The Basics of Life Insurance

Buckle up, folks, because today's topic is one that some people don't like to think about … life insurance. You were expecting something worse? OK, I guess maybe I made that sound worse than it is. It's not all that controversial a topic. But life insurance can be hard to discuss because it makes you think about — and then plan for — a painful loss.

Understanding the Basics of Life Insurance and the strategy behind it can help. So today, we're going to review some situations where life insurance can be an important tool, as outlined by the Insurance Information Institute's helpful article, "Life Insurance Basics." Then, I will talk about the types of life insurance that are available and why different types appeal to different people.

Life insurance is a foundational component of many people's financial lives, and because of that, we all have a basic understanding of what life insurance does. But we don't always think about the why. So to help you examine the why; here are four common reasons why people choose life insurance:

1. To replace income for dependents

This one may be the first thing to come to mind. When a family relies on an individual's income to make ends meet, life insurance plays an important role as a safety net if that person were to pass away. Most often, we see this scenario play out with the parents of young children.

And life insurance is an even more valuable backup plan if the surviving domestic partner or spouse would receive reduced benefits after their partner's death, as is the case with certain government- or employer-sponsored benefits. Replacing income is a very common reason we see people invest in a life insurance policy.

2. To pay final expenses.

If replacing income isn't your first thought, final expenses probably are. Funeral and burial costs can be significant, not to mention probate and other estate administration costs. Often, there are also debts and medical expenses that health insurance doesn't cover. Life insurance can be used to help anticipate and take care of these costs.

3. To create an inheritance for heirs.

One of the retirement goals we hear about most often is for someone to be able to pass along an inheritance to their heirs. Unfortunately, not everyone has enough assets to do so.

By purchasing a life insurance policy and naming their heirs as beneficiaries, though, someone may be able to create an inheritance.

4. To make significant charitable contributions.

Some people choose to buy a policy and make a charity the beneficiary. This may enable them to make a much more significant contribution than if they instead donated the cash value of the policy's premiums. For someone who wants to make a sizeable donation to an organization, it can make a lot of sense.

We certainly haven't covered every reason to get a life insurance policy, but we've covered a few of them. Now, let's discuss the types of life insurance and what makes them unique.

You've likely heard of the two types of insurance: term and whole life. Just as they sound, term policies are only good for a certain period of time, and whole life policies pay a death benefit whenever the policyholder dies. But there's also a little more to them than that.

Whole life policies, in particular, can be complicated. So let's start with term, the simplest form of life insurance.

The idea behind term insurance is to provide financial protection for a set amount of time — usually from one to 30 years. For the entirety of the coverage period you choose, the premium payment amount for your term insurance will typically stay the same.

Then, once that period is up, the insurance policy may cease, or it may offer continued coverage — usually with a premium payment rate that is significantly higher.

Generally speaking, though, term life insurance is cheaper than permanent life insurance. It can be a good option for those that may need to replace lost potential income during their working years.

It can also help act as a safety net for your beneficiaries and help to meet financial goals like paying off a mortgage, maintaining a business or assisting with tuition costs if there is an unexpected death.

That's just a quick synopsis of term life insurance policies. Now, let's discuss whole life insurance.

Whole life, also known as permanent insurance, pays a death benefit whenever the policyholder dies. The two main types of permanent life insurance are universal life and whole life. We'll go over both today.

While both types of policies are designed to last until the policyholder dies, there are some important differences. In traditional whole life policies, both the death benefit and the premium remain the same throughout the life of the policy.

On the other hand, universal policies are flexible and you may be given opportunities to raise, or lower, your premium payment or coverage amounts over the course of your life.

Where we most often see people benefit from universal life insurance is when it is part of a flexible estate planning strategy that is designed to help preserve wealth and allow it to be transferred to beneficiaries.

Another way that universal life insurance may benefit someone is if they need a long-term income replacement that extends beyond working years.

Depending on the design of the universal life insurance product, it may be focused on providing both death benefit coverage and building cash value, or it may be focused only on providing guaranteed death benefit coverage.

The right life insurance policy differs for everyone based on their unique situation and retirement goals. But for many people, a life insurance policy can be the cornerstone of a well-rounded retirement strategy.

Sources:

https://www.iii.org/article/life-insurance-basics