LIFE INSURANCE: THE BASICS

WHAT IS INSURANCE?

For thousands of years, people have used insurance as protection against events that probably won't happen — but would be potentially catastrophic if they did. Insurance is based on the simple idea of pooling risk: if many people pay a relatively small amount into the insurance pool, there is enough to mitigate the cost of the few instances of an insurable event. In this way, insurance spreads the cost risk of a devastating event — the loss of a family's breadwinner, a house fire, or a serious accident — from one to many.

STEPS TO GETTING LIFE INSURANCE[1]

1 DECIDE IF YOU NEED IT

If there are people who depend on your income, you probably do.

2 EVALUATE TYPES OF LIFE INSURANCE

Although there are many variations, there are two basic kinds of life insurance: term and permanent. Term covers you for a specific time frame (for example, 20 years); permanent typically continues until your death or you cancel the policy.

3 BALANCE NEEDS AND AFFORDABILITY

That depends on your specific situation, but doesn't require complicated calculations to figure out. You may want to work with an insurance professional.

4 COMPARE POLICIES

You can compare policies from different companies on your own or use a life insurance agent.

5 PREPARE FOR A MEDICAL EXAM

Many times, the life insurance company sends a medical professional to your home.

A life insurance policy is a contract between you and the life insurance company. You pay the life insurance company a premium (which can be annually, monthly, quarterly, or even just once) and they guarantee* the death benefit.

While protection for people who depend on you financially is its primary purpose, life insurance may sometimes be used for things like supplemental retirement income or tax-efficient transfer of wealth between generations.

TYPES OF LIFE INSURANCE

Life insurance can be structured in myriad ways to fit any number of specific needs. In general, though, you can divide life insurance into two broad categories:

TERM INSURANCE

Term insurance provides death benefit coverage for a specific time period and is considered a simple form of life insurance. Since term insurance is temporary, it's well-suited for temporary needs like providing extra protection during child-raising years. Term insurance typically offers the most affordable premium payments; however, has no cash value and the policyholder most often receives nothing back once the term expires.

PERMANENT LIFE INSURANCE

Permanent life insurance includes all life insurance other than term. Permanent life insurance generally includes two components: the death benefit and the cash value. The cash value portion grows tax-deferred until distribution. Some types of life insurance have a minimum growth guarantee. The most common types of cash value insurance are whole life and universal life. Whole life typically offers more stability, while universal life is more flexible.

WHY LIFE INSURANCE?[2]

People purchase life insurance for a variety of reasons.

1 PROTECTION

Life insurance was created to provide financially for your de-pendents if something happens to you. This remains its most import-ant benefit.

2 TAX ADVANTAGES

With few exceptions, the death benefit from a life insurance policy is income tax-free to the beneficiaries. This special status acknowledges the important role that life insurance plays in allowing families to remain self-sufficient after the loss of a breadwinner.

3 FINAL EXPENSES

An insurance policy can help offset the cost of a funeral (approximately $8,000 - $10,000[3]).

4 TERMINAL ILLNESS OR LONG-TERM CARE

Many life insurance policies include some coverage to pay costs associated with these types of healthcare.

5 SUPPLEMENTAL RETIREMENT INCOME

Permanent life insurance can provide options for tax-free withdrawals or low interest loans.

THINGS TO CONSIDER

Life insurance usually requires health underwriting, which often means a medical exam. Not everyone is healthy enough to get life insurance.

WHAT IS AN ANNUITY?

An annuity is also an insurance contract; however, annuities are meant to provide a steady stream of income in retirement (thereby "insuring" retirement income). Annuities can offer an income stream that's often compared to a pension. Annuities typically have two phases.

PURCHASE/GROWTH PHASE

You can purchase with a one-time lump sum (for example, a 401(k) rollover) or with a series of premium payments during a set time period. During this phase, any annuity earnings are tax-deferred.

INCOME/DISTRIBUTION PHASE

While you can receive a one-time lump distribution, most people use annuities to provide an income stream in retirement. This can be for a set amount of time (for example, 20 years) or can be a guaranteed income for life, depending on the product. Withdrawals from annuities are taxed at ordinary income rates.

WHY ANNUITIES?[4]

While there are many different types of annuities, a large portion are designed to provide retirement income.

1 STEADY RETIREMENT INCOME

Annuities provide a steady stream of retirement income on a regular schedule. This helps with budgeting.

2 LIFELONG INCOME

Some retirement annuities create income for life, helping to mitigate the risk of outliving your savings.

3 TAX DEFERRAL

During the accumulation phase, gains in an annuity are tax-deferred. When withdrawn, that money is taxed at the rate of ordinary income.

THINGS TO CONSIDER

Annuities are long-term insurance products and not meant for money that will be needed soon. Most charge a surrender fee if the money is withdrawn during the first several years of your contract.

Some annuities charge hefty fees and can be hard to understand. It's important to work with someone who can explain the annuity and the fees so that you know what you are buying and what it costs.

INSURANCE REGULATION[5]

Because consumers depend on insurance to protect their families, their homes and their possessions, the financial strength and stability of insurance companies is a foundation of the industry. Regulations require insurance companies to maintain financial reserves to pay claims, and several independent third-party companies regularly rate the financial strength of insurance companies. Consumers can use these ratings to help choose between competing insurance companies.

FIND OUT MORE

Life insurance and annuities fill a need for many people, but the multitude of available products can be daunting. Many different factors go into determining if one of these policies might be a good fit for you, and if so, what kind.

As a financial services professional, I can be your ally. I know what questions to ask and what products are available. Together, we can explore what life insurance and annuities can offer you and your family.

Sources:

[1] https://www.protective.com/learn/how-to-buy-life-insurance-in-six-easy-steps

[2] https://www.investopedia.com/5-top-benefits-of-life-insurance-5105062

[3] https://www.policygenius.com/life-insurance/how-much-does-a-funeral-cost/

[4] https://www.investopedia.com/articles/retirement/121416/retirement-annuities-know-pros-and-cons.asp

[5] https://www.valuepenguin.com/insurance-company-ratings

Annuities are long-term insurance products primarily designed to provide retirement income. Early withdrawals from an annuity may result in loss of principal and credited interest due to surrender charges. Please keep in mind that life insurance typically requires health underwriting and, in many instances, financial underwriting. Policy loans and withdrawals from a life insurance policy will reduce available cash values and death benefits and may cause the policy to lapse or affect any guarantees against lapse. Additional premium payments may be required to keep the policy in-force. In the event of a lapse, outstanding policy loans in excess of unrecovered cost basis will be subject to ordinary income tax. Withdrawals are generally income tax free unless the withdrawal amount exceeds the amount of premium paid.

*Guarantees are based on the claims-paying ability of the issuing insurance company.

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