Basic life insurance terms

Life insurance
Life insurance is a contract between a policyholder and an insurance company. The policyholder agrees to pay premiums to the company and, in exchange, the company agrees to pay a certain amount to the policyholder's chosen beneficiaries when the insured person dies.
Life insurance also has a legal definition in the United States. For something to count as life insurance, the company issuing the policy has to have a specific amount of money "at-risk." That basically means, if you've paid more into a life insurance policy than the company is going to pay out when you die, it's not life insurance anymore. This issue only ever comes up with permanent life insurance and, even then, only rarely.

Insured person
An insured person is the person whose death is covered by a life insurance policy. This can be the same person who buys and owns the life insurance policy, but that's not always the case. For instance, a company may insure one of its key leaders so that it gets paid if that person dies and leaves a gap in the business.
A person also can take out a policy on a loved one, like a child. In that case, the person taking out the policy is the policyholder and the child is the insured person. With some permanent children's policies, the child will take ownership of the policy once they reach a certain age, often around 18 to 21.
Beneficiary
A life insurance beneficiary is simply the person (or people, you can have multiple beneficiaries) who will receive the death benefit when the insured person dies. This can be a family member or charity, but it doesn't have to be. You could name the neighbor's kid or your favorite restaurant, if you wanted to.
The options are narrowed if you live in a community property state. In those states, assets are considered to be equally owned by spouses. If you want to name anyone besides your spouse, you'll need their consent.
Policyholder
The policyholder is the person who actually owns the policy. They're responsible for making payments and determining the details of the policy. Barring an external agreement, like an employment contract, a policyholder is in complete control of a life insurance policy. That means they can make changes, even if they're not the insured person.

Mutual life insurance companies

A mutual insurance company is a company that’s run for the mutual benefit of its members, which are its policyholders. Mutual companies don’t have stock, and the members can vote for the board of directors and receive payments in the form of dividends.
Mutual companies have the benefit of being run by the policyholders, which means there aren’t shareholders to constantly appease. It’s a bit like a credit union, which is owned and run by its members. Any benefits generated by the business are pumped right back into it.

Premiums
Premiums are the payments you make to your insurance company for the life insurance they provide. With term insurance, premiums cover the cost of administration and your life insurance coverage. With a permanent policy, they also fund your cash value account.

Face value
The face value of a life insurance policy is the death benefit the policy will pay. If you take out a $100,000 life insurance policy, $100,000 is the face value. That value can change over time as you borrow from the policy or increase the amount of coverage you have. Face value is not the same as cash value, which is the excess premiums you’ve paid plus interest earned, which accumulates in the policy’s cash value account.

Cash value account
A cash value account is the part of a permanent life insurance policy that accrues value over time. With some policies, this is like a savings account, earning a fixed amount of interest. With others, the account functions more like an investment account, allowing the policyholder to make decisions on how the money is invested.
The cash value account is funded through your premium payments. After administrative and insurance costs are taken out of your premium, the rest is put into the cash value account. When you’re younger, more of your total premium will go into the account since you’re cheaper to insure. Term life insurance products don’t have cash value accounts.

Surrender value
The surrender value of your life insurance policy is the value the insurer will pay you at any given time for the policy. It is not the same as the face value or death benefit of the policy, except under very rare circumstances. Term life policies have no surrender value.

Permanent life insurance policies have a surrender value equal to some chunk of the policy's cash value account. This is usually the total cash value minus any loans and fees. Policies generally have a period of time (sometimes up to 20 years) when a policyholder will be charged a surrender fee for cashing in his or her policy.

Dividends
Life insurance companies sometimes make more money than they expect to if, for example, fewer policyholders die or the company's investments perform better than expected. When this happens, the company may pay a portion of the excess back to customers with eligible policies. These policies are called "participating," and the cash returned is called a dividend.
This payment can often be taken as cash, used to make your premium smaller, deposited into your cash value account or used to purchase additional life insurance coverage, called "paid-up" coverage.

Lapse
A policy lapses when you fail to make payments on time. At this point, the policy stops covering you. If you have a permanent policy, the money in your cash value account can be used to cover missed payments, but term policies have no such backup. Most companies offer a grace period when you can repay to regain coverage.

Underwriting
When a life insurance company underwrites your life insurance policy, it examines your health and lifestyle to decide how much risk you pose to the company. Based on that risk, you're assigned an insurance classification. If the risk is acceptable to the company, that classification will be combined with your policy details to determine how much the company will charge you.
Not every life insurance policy is fully underwritten.

Guaranteed issue policies, for instance, don't take your individual risk into account. Instead, the insurer decides how much it needs to charge a group of people based on widespread risk.

Evidence of insurability
Evidence of insurability is documentation you provide during the life insurance application process to prove how healthy you are. This proof is often required when adding benefits like increased life insurance coverage through your

employer’s group plan. You’ll need to provide documentation from a doctor or other health care provider detailing tests or medical procedures you’ve had.

Types of life insurance

Individual life insurance

An individual life insurance policy is a policy on a single person (though two individual policies can be combined in a survivorship life insurance policy). These policies are usually purchased by individuals for themselves and are the main alternative to group life insurance. If you’ve ever been told to get life insurance by a financial advisor or friend, this is almost certainly the type of policy they were talking about.

Individual life insurance policy prices are usually based on the health and age of the person being insured, although guaranteed issue policies (which usually charge a higher premium for the same level of coverage) don’t rely on the insured person’s health.

Group life insurance

Group life insurance is the life insurance you’ll most likely be offered by your employer, union or other member organization. Group life insurance doesn’t require a medical exam and provides some amount of life insurance (often based on your salary) for a low monthly cost.

Life insurance companies can offer this cheaper alternative because they both get higher enrollment than they would with term policies and wind up with lower expenses. For buyers, group life insurance can provide valuable coverage for very little cost, though being tied to employment makes group life a less flexible alternative to individual policies.

Term life insurance

Term life insurance is life insurance that covers you for a set period of time, usually between one and 30 years. Term life insurance doesn’t gain value over time, unlike permanent life insurance. If you have a 20-year term policy and die in year 21, you’ll get nothing.

On the other hand, term life is cheaper than permanent life and, for most people, term life insurance is all they’ll need. The term can extend to cover their working years, children’s schooling or mortgage, ensuring that costs are covered if they die during this period.

Most insurers offer some sort of term coverage, so it pays to compare rates on term life insurance when shopping.

Permanent life insurance
Permanent life insurance is life insurance that doesn't have a fixed term. It will remain in force until you die or reach an age so advanced it just pays you out the value of the policy (often between ages 95 and 120). Permanent life insurance has a death benefit like term life and a cash value account that builds over time.
Policyholders can borrow from or withdraw cash from their cash value accounts, paying it back or lowering the death benefit of their policies.
Permanent life insurance includes whole life, universal life and variable life insurances, along with all of their variations.

Whole life insurance
Whole life insurance is the most basic type of permanent life insurance. It's basically a never-ending term life policy stapled onto a cash value account. The account grows in size and may pay a dividend occasionally. Whole life policies are easy to understand and were the standard for permanent life until people realized they could earn more money by investing their cash value accounts.

Universal life insurance
Universal life insurance is a type of permanent life insurance that allows the policyowner to invest their cash value account in funds designed by the insurance company. These funds are supposed to earn a higher rate of return than a whole life policy could offer.
Universal life insurance accounts also give you slightly more control over your policy when compared with whole life policies. You can increase or decrease the value of your policy, make smaller or larger payments and change how your cash value account is invested.
The value of a universal life cash value account can decline, as premium payments are often designed to be supplemented by income from that account. If the insurer's funds don't perform as predicted, the policyholder can end up needing to make additional payments to cover the gap between the financial plan and reality.

Variable life insurance
Variable life insurance is designed to provide the maximum amount of investment flexibility for policyholders. With a variable life policy, the money in your cash value account is held in a separate investment account that you

control. As a result, the death benefit of the policy can go up and down, depending on the performance of that account.
Variable life insurance is as much an investment as it is a life insurance product. In fact, the U.S. government treats it like stocks and other investment products. This is not a “set it and forget it” product, unlike some other life insurance options.

Variable universal life insurance
Variable universal life insurance is a variable death benefit product with flexibility in premiums and face value. You can invest in many different products through the separate cash value account and can increase or decrease your premiums based on the performance of that account, using its income to cover some of your payments.
Like plain variable life insurance, variable universal life insurance is an investment as much as it’s a life insurance plan.

Indexed universal life insurance
Indexed universal life insurance is a version of universal life that uses an index to determine the interest rate it pays. That means, your insurer will pick a stock index, set of investments or other basket of investments and tie your rate to that index’s performance.
Indexed universal life has many of the benefits of plain universal life without some of the controls or decisions. Premium payments are based on projected earnings, so it too can fall short and require additional payments if the index doesn’t perform as well as predicted.

Guaranteed issue life insurance
Guaranteed issue life insurance is coverage that you don’t need any medical exam to qualify for. If you fit the basic requirements (often just age-based), you qualify for coverage. To open the door that wide, the insurance company increases rates and lower the overall size of death benefits.
Guaranteed issue life insurance can be a good last resort for buyers who can’t find coverage elsewhere or who only need a small amount of coverage without hassle. It’s important to note that although you won’t need a medical exam, you may be denied if you have a terminal illness or are in end-of-life care.

Simplified issue life insurance

Simplified issue life insurance is a step removed from guaranteed issue. You won't have to have a medical exam but you will need to answer some medical questions and you can be denied based on those answers.
Simplified issue life insurance has many of the same benefits and drawbacks as guaranteed issue life insurance. You can get life insurance without as many hoops to jump through, but you'll pay more and be offered less.

Survivorship life insurance

Survivorship life insurance (also called "second-to-die" life insurance) is a policy covering two people. The policy doesn't pay out until both people die and usually costs less than two individual policies added together.
Survivorship life policies are useful for people worried about estate planning, leaving a charitable gift or taking care of children after both parents die.

Funeral insurance (pre-need)

Pre-need funeral insurance is a way to prepay for your funeral. Unlike many other types of life insurance, like burial insurance, pre-need funeral insurance doesn't pay a death benefit to anyone other than a funeral provider. It's kind of like a gift card for a funeral, but if all of the proceeds are not used on your funeral, your beneficiaries don't get anything back.

Burial insurance

Burial insurance is a more general final expense life insurance option than pre-need funeral insurance. In reality, burial insurance is just a relatively small term or whole life policy designed to cover end-of-life costs. However, the death benefit will be paid to your chosen beneficiaries, who can spend the money however they see fit.

Types of life insurance riders

Life insurance riders

Life insurance policy riders are optional extras you can add to a policy. Riders can increase the value, flexibility or features of a policy, but they're not the core policy itself. Many common riders can be included in policies to make them more attractive to buyers.

Accelerated death benefit rider

An accelerated death benefit rider is an addition to a life insurance policy that allows the policy to pay out a portion of its value while you're still alive if you are diagnosed with a terminal illness or can no longer perform routine daily tasks. This can help you continue to live your life, pay medical bills and cover your other insurance needs even if you can't work.

Different insurers have different triggers for paying out an accelerated death benefit, but many rely on the six activities of daily living list. If you're unable to perform some number of the activities determined by your insurer, the rider will kick in. The activities are:

- Eating.
- Bathing.
- Continence.
- Dressing.
- Toileting.
- Transferring (getting into and out of bed or a wheelchair).
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Accidental death benefit rider

Accidental death benefits can be purchased as a rider to an existing policy or as a stand-alone policy from some insurers. These benefits pay out when your death is due to an accident. Most commonly, that's a car accident or some sort of industrial accident, but it can be due to many things.

There is usually a long list of exclusions, though. For instance, accidental death benefits won't pay out in the case of war, suicide, car accidents where the insured is drunk or accidents that happen while you're piloting an aircraft. These exceptions will vary by carrier.

Children's rider

A children's rider is an extra life insurance policy attached to your policy, insuring the lives of your children. Children's riders usually provide a relatively small amount of coverage for your child as long as they're younger than a cutoff age (21 or 25 are common) and your policy is still active.

These riders don't require a medical exam for your child and they're relatively cheap. Some riders may even be convertible to permanent policies after their expiration.

Long-term care rider

A long-term care rider provides money from your life insurance death benefit while you're still alive if you need long-term care, like that provided in a nursing home. These riders usually cover only a specific period of time, so they might not cover the entire long-term care need of an individual.

Other life insurance definitions

Contestability period

The contestability period of a life insurance policy is the first two years of the policy's life when the insurance company can contest the accuracy of your

application if you die. In some states, nothing can be done if you die after two years, while in others, you can still have your benefit payment denied if you knowingly lied on your application.

Graded death benefit

A graded death benefit is one that pays out less during the early years (typically the first two or three years) of a life insurance policy. These are often part of higher risk policies, where the insurance company wants to make sure it's not on the hook for a death benefit right away.

There are two types of graded life insurance policies, one that returns the premiums you've paid plus interest if you die during the defined period (this is called a return of premium policy) and one where you receive a percentage of the death benefit, but not the whole thing.

Renewable life insurance

Some term life insurance policies are renewable after their initial term is complete. What's more important is that you can renew without having to prove that you're still insurable. That means you can get coverage even if your health has declined and you'd no longer be able to get approved for a new policy.

Convertible life insurance

A convertible term life insurance policy is one that can be turned into a permanent policy at the end of its term or at some other predefined time. Converting a policy normally doesn't require you to requalify for coverage and you won't have to take another health exam. This can be a good option for people who want a permanent policy in the future, but who can afford only term right now.

1035 exchange

A 1035 exchange is a way to turn one permanent life insurance policy into another without being taxed on the financial gains in the old policy. Like many important financial tools, it's named after a section of IRS code.

The big deal with 1035 exchanges is that you can earn money inside a life insurance policy, tax-free, and then use that money to purchase another policy without having to pay tax on the gains. This makes it easier to move from one policy to another later in life while maintaining the tax benefits of life insurance. 1035 exchanges actually cover more than just life insurance, and you can use them to convert annuities and endowments as well.

Paid-up life insurance

Paid-up life insurance is coverage that doesn't require a premium payment. You'll most often see the term in relation to dividend payments, which can often be used to purchase small, paid-up plans to add on to your existing coverage. As a result, you can increase your death benefit without increasing your premium payments.

Modified endowment contract

A modified endowment contract, or MEC, is a financial instrument with similarities to life insurance but with many important tax differences. The reason you'll hear about MECs is that a life insurance policy can turn into a MEC if it's funded too quickly. Policies have to pass the "seven-pay" test, which means keeping payments under a certain amount for the first seven years of the policy.

Your insurance company will let you know if you're in danger of crossing the MEC threshold, and this is a concern only for quickly funded, permanent life policies. If a life insurance policy becomes a MEC, it can't be reversed and you'll lose a lot of the tax-free borrowing benefits that come with life insurance