during the specified period. If the insured person outlives the original policy period, coverage renewal may be an option, but the premiums may be higher.

How term life coverage works

A term life policy may be the most simple, straightforward option for life insurance for many people. A death benefit can replace the income you would have earned during a set period, such as until a minor aged dependent grows up. Or, it can pay off a large debt, such as a mortgage, so that a surviving spouse or other heirs won't have to worry about making the payments.

When exploring life insurance options, you may encounter the word "cash value." Term life policies do not build cash value. Your premiums go towards your payout, making costs for policyholders comparatively lower than for permanent life insurance. However, some insurers have created term life products with a "return of premium" feature, returning a portion of the premiums you pay if a claim is not filed before the end of the coverage term. These policies can be more expensive upfront than standard term life insurance.

There are different types of term life, including level term and decreasing term.

- **Level term** life insurance offers a death benefit that stays the same throughout the policy.
- **Decreasing term** life insurance reduces potential death benefits over the policy's term, usually in one-year increments.

For more details on the different types of term life insurance, click here.

What is permanent or whole life insurance?

Permanent life, often called whole life insurance or cash value life insurance, provides coverage for the insured person's lifetime as long as premium payments are in good standing. Unlike term life, these policies may build cash value, which a policyholder or their heirs can access under certain conditions. Premiums, as a result, can be higher than for term life policies. Whole life products include several subcategories, including real traditional life, universal life, variable life, and variable-universal life.

How does "cash value" work?

When you pay premiums for permanent life insurance, they go toward the cost of insuring you, your policy fees, and building cash value. In the case of traditional whole life, both the death benefit and the premium are typically designed to stay at the same (level) throughout the policy period. However, the costs to insure you can climb high as you age, especially when you live past age 80.

Charging a premium that increases each year would make life insurance unaffordable for many people in their advanced ages. Instead, the insurance company charges throughout the coverage period a higher premium than needed to pay out claims in the policy's early years. The company invests this money and, as necessary, uses it to supplement the level premium to help defer the cost of insuring older policyholders.

By law, when these "overpayments" reach a certain amount, they must become available to the policyholder as a cash value, accumulating in a savings account. Under certain conditions, the policyholder can withdraw or take out a loan against the accumulated cash value. It's important to remember that cash value is usually restricted as a living benefit, remaining with the insurance company when the insured dies. Any loans against the cash value may reduce the death benefit.

Term life or permanent life: which is right for me?

All permanent or whole life policies typically offer the advantage of coverage during your entire life but can charge higher premiums than term life products. Therefore, your death benefit can be smaller than with term life for the same amount of money. People choosing whole life are likely to prioritize certain features that fit with their individual financial goals, such as the ability to plan for consistent benefits and premiums and the potential for tax-deferred savings growth via the cash value component of their policy.

Click here for more details on whole life/permanent life insurance.

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