Life Insurance: Types and Needs

By Louis E. Conrad II, CFA

- Life insurance is one of those financial vehicles that can be used to reduce the financial risk if you are not around long enough to sufficiently fund your family's financial goals.
- If you need life insurance, be sure to pursue it while you are still healthy (insurable) and premiums are more cost-effective.

Despite the end of the Mayan calendar, we are all still here. Yet, as Benjamin Franklin expressed in a letter many years ago, two things are known with certainty: death and taxes. While taxes have been the subject of other articles in The COMPASS Chronicle, including an article regarding the fiscal cliff on page one, this article discusses how you may offset the financial risk of your passing.

Types of Life Insurance

Two general types of life insurance exist: term and permanent.

Term insurance is a policy with a set coverage period, or term, of usually five to thirty years, though some policies may provide the option to extend the original term (known as renewable term). If the insured dies during the term, then the stated death benefit is paid to the policy's beneficiaries. As "pure" insurance, term policies do not provide a buildup of cash value like permanent insurance, but term policies are also less expensive than permanent insurance for a similar death benefit.

Different types of term insurance are available, including:

* Level Premium Term—premiums are fixed for a guaranteed period of time and the death benefit remains constant throughout the policy's term.

* Decreasing Term—also known as mortgage insurance, where the death benefit slowly declines over time, but the premium generally remains level.

* Increasing Term—a rarely used variation of term insurance, which provides a death benefit that gradually increases during the life of the policy. Premiums generally increase as the death benefit increases.

Some term policies have convertible or renewable options at the end of their term. Convertible term policies convert to a permanent insurance policy with a higher premium, but no proof of insurability is usually required at the time of conversion, which normally must occur within a certain time after the policy is issued or before you reach a certain age. Annual renewable term policies usually offer the option to renew your term coverage without a new medical exam. Such policies are initially less expensive, but the annual premiums increase as you grow older. Group policies provided through employers are usually annual renewable term and often do not require proof of insurability.

Permanent insurance can provide coverage throughout your entire life. Such a policy accumulates a cash value, which the owner can access by borrowing through a policy loan or surrendering the policy to receive its surrender value.

Different types of permanent insurance are available, including:

* Whole Life—provides a guaranteed death benefit and cash value for a guaranteed premium, which normally remains fixed. The policy earns dividends, which may increase the tax-free buildup of the policy's cash value and, perhaps, the policy's death benefit. One drawback is that the internal rate of return of such policies may not be competitive with other savings vehicles.

* Universal Life—offers more flexibility than a traditional whole life policy, such as allowing adjustments to premium payments and death benefits, along with the potential for greater growth in a policy's cash value.

* Variable Life—includes an investment component tied to stock and/or bond returns, though returns are not guaranteed.

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Permanent insurance is usually appropriate for estate planning needs, such as to pay estate taxes, to fund a special needs trust, to care for elderly parents, to leave a legacy to your children or a charity, or for your final expenses.

How Much Life Insurance Do You Need?

You may see standard formulas used in calculating life insurance needs that suggest having 5 – 7 or 8 – 10 times your annual income in life insurance death benefits. In most situations, I approach a client's life insurance needs differently—focused squarely on reaching their financial goals rather than a multiple of their current income.

Other than where permanent insurance makes sense as indicated above, I often suggest clients consider term insurance that would meet their family's other financial risks and goals, such as to cover (1) mortgages and other debts; (2) educational expenses; and (3) income replacement and retirement needs. This entails creating projections of what these financial risks will be over time and then purchasing term insurance in appropriate amounts to neutralize these risks.

If you have questions regarding your existing life insurance or whether you are adequately insured, please contact us for an insurance analysis.

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