Life Insurance Explained

A quick look at the different types of policies.

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When it comes to life insurance, there are many choices. Whole life. Variable universal life. Term. What do these descriptions really mean?

All life insurance policies have two things in common. They guarantee to pay a death benefit to a designated beneficiary after a policyholder dies (although, the guarantee may be waived if the death is a suicide occurring within two years of the policy purchase). All require recurring payments (premiums) to keep the policy in force. Beyond those basics, the differences begin.[1]

Some life insurance coverage is permanent, some not. Permanent life insurance is designed to cover you for your entire life (not just a portion or "term" of it), and it can become an important element in your retirement planning. Whole life insurance is its most common form.[2]

Whole life policies accumulate cash value. How does that happen? An insurer directs some of your premium payments into a reserve account and puts those dollars into investments (typically conservative ones). The return on the investments influences the growth of the cash value, which builds up according to a formula the insurer sets.[3]

A whole life policy's cash value grows with taxes deferred. After a while, you gain the ability to borrow against that cash value. You can even cancel the policy and receive a surrender value. Premiums on whole life policies, though, are usually higher than premiums on term life policies, and they may rise with time. Also, beneficiaries only receive a death benefit (not the policy's cash value) when a whole life policyholder dies.[2,4]

Universal life insurance is whole life insurance with a key difference. Universal life policies also build cash value with taxes deferred, but there is the chance to eventually pay the monthly premiums out of the policy's investment portion.[5]

Month by month, some of your premium on a universal life policy gets credited to the cash reserve of the policy. Sooner or later, you may elect to pay premiums out of the cash reserve – so, the policy essentially begins to "pay for itself." If all goes well, a universal life policy may have a lower net cost than a whole life policy. If the investments chosen by the insurer severely underperform, that can mean a dilemma: the cash reserve of your policy may dwindle and be insufficient to keep paying the premiums. That could mean cancellation of the policy.[5]

What about variable life (and variable universal life) policies? Variable life policies are basically whole life or universal life policies with a riskier investment component. In VL and VUL policies, you may direct percentages of the cash reserve into investment sub-accounts managed by the insurer. Assets allocated to the sub-accounts may be put into equity investments of your choice as well as fixed-income investments. If you choose equity investments, you (and the insurer) assume greater risk in exchange for the possibility of greater reward. The performance of the subaccounts cannot be guaranteed. As an effect of this risk exposure, a VUL policy usually has a higher annual cost than a comparable UL policy.[6]

The performance of the stock market may heavily affect the performance of the subaccounts and the policy premiums. A bull market may mean better growth for the policy's cash value and lower premiums. A bear market may mean reduced cash value and higher monthly payments to keep the policy going. In the worst-case scenario, the cash value plummets, the insurer hikes the premiums in order to provide the guaranteed death benefit, the premiums become too expensive to pay, and the policy lapses.[6]

Term life insurance is life insurance that you "rent" rather than own. It provides coverage for a set period (usually 10-30 years). Should you die within that period, your beneficiary will get a death benefit. Typically, the premium payments and death benefit on a term policy are fixed from the start, and the premiums are much lower than those of permanent life policies. When the term of coverage ends, you may be offered the option to renew the coverage for another term or to convert the policy to a form of permanent life insurance.[2,7]

Term life is cheap, but the tradeoff comes when the term is up. Just as you cannot build up home equity by renting, you cannot build up cash value by "renting" life insurance. When the term of coverage is over, you usually walk away with nothing for the premiums you have paid.[7]

Which coverage is right for you? Many factors may come into play when deciding which type of life insurance will suit your needs. The best thing to do is to speak with a qualified insurance professional who can help you examine these factors, so you can determine which type of coverage may be appropriate.

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