What Are the Basic Types of Life Insurance?

One of the best ways to protect against the financial consequences of a primary wage earner's premature death is life insurance. However, only about 6 out of 10 Americans actually own life insurance and half believe they do not have enough.1 However, choosing from the many types of life insurance policies that are available can be a difficult process. A few main categories are described here to help you search for a life insurance policy that is appropriate for you.

Keep in mind that the cost and availability of insurance depend on factors such as age, health, and the type and amount of insurance purchased. Before implementing a strategy involving insurance, it would be prudent to make sure that you are insurable.

Term Life Insurance

Term life insurance is the most basic and usually the most affordable. Policies can be purchased for a specified period of time. If you die within the time period defined in your policy, the insurance company will pay your beneficiaries the face value of your policy.

Policies can usually be bought for one- to 30-year time spans. Annual renewable term insurance usually can be renewed every year without proof of insurability, but the premium may increase with each renewal. Term insurance is useful if you can afford only a low-cost option or you need life insurance only for a certain amount of time (such as until your children graduate from college).

Permanent Life Insurance

The other major category is permanent life insurance. You pay a premium for as long as you live, and a benefit will be paid to your beneficiaries upon your death. Permanent life insurance typically comes with a "cash value" savings element. There are three main types of permanent life insurance: whole, universal, and variable.

Whole life insurance. This type of permanent life insurance has a premium that stays the same throughout the life of the policy. Although the premiums may seem higher than the risk of death in the early years, they can accumulate cash value and are invested in the company's general investment portfolio. You may be able to borrow funds from the cash value or surrender your policy for its face value, if necessary.

Access to cash values through borrowing or partial surrenders can reduce the policy's cash value and death benefit, increase the chance that the policy will lapse, and may result in a tax liability if the policy terminates before the death of the insured. Additional out-of-pocket payments may be needed if actual dividends or investment returns decrease, if you withdraw policy values, if you take out a loan, or if current charges increase.

Universal life insurance. Universal life coverage goes one step further. You have the same type of coverage and cash value as you would with whole life, but with greater flexibility. Once money has accumulated in your cash-value account, you may be able to vary the frequency, as well as the amount, of your premiums. In fact, it may be possible to structure the policy so that the invested cash value eventually covers your premium costs completely. Of course, it's important to remember that altering your premiums may decrease the value of the death benefit.

Variable life insurance. With variable life insurance, you receive the same death protection as with other types of permanent life insurance, but you are given control over how your cash value is invested. You have the option of investing your cash value in stocks, bonds, or money market funds. The value of your policy has the potential to grow more quickly, but there is also more risk. If your investments do not perform well, your cash value and the death benefit may decrease. However, some policies provide a guarantee that your death benefit will not fall below a certain level. The premiums for this type of insurance are fixed and you cannot change them in relation to the size of your cash-value account.

Variable universal life is another type of variable life insurance. It combines the features of variable and universal life insurance, giving you the investment options as well as the ability to adjust your premiums and death benefit.

As with most financial decisions, there are expenses associated with life insurance. Generally, life insurance policies have contract limitations, fees, and charges, which can include mortality and expense charges, account fees, underlying investment management fees, administrative fees, and charges for optional benefits. Most policies have surrender charges that are assessed during the early years of the contract if the contract owner surrenders the policy. Any guarantees are contingent on the financial strength and claims-paying ability of the issuing company. Life insurance is not guaranteed by the FDIC or any other government agency; it is not a deposit of, nor is it guaranteed or endorsed by, any bank or savings association.

Withdrawals of earnings are taxed as ordinary income and may be subject to surrender charges plus a 10% federal income tax penalty if made prior to age 59½. Withdrawals reduce contract benefits and values. For variable life insurance and variable universal life, the investment return and principal value of an investment option are not guaranteed and fluctuate with changes in market conditions; thus, the principal may be worth more or less than the original amount invested when the policy is surrendered.

Variable life and variable universal life are sold by prospectus. Please consider the investment objectives, risks, charges, and expenses before investing. The prospectus, which contains this and other information about the variable life or variable universal life insurance policy and the underlying investment options, can be obtained from your financial professional. Be sure to read the prospectus carefully before deciding whether to invest.

Source: 1) LIMRA, 2013