

Financial Planning Building Blocks: Life Insurance Basics

For many people, life insurance is the best option for transferring the risk of financial loss caused by death. The economic need at death is for cash so that your dependents can pay your final expenses, settle your estate, and continue their lives—without experiencing adverse financial consequences as a result of your death. The money can come from existing assets or from life insurance proceeds. Most people do not have the required assets, so they use life insurance to provide cash when the need arises. As your personal estate increases, you may decide to begin retaining more of the risk yourself. However, it is unlikely that anyone who has dependents of any sort will completely outgrow the need for some life insurance.

Now, the real question is, "How do I determine how much life insurance I should have?" The complete answer to that question is best left up to an in-depth discussion between you and a competent life insurance professional. However, there *are* a couple of methods you can use to arrive at a general answer to this question: the income-based method, and the needs-based method.

The income-based (human life value) method requires the use of a financial function calculator, and provides only the most general estimate of life insurance needs. The income-based method uses five basic steps to determine a person's human life value.

1. Estimate future average annual earnings.
2. From these future earnings, subtract income taxes, Social Security taxes, insurance premiums, and personal living expenses. This shows how much income the rest of the family actually uses. This would be the annual payment needed at the beginning of each year (pmt).
3. Decide how many productive years (n) the individual has left (i.e., until retirement).
4. Determine an appropriate discount rate (i) for the future earnings (you may want to review time value of money concepts).
5. Compute the present value. Use the annuity due mode so that the individual can start withdrawing money immediately upon receipt of the life insurance proceeds.

An example may help illustrate. Using the income-based, human life value approach just described, determine your need for life insurance. What do you estimate your average annual earnings will be in the future? (We'll assume \$100,000 for calculation here.) Deduct all taxes, FICA, insurance premiums, and personal living expenses. (We'll use \$25,000.) How many years do you have before retirement? (We'll use 15 years.) What is the discount rate? (We'll use 7%.)

For this example, the income-based need for life insurance is \$730,910. Are you surprised by the amount? Remember that your needs will likely change year by year as you get older, children are born and grow up, etc.

Needs-based methods try to determine the needs of the income earner's dependents, and provides a more specific estimate of life insurance needs. While actual needs will vary from family to family and situation to situation, five basic areas apply in most situations.

- final and fixed expenses (burial, unreimbursed medical, estate settlement, mortgage elimination, bequests, education, etc.)
- income for the readjustment period (to provide for a gradual adjustment to the family's standard of living)
- dependency period income (while the children are still at home)
- life income for the remaining spouse (after the children are grown)
- retirement needs for the surviving spouse

The actual process is a bit more involved than can be discussed in this article, but you can do the basic calculations. After determining the needs, you need to find out what assets are available from existing sources (other than life insurance). The difference between the needs and the available assets is the basic insurance need.

Many individuals, especially those with children at home, need much more life insurance than they initially believe they need. A discussion with a competent life insurance professional probably will help you determine the best way to proceed, but term insurance often is a good way to get a lot of insurance coverage for the fewest dollars (for now, but prices will rise as you get older). The worst way to proceed is to do nothing, and potentially leave your dependents on their own. Why not evaluate your life insurance needs today?

— Michael Snowdon, CFP®