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Determining the Need for Life Insurance: How Much Is Enough? (General Discussion)

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- What determines your life insurance need?
- Methods of calculating life insurance need
- Insurance mistakes

What determines your life insurance need?

Life stages and circumstances

When determining your life insurance need, you should first consider your life stage and circumstances. Marital status, number of dependents, size and nature of financial obligations, your career stage, and your intentions to pass on your property are all factors to consider. Your need for life insurance changes as the circumstances of your life change.

Starting out

In the "starting out" stage of life, you may be just beginning your career or family. You may not have children or other dependents at this stage, but that doesn't mean you have no obligations. For instance, if you paid for your college education with student loans, you likely had a cosigner for your loan−−maybe your parents or a grandparent. The same may be true of your car loan. If you were to die before the loan is paid, your cosigner would be obligated to pay the debt. Under law, a cosigner is responsible for full payment of a debt in the event of default. Death doesn't erase the debt obligation.

Single adult

A growing percentage of the population now falls into the single adult demographic group. This group covers a broad spectrum of ages, lifestyles, and obligations.

Family obligations−−Parents

Although you may not have a spouse, your death could have a serious financial impact on other family members. If, like many adults, you are supporting your parents (either financially or with care), your death could have a major impact, both emotionally and financially. They would not only lose the support you have been providing to them, but they would also need to come up with the money for your final expenses.

Family obligations−−Children

If you are a single parent, the primary financial support for your children would die with you. If you are lucky, you may have family members who would step in and help your children if you died. If

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you are even luckier, they will be able to provide your children with the education and lifestyle you had hoped for them to have. Your need for life insurance as a single parent is even greater than that of a dual−parent, dual−income household, which would still have one income if one parent died. Life insurance is a cost−effective way to make sure that your children are protected financially should anything happen to you.

Debt obligations

In this stage of life, you may still be paying for or even still accumulating education loans. You may have purchased a house or condo with a cosigner. If you died, your cosigner would be legally liable for the payments on the debt.

Protect your insurability

Another reason to buy life insurance at this stage of your life is to protect your future insurability. Once you buy a permanent, cash value life insurance policy, it remains in effect for your entire life (assuming the premiums are paid), even if your health changes. If you were to experience a serious change in health, you might not be able to buy additional insurance coverage, but you would still have the permanent coverage you already own.

Dual−income couple or family

If you and your spouse both earn an income, it is possible that if one of you died, the other may be able to cope financially on the remaining income. If there are mortgages, joint credit cards or other debt, or children in the picture, the loss of one income could be much more difficult to overcome. The more people who depend on your income while you are alive, the more life insurance you should own. If you died today with insufficient or no insurance, your mate could be forced to give up the residence or lifestyle for which you have both worked. When there are children involved, the loss of one breadwinner could mean a setback in the daily way of life, not to mention any plans for private school or college.

Parent of grown children

Just because your children have grown up and left the nest doesn't mean you have no need for life insurance. You may have spent your entire adult life building an estate that you intend to pass on to your children, grandchildren, or favorite charity. You can use life insurance to ensure that the bulk of your estate passes to your heirs or designated charitable organization subject to certain tax advantages.

Part of overall financial planning

Determining your life insurance needs should not be done in isolation. Instead, it should be looked at as part of your overall financial plan, with consideration given to your goals for savings and retirement, as well as tax and estate planning. As your life changes, your financial goals may change, as well as your need for life insurance, making it important to also periodically review your coverage .

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Methods of calculating life insurance need

Several methods are used to calculate the appropriate level of insurance for you and your situation. While they all share common features, some methods strive to be more simplistic, while others involve more sophisticated calculations. Some of these differences are illustrated in the Table of Alternatives. You may want to determine an amount on your own, using one of the simpler methods. This can provide a basis for your discussions with your financial planner.

Insurable interest

Before you begin calculating your insurance needs, it is important to determine insurable interest . Basically, having an insurable interest in a person's life means that you would suffer emotional or financial harm or loss if that person were to die. It is always assumed that you have an insurable interest in your own life. However, to prove an insurable interest in someone else's life, you must have a relationship to that person based on blood, marriage, or monetary interest. You must have an insurable interest before you can purchase an insurance policy.

Family needs approach

The family needs approach is one of the more comprehensive methods of calculating your life insurance needs. It assumes that the purpose of life insurance is to cover the needs of the surviving family members. This method takes into account the immediate and ongoing needs of the surviving family members, as well as income from other sources and the value of assets that could be used to help defray the family's expenses (such as bank accounts and real estate).

Capital retention approach

The capital retention approach is one of two calculation methods under the family needs approach. This approach assumes that life insurance principal will support the family indefinitely into the future. Because you will purchase more life insurance under this method, you will be in a better position if the surviving spouse lives longer than expected.

Capital liquidation approach

The capital liquidation approach is the second of two calculation methods under the family needs approach. This method does not provide as much continuing capital for the surviving spouse or for heirs after the death of the surviving spouse. However, it does allow you to spend less money by purchasing a lesser amount of life insurance coverage.

Estate preservation and liquidity needs

The estate preservation and liquidity needs approach attempts to determine the amount of insurance needed at death for items such as taxes, expenses, fees, and debts while preserving the value of the estate. This method considers all the variables of family lifestyle and the total cash needed to maintain the current value of the estate while providing adequate cash needed to cover

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estate expenses and taxes.

Income replacement approach

The income replacement calculation is based on the theory that the purpose of insurance is to replace the loss of your paycheck when you die. This analysis determines an economic or human life value and factors in salary increases and the effects of inflation in determining the appropriate level of coverage. While more comprehensive than the rules of thumb, this method still fails to consider special circumstances or financial needs and operates on the premise that the current level of income provides a satisfactory standard of living that will remain level throughout the future.

Rules of thumb

The rules of thumb are extremely basic calculations. They provide a starting point but fail to recognize special family circumstances or needs and focus only on the most basic components. One rule of thumb dictates that multiplying your salary by a certain number will provide an adequate level of insurance, while another calculates need based on normal living expenses.

Insurance mistakes

No insurance

The worst mistake you could make concerning life insurance is having a need and not having any insurance at all. Very often, people can find all sorts of excuses for not buying life insurance. It's no fun to plan for your death, for one thing. For another, there's the tendency to think that dying won't happen to you, only to some person you read about in the obituaries. But how many times have you heard about a young, apparently healthy person dying suddenly in a car accident, leaving behind a spouse, a young child, and no insurance? Sadly, it happens, and when it does, the family faces not only emotional trauma but possibly an extremely difficult financial situation, as well.

Not enough insurance

The majority of people with insurance are underinsured. Insufficient coverage can occur as a result of buying what is affordable instead of what is needed. Failure to review your coverage periodically could also result in insufficient insurance, even if you started out with adequate levels. Inflation rates, your career, and your lifestyle may have changed. Your family could be faced with a large financial gap and left unable to maintain the current lifestyle if you died today. Consequences could include loss of the family home, scaling back of college plans, and possibly years of financial difficulty.

Too much insurance

If you purchased a large policy during one point in your life and then didn't adjust your coverage when your insurance need was reduced, it is possible that you have too much life insurance. This is another good reason to periodically review your coverage with your financial planning professional.

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Periodic reviews of your insurance coverage can reveal opportunities to change your levels of coverage to match your current and projected needs.

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