

Life Insurance: Calculating Life Insurance Needs

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Overview

How much life insurance do you need? This publication will help you determine if you need life insurance, and if so, how much you need.

Think about Your Goals

The first step to finding out how much life insurance you need is to think about your goals for life insurance. Think about what would happen if you were to die unexpectedly.

- Do you have a mortgage or other debts that you would like paid off at your death?
- Would you like to make sure that someone who is financially dependent on you (i.e., a spouse or child) has enough income if you die?
- Would you like to make sure that a child has enough money to go to college?
- Do you have enough in assets set aside to cover your final expenses, such as funeral and final medical expenses? If not, would you like to provide some money to cover these expenses for your family?
- Do you have any other goals for friends or family or charitable organizations for which you would like life insurance to provide a benefit?
- Is your net worth large enough that there may be substantial estate taxes when you die? Do you have cash to cover these taxes or are your assets mostly in property such as a farm or small business that you would prefer that your heirs not have to sell?

If you find that you answer “yes” to any or all of these questions, then you may want to think about buying a life insurance policy. The next step is to apply a dollar amount to each of these goals.

Paying Off Debts

To ensure that your family has enough money to pay off your debts, the easiest way may be to buy a life insurance policy that will pay a benefit equal to the amount of your current debts. If, after you buy a life insurance policy for this amount, you find that your debts have decreased, then you may want to periodically lower the amount of your life insurance or keep the policy and use it to cover funeral and other final expenses as well.

Example: Let us assume that Bob has a mortgage of \$50,000 and credit card debts of \$5,000 that he wants to be paid off if he dies.

To cover this goal, Bob knows he needs a life insurance policy with at least a \$55,000 death benefit.

Providing Income

To provide income for other family members in the event of your death, consider the following:

- How much income do you wish to provide (per year)?
- How many years do you wish to provide this income?
- Will your family members receive any other income (such as Social Security) so that you can lower the amount you provide with life insurance?



The simplest way to calculate this need is to multiply the annual amount of income needed by the number of years. To obtain a much more accurate figure, you can calculate a present value of this amount that includes the interest rate that your family is likely to earn, and adjust the figure for the inflation rate that you expect. However, making adjustments using interest and inflation rates may require a financial calculator. You may want to ask your financial or insurance advisor to help you with calculations like these, or you can use the tips for these calculations later in this publication.

Example: Let us assume that Bob would like to leave his family with \$20,000 per year for 10 years if he dies. Inflation is 3 percent and Bob feels that his family can earn a 6 percent rate of return. Bob also expects that his family will receive \$5,000 per year from Social Security. In this case:

The present value of (\$20,000 - \$5,000) = \$15,000 for 10 years, adjusted for interest and inflation = \$132,269.

Planning for a Child's College Education

Planning for a goal, such as paying for college tuition, is similar to the income goal above. However, to plan for the amount of death benefit you need to fund a goal that is in the future, such as a college education goal, it is important to consider that inflation may dramatically increase the amount of money needed. You may want to talk to a financial or insurance advisor about the amount your family would need to pay for a college expense in the future.

Example: Let us assume that Bob wants to pay for 100 percent of his 8-year-old child's four-year education at a public university when she reaches age 18. The current cost of college is \$15,000 per year and this amount is increasing by 7 percent per year. Bob feels that his family could earn a 6 percent rate of return on their college education savings.

Using a financial calculator, the present value of this amount is \$66,845.

Final Expenses

Many people feel more comfortable when they know that their families will not be burdened with the expenses associated with a funeral and attorney's fees.

These expenses can vary substantially, but most may average between \$2,000 and \$25,000.

Example: Let us assume that Bob expects his final expenses will be \$10,000.

Medical Expenses

A lengthy stay in the hospital can cost a lot of money. If your hospital stay results in your death, then someone else may need to cover your final medical expenses. It is impossible to predict what medical expenses may be. If you have a comprehensive health insurance policy or if you are on Medicare, then most of your medical expenses should be covered, but you may wish to set aside some additional life insurance funds to help pay for any medical expenses not covered by your health insurance such as deductibles and co-pays.

Example: Bob chooses to purchase an additional \$10,000 to help cover any of these expenses.

Estate Taxes

The estate-tax system is very complicated and beyond the scope of this publication. If your net worth is substantial (over \$1,000,000) then you may wish to consult a financial advisor about your possible estate taxes, and how life insurance may be used to help protect your assets from these taxes.

Putting it all Together

Your personal goals for life insurance should help you decide how much life insurance to purchase. If you have some or all of the goals listed above, and do not have enough assets or current life insurance to cover them, then you may wish to talk to a life insurance agent about purchasing a policy.

Example of a policy size for Bob:

Pay off debts	\$ 55,000
Provide income	\$132,269
Provide education	\$ 66,845
Final expenses	\$ 10,000
Medical expenses	\$ 10,000
Total	\$274,114

Note that if Bob has any other life insurance or assets that he wishes to use for these goals, he could lower the size of the policy that he plans to purchase by these amounts.

How Can I Find Out the Present Value Calculations for My Goals?

If you have a financial calculator, you may be able to calculate the present value of your income goal and other goals like education. However, there are present and future value calculators available on-line at <http://www.uic.edu/classes/actg/actg500/pfvatutor.htm>.

On-Line Life Insurance Need Calculator

Instead of calculating values yourself, it may be easier to just use an insurance need calculator. These calculators will calculate values for you. Check out http://moneycentral.msn.com/investor/calcs/n_life/main.asp.

Monitor Your Goals

Once you decide on the policy size you need and purchase it, be sure to re-evaluate your goals and your life insurance needs at least once every five

years or when you have a significant life event (i.e. marriage, divorce, inheritance, job change, birth of a child, just to name a few). If your life insurance no longer fits with your goals, then think about taking some action. You may be able to lower your coverage (and lower your premiums) if you find that you have too much insurance. On the other hand, if you find that your goals have increased, and your current life insurance is no longer adequate, you may be able to purchase more insurance to ensure that all your goals are covered.

Life insurance can be a good asset, so be careful when it comes to lowering your coverage.

Conclusion

If you think about your goals for life insurance, then you can probably determine how much life insurance you need. However, it is still wise to talk to your financial advisor or insurance agent to get a professional opinion. They may be able to help you see strategies or point out gaps that you may have missed.

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