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10 Things You Absolutely Need To Know About Life Insurance

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Personal Finance
Personal finance is more personal than it is finance.

Life insurance is one of the pillars of personal finance, deserving of consideration by every household. I'd even go so far as to say it's vital for most. Yet, despite its nearly universal applicability, there remains a great deal of confusion, and even skepticism, regarding life insurance.

Perhaps this is due to life insurance's complexity, the posture of those who sell it or merely our preference for avoiding the topic of our own demise. But armed with the proper information, you can simplify the decision-making process and arrive at the rig[h]t choice for you and your family.

To help, here are 10 things you absolutely need to know about life insurance:

1. **If anyone relies on you financially, you need life insurance.** It’s virtuall obligatory if you are a spouse or the parent of dependent children. But you may also require life insurance if you are someone’s ex-spouse, life partner, a child of dependent parents, the sibling of a dependent adult, an employee, an employer a business partner. If you are stably retired or financially independent, and no one would suffer financially if you were to be no more, then you don’t need life insurance. You may, however, consider using life insurance as a strategic financial tool.

2. **Life insurance does not simply apply a monetary value to someone’s life.** Instead, it helps compensate for the inevitable financial consequences that accompany the loss of life. Strategically, it helps those left behind cover the costs of final expenses, outstanding debts and mortgages, planned educational expenses and lost income. But most importantly, in the aftermath of an

unexpected death, life insurance can lessen financial burdens at a time when surviving family members are dealing with the loss of a loved one. In addition, li insurance can provide valuable peace of mind for the policy holder. That is why life insurance is vital for the bread winner of a single-income household, but stil important for a stay-at-home spouse.

3. **Life insurance is a contract (called a policy).** A policy is a contract betwee a life insurance company and some*one* (or occasionally some*thing*, like a trust) who has a financial interest in the life and livelihood of someone else. The insurance company pools the *premiums* of policyholders and pays out *claims*—called a death benefit—in the event of a death. The difference between the premiums taken in and the claims paid out is the insurance company's profit.

4. **There are four primary players, or roles, in a life insurance policy.** These roles belong to the insurer, the owner, the insured and the beneficiary. Th *insurer* is the insurance company, responsible for paying out claims in the case o a death. The *owner* of the policy is responsible for premium payments to the insurance company. The *insured* is the person upon whose life the policy is base The *beneficiary* is the person, trust or other entity due to receive the life insurance claim—or death benefit—in the case of the insured's passing. For example, I am both the owner and the insured for two life insurance policies (with two different insurers, as it happens). My wife is the beneficiary of each. W walk through the numbers together at least annually (and after major argument to prove that I'm still worth more alive!).

5. **Life insurance is a risk management tool, not an investment.** While some life insurance policies have an investment feature that can offer a degree o tax privilege, insurance is rarely an optimal investment. There's usually a better, more efficient tool for the financial task you're trying to accomplish. If you haven't yet filled up your emergency cash reserves, paid off all non-mortgage debt, maxed out your 401(k) or Roth IRA, contributed to an education savings plan (where appropriate) and set money aside for large purchases you expect in the next decade, then you likely need not concern yourself with types of life insurance that contain an investment component. (You'll see why in #7.)

6. **There are two broad varieties of life insurance about which you should become aware—term and permanent**. *Term life* is the simplest, th least expensive and the most widely applicable. With term life, a life insurance company bases the policy premium on the probability that the insured will die within a stated term—typically 10, 20 or 30 years. The premiums are guaranteed for the length of the term, after which the policy becomes cost-prohibitive to maintain or you decide to let it lapse. Yes, this means that you may very well pay premiums for decades and "get nothing out of it." But that's good news, because means you're winning at the game of life.

Permanent life insurance includes this same probability-of-death calculus, but also includes a savings mechanism. This mechanism, which is often referred to as "cash value," is designed to help the policy exist into perpetuity. *Whole life*—the original– has an investment component much like bonds or CDs (but backed by the insuranc company). *Variable life* offers investment options more like mutual funds. *Univers life* was designed as a less expensive permanent life insurance alternative with adde flexibility, but increased interest rate risk for the owner. Although they tend to be more complex and expensive, there are financial dilemmas—often related to business planning and/or high-net-worth estate planning—for which permanent lif insurance may be the only solution. There are a few select instances where permanent policies are engineered to maximize the tax-privileged growth of cash value. They are, however, only appropriate for a small number of people and still dependent on numerous other factors to work the way they're intended.

7. **Life insurance can be extremely expensive, but it can also be surprisingly inexpensive.** If you apply for a bells-and whistles permanent policy, the size of the premiums alone might cause you to need a life insurance benefit right then and there. But most people are pleasantly surprised when they see the relatively low premiums of a plain-vanilla term policy. A healthy, non-smoking, 30-something male, for example, might pay less than $500 per *year* for a 20-year term policy with a million dollar death benefit. That same individual might be required to pay 10—or even 20—times as much for a variable or whole life insurance policy with a matching death benefit. No, a term/perm compariso is not apples-to-apples. I would hazard to guess, however, that a recent widower

cares little for bells-and-whistles but a great deal for the death benefit. Of course a smoker will likely pay twice as much for any of the above. Someone with health problems could pay triple or more (or simply be declined for coverage).

8. **Determining the optimal life insurance policy for you doesn't have to be complicated.** While we could get really granular with a detailed life insurance needs analysis, it's more important to get set up with something you can comprehend than it is to push off an important decision due to life insurance's intimidating complexity. In the vast majority of situations, a household would be well cared for simply by buying enough life insurance to replicate all or most of the insured's income for a term as long as the household expects to need that income.

Therefore, consider this simple but effective strategy for determining how much life insurance your household needs. Multiply a wage earner's income by 15 and purchase a policy with an equivalent death benefit for a term that extends until the person insured would presumably retire. Why 15? Because it works. But it works because it results in a number that should re-create 75% of a wage earner's income the death benefit was conservatively invested to earn 5% (hopefully plus a bit more for inflation) annually. Here's an example:

- Dave makes $100,000.
- $100,000 x 15 = $1,500,000 of death benefit
- $1,500,000 earning 5% annually produces $75,000 of income.

9. **Consider using a live person to help in your death planning.** There are many online tools that can help give you an idea of how much money you should pay for the policy you need. But once you get to that point, I would recommend contacting a real, live insurance agent who can walk you through the application and underwriting process. The premiums at a given insurance company are identical whether you apply online, via a toll-free number or with a person. Indeed, a knowledgeable and dedicated insurance broker or agent may help you save money by choosing the best carrier for your particular situation.

Underwriting, by the way, is the necessarily tedious process through which the insurance company classifies how much of a risk you are, based on your current health, past health, the health of your parents and siblings and enough other questions to make anyone blush. Answer truthfully—but succinctly.

10. **Know your options when cancelling an existing life insurance policy so you don't leave money, or coverage, on the table.** If you have a policy that isn't appropriate for you—or you simply no longer need it—it's important to proceed carefully. First, if you realize that you have overpaid for a policy that doesn't meet your needs, but you still need life insurance, don't cancel the wrong policy until the right policy is in place. Who knows, you could learn of a health complication that is going to lead to you being declined for the new policy. Then you'd be left without any coverage. If you have an existing term policy you no longer need, you can simply cease premium payments and it will go away. If you have an unnecessary permanent policy with a cash value, however, you should analyze its present and expected future investment value, as well as any prospective tax complications, before cashing it in. You can do so by requesting an "in-force illustration" and a "cost basis report" from your agent.

I suspect we don't love talking about life insurance because we don't like talking about death. No shocker there. But open and honest discussions about planning for an unexpected death can be surprisingly life-giving. And even if you don't buy that, the chances are good that purchasing life insurance is still an important part of your long-term and comprehensive financial plan.

This post is part of an invaluable series pulled together by Forbes*: "[100 Things You Absolutely Need To Know About Money Before You're 35](#)."*

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