A Short Course in Insurance: Term vs. Permanent

When faced with the wide range of life insurance coverage available, you may wonder which type is best suited to your needs. As the years go by, it will be important to review and update your plans, as you will likely find that your coverage needs will evolve with your changing life goals. There are two basic types of coverage—permanent (sometimes referred to as cash value) and term life insurance. A closer look can illustrate the short- and long-term benefits that each provides.

Cash Value Life Insurance—Value for Your Dollar

Cash value life insurance not only helps provide financial security for surviving loved ones at the death of the insured, but it also maintains a cash value for the policyholder. Premium payments first pay the cost of the policy coverage itself. Then the insurance company, in order to build the cash values of the policy, invests the “leftover” dollars. Cash value insurance links protection with savings, as assets and earnings accumulate throughout the life of the policy, which the policyholder can access for any purpose.

Some cash value policies provide policyholders with annual dividends. These dividends are the result of higher investment returns and lower expenses than were originally predicted when premium amounts were set. Dividends can be used in many ways, including as a means of paying future premiums, and they can even be reinvested into the policy to generate additional cash values.

Premium amounts owed are contractually guaranteed and will not change as long as premiums are paid in accordance with the schedule set forth in the policy. Payments may continue for a predetermined period chosen by the policyholder, typically ranging anywhere from ten years after the date of purchase to the number of years until a person reaches age 100. The length of the payment period and the amount of coverage will affect the premium cost. Permanent life insurance protection is guaranteed. As long as premiums are paid, the insured is guaranteed coverage for life in accordance with the terms of the policy. Evidence of insurability will never be necessary as long as the original policy remains in force, and benefits will never decrease.

Another feature to consider is its value as a “creditor.” Funds may be borrowed against the cash value of the policy at a predetermined loan interest rate. Loan approval comes from the insurer, but it is generally granted. No repayment schedule is set beyond regular payment of interest on the loan, with outstanding loan balance deducted from the cash value and death benefit by the amount of the loan outstanding plus interest. These loans are generally tax free, and there are no restrictions on their use. However, keep in mind that withdrawals may be subject to surrender charges and could have a permanent effect on the cash value and death benefit.

Term Insurance—Pure Protection for Your Dollar

In a term insurance policy, there are three basics to consider: first, the period of protection is for a predetermined, specified term; second, policies do not accumulate cash values like permanent insurance; and third, premiums may initially be substantially lower than cash value premiums.

Nonrenewable, nonconvertible term insurance for one, five, or ten years may provide the most inexpensive protection available, and this option may be advantageous for those who want to be covered while their children are underage, to back a business loan, etc. Premiums will, however, increase over the period of protection. Term insurance is also available for longer durations (e.g., to age 95), but increasing premiums may result in higher overall costs than permanent insurance in the long term.

Term insurance may be ideal to help cover a specific need, such as an outstanding mortgage. These goals can be met by purchasing coverage for a specified period of time and at the lowest premium outlay. In fact, many companies offer decreasing term insurance in which the death benefit proceeds diminish over time (for instance, to cover a decreasing mortgage balance).

Which Product When?

A thorough review of your insurance needs can help you choose the right policy for your individual situation. It is important to determine the short-term and/or long-term nature of your needs, your current cash position, and the coverage you can afford.

About the Author

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