

How much life insurance do I need?

The question

“How much life insurance do I need?” is a critical question. The answer will vary depending on personal circumstances and how the individual responds to these questions:

- Will I leave debts behind that my family will have to pay?
- How much will my final expenses be (medical expenses, hospital bills, funeral costs, etc.)?
- Is there a mortgage to pay off if I die, or do I want to provide funds for continuing mortgage or rent payments?
- Do I want to provide an education fund for my children?
- Should I accumulate an emergency fund?
- What ongoing income needs will my family have?
- Where will the money come from to pay expenses?
- Will Social Security help if I die prematurely?
- How much life insurance do I own now?
- Is my insurance limited term insurance or permanent?

Cash needs

- The appropriate amount of life insurance depends on the cash and income needs a surviving family would face if a wage earner were to die prematurely.
- The first step is to estimate how much immediate cash survivors would need to pay the expenses associated with death—medical bills, funeral costs, and estate administration expenses.
- Cash needs may also include funds to pay off a home mortgage, retire outstanding debts (car loans, credit card balances, or other consumer debt), and pay any taxes (federal income, estate taxes, and state death taxes) that are due when a wage earner dies.
- Typically, there’s also a need for an emergency fund, and perhaps an education fund.
- Business owners face additional challenges and considerations that extend beyond ordinary family needs for cash.

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How much cash

- Since costs vary from one location to another, it's important to personalize the needed amount based on regional costs and personal desires.
- Funds to pay for a private college or an out-of-state university will far exceed the cost of in-state schooling at a public university.
- One family might have a car loan and considerable credit card debt, while another family might have minimal consumer debt or none at all.
- One family might think an emergency fund should equal six months' salary; another might want more or less.

Ongoing income needs

- In addition to immediate cash needs, families invariably need a source of regular, continuing income or supplementary income for a number of uses.
- Money to replace the deceased's income will be needed to pay day-to-day living expenses—food, clothing, transportation, school expenses, medical and dental checkups, entertainment, gifts, utilities, home and car repairs, and more.
- There may be monthly mortgage payments or rent due on an apartment or condominium.
- Of course, income needs vary greatly and are impacted by factors such as geographic location, how much the deceased was earning, and the standard of living to which the family is accustomed. Since expenses typically increase as income rises, the income needs for families of high earners may be greater than households with more modest incomes.

Making adjustments

- After establishing dollar amounts for cash and ongoing income needs, estimates can be adjusted to determine how much life insurance is enough.
- Clearly, existing life insurance reduces the need for new insurance. For example, when \$100,000 is needed for an education fund and there is existing life insurance in that amount, this need is met.
- Savings—bank accounts, certificates of deposit, or securities—may also be available to meet identified needs. It is important to note, of course, that funds must be readily available at the precise time the family has a need for money.
- Adjustments can also change the amounts required for ongoing income needs.
- Surviving family members can usually maintain their standard of living with a percentage of the deceased worker's income—65% to 75% is common, since replacement income below that usually means the family will have to adjust its lifestyle.

Other income sources

- In most cases, Social Security will be available if dependent children up to a certain age are living at home.
- For example, assume a family has a \$70,000 income need and Social Security will pay the survivors \$20,000 per year. This leaves an income need of \$50,000 per year for the years the benefit is available.
- Ongoing income from any other source—such as the deceased person's retirement account or the surviving spouse's paycheck—can also reduce the amount required to replace the wage earner's income.
- The final step is to decide the number of years for which replacement income will be needed. Take into account that less income may be needed when children leave home and become self-supporting or the surviving spouse's income increases.

The human life value approach

- Another way to determine life insurance needs is the human life value approach, which looks at the monetary value of a person's future earnings to dependents.
- To calculate the human life value, subtract the amount needed for self-maintenance from the person's net income. Self-maintenance includes all personal expenses as well as income taxes, life and health insurance premiums, and any other personal costs attributed directly to the wage earner.
- The remaining income is considered to be the amount that supports the rest of the family.
- The present value of future earnings is the human life value. This provides a starting point for deciding how much life insurance is needed to replace the income that would be lost if the wage earner dies.

Calculating human life value

- Insurers use different formulas to determine how much income the wage earner would have generated for the family.
- Usually, the tables and rates used to determine the value of a human life are based on variables such as earning potential, inflation, and the projected number of working years.

The bottom line

Finding the answer to "how much life insurance do I need?" begins with a careful examination of current and future needs. It's a solid first step in keeping lifetime responsibilities and objectives intact.

Summary

What needs can life insurance fulfill?

When an individual dies, life insurance provides immediate cash to satisfy needs created as a result of the insured's death, and it can continue to provide for survivors' needs for years to come.

Life insurance can pay final expenses such as medical and funeral bills, estate administration costs and taxes. It can also pay off a mortgage, retire outstanding consumer debts, establish emergency funds, and provide education funds.

Life insurance can also help replace a wage earner's income by providing ongoing income to pay day-to-day living expenses including food, clothing, transportation, school expenses, medical and dental checkups, entertainment, gifts, and incidentals. If the mortgage isn't paid off, the proceeds can also be used for monthly mortgage or rent payments.

The amount needed can vary depending on the geographic area and the individual's income level, lifestyle and personal preferences.

Do cash and income needs alone determine how much insurance I need?

Not necessarily. Immediate cash needs can be adjusted for life insurance already in force, as well as other savings and investments available to survivors. Adjustments can also be made to the income needs by deducting available Social Security income, a surviving spouse's income, pension distributions from the deceased person's account, and other available income.

What's more, surviving family members may not need to replace 100% of the wage earner's income. From 65% to 75% of prior income may be sufficient to maintain the family's standard of living.

Once you have considered these factors and made any adjustments, the next step is to determine the number of years survivors will need the income. Less income may be needed when children become self-supporting or a surviving spouse's earnings increase.

What is the human life value approach?

This method for determining life insurance needs takes into consideration the lifetime monetary value of a person's future earnings projected through retirement. It looks at the income the wage earner spends for self-support and assumes the remaining earnings are spent for the support of the dependents.

This figure is used to calculate the present value of future earnings (also called the human life value). Insurance companies use standardized tables to determine this amount, which can be a starting point for identifying life insurance needs.

Finding the answer to "how much life insurance do I need?" begins with a careful, detailed examination of current and future needs. It's a solid first step in keeping lifetime responsibilities and objectives intact.



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