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Life Insurance: Term Insurance

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Overview

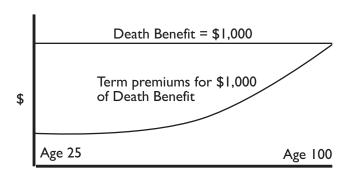
Term insurance is basic life insurance. It is the easiest type of policy to understand. A life insurance company will charge a dollar amount, known as the *premium*, to provide the *beneficiary* with a tax-free cash benefit if the *insured* dies in that year. A beneficiary might be a spouse, children, or anyone else the owner wants. If the insured does not die in that year, no cash benefit is paid. The premium paid to the insurance company was the cost of the *death benefit* protection for that year. The *owner* does not get the premium back if the insured does not die.

In order for the insurance company to agree to pay a death benefit to a beneficiary, the company will want to make sure that the insured does not have any health problems that will increase the odds that they would have to pay the death benefit. Therefore, the insurance company will probably ask insured to be examined by a doctor. This process of deciding whether the insurance company will issue a policy is known as **underwriting**.

Annual Renewable Term

With a renewable term policy, the insured will need to visit the doctor to get the first year of insurance. After the first year, the owner will have the option to buy another year's worth of insurance without a second doctor's visit. The owner may continue to renew the policy year after year, as long as he or she agrees to pay the premium each year. With term insurance the premium for the same amount of death benefit will go up each year.

Let us assume that you want a \$1,000 death benefit. If you are 25 years old, the term cost is very low, but when you are age 100, the annual premium will be the same as the death benefit, \$1,000. The following chart may help you get an idea of the cost of term insurance.



Level-Premium Term

As stated, each year the owner renews a term policy, the cost of the policy will go up because the insured is getting older. Instead of buying term insurance on a year-to-year basis, the owner can buy a policy with fixed costs for five or more years at a time. The longest term is usually 20 or 30 years. These policies are called **level-premium term** because the premium stays the same for the length of the term. The fixed cost in the early years will be higher than the annual term cost, but the later years it will cost less than the annual term cost. The up side is that the owner does not need to budget for yearly increases in cost, and the total premiums paid over the term of the policy could be quite a bit lower than annual renewable term premiums.

For example, your husband is a 25-year-old male. You have a child and you want her to have \$100,000 to go to college if your husband dies. Let's also assume that your child is now 2 years old. It may make sense to buy a \$100,000 20-year term policy, because at 22, your child may be out of, or close to finishing college.

- 20-year term annual premiums are \$150 per year; total cost \$3,000.
- 1-year annual renewable term premiums start at \$130 in the first year, but in the 20th year, the annual premium has risen to \$560; total cost \$5,800.





Often, the owner can renew these longer term policies, but the new premium will be higher if the policy is kept longer than the stated number of years.

Group Term

Many times a company will purchase group term policies for its workers. Group term policies usually provide a cash payment to the worker's named beneficiaries if the worker dies while employed by that company. The cost for this type of policy is very low, and sometimes free. The employee may be able to convert the policy to an individual policy if he or she changes jobs. Talk with your human resources contact to see if you have a group term benefit.

Decreasing Term

Many agents no longer sell decreasing term. This type of term policy is similar to a longer term policy, but will pay the highest death benefit in the first year. Each year thereafter, the death benefit will be lower and lower, until it goes away entirely. Your costs can vary from year to year, but usually remain level. If you have bought a home, you may be tempted to buy this type of policy to cover your family's mortgage if you were to die. However, with a regular term policy, your family will have the difference between the death benefit and the mortgage balance to use for other things if they decide to keep the house and pay off the mortgage.

Convertible-Term

In this overview, we have only looked at term policies. Another type of policy is known as a permanent policy. A permanent policy will help you plan your payments to insure your entire life. In other words, no matter when you may die, a permanent policy (if designed correctly) will pay a death benefit. You may be thinking that you could achieve the same goal by renewing your term policy. This is true, but the costs will keep on rising as you get older, to the point where they may be too high to keep paying. A convertible term policy will allow you to start with a term policy, but later, you can convert (or switch) your policy into a permanent policy. Permanent policies such as whole-life, universal-life, and variable universal-life are covered in Life Insurance: Whole-Life Insurance, Virginia Cooperative Extension publication 354-145; Life Insurance: Universal-Life Insurance, Virginia Cooperative Extension publication 354-146; and *Life Insurance: Variable Universal-Life Insurance*, Virginia Cooperative Extension publication 354-147.

If you know you have a lifetime need for insurance, it makes sense to look at a permanent policy as soon as possible. However, if you need a policy now, but you do not have a lot of money to pay premiums, a convertible-term policy may work for you. In a few years, if your income is higher, you will be able to afford a permanent policy and you can convert the term policy to a permanent policy.

A Final Word on Term Insurance

Term insurance is good way to protect your beneficiary for a limited amount of time. Term insurance also allows for the lowest cost if your need for the policy is only temporary. If you are a disciplined saver, buying a term policy and investing the difference between the cost of the term policy and the cost of a whole-life policy means your beneficiaries will have both the death benefit and the value of the investments. In addition, you will have the investment account to assist you in paying the higher premiums in the later years of the policy. For more information on term insurance, see the following websites: Life and Health Insurance Foundation for Education (http://www.life-line.org), the American Council of Life Insurers (http://www.acli.com), and the Insurance Information Institute (http://www.iii.org).

Definitions of Terms

Beneficiary – The person or entity receiving the death benefit at the death of the insured.

Cash Value – The amount of total premiums paid for a policy minus the costs for insurance in whole-, universal-, and variable universal-life policies. The cash value grows tax-free in an insurance policy.

Death Benefit – The total cash payment made to the beneficiary upon the death of the insured.

Insured – The person on whose life the insurance has been purchased. If the insured dies, a death benefit will be paid to the named beneficiary.

Owner – The person or entity who owns the insurance policy. The owner may or may not be the insured. The

owner can designate the beneficiary, and is responsible for paying premiums. See *Life Insurance: The Impact of Ownership*, Virginia Cooperative Extension publication 354-142, for more information on the impact of ownership.

Premium – The amount billed to the owner of an insurance policy (usually monthly, quarterly, or annually) by the insurance company. In term and whole-life the full premium must be paid to keep the insurance. In universal- and variable universal-life, the amount billed may or may not be a mandatory payment to keep the insurance.

Reference

Baldwin, B.G. (2002). The new life insurance investment advisor, second edition. New York: McGraw Hill.

Disclaimer: Insurance examples used in the publication are for illustrative purposes only. The premiums may not be estimates of an actual policy. Consult your insurance agent for actual insurance illustrations.