

Developing a Financial Plan Step 3 in the Financial Planning Process “Determining How Much Life Insurance You Need”

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There are two purposes of life insurance: 1) Protect your surviving family members from the financial and social stresses of your premature death. 2) Provide cash at your death to pay estate taxes and other expenses that would otherwise diminish the value of your estate and the standard of living for your survivors.

There are many methods and combinations of methods used to quantify the amount of life insurance you need. The Life and Health Insurance Education Foundation has a calculator on their website at www.lifehappens.org/life-insurance/life-calculator. We recommend the use of this calculator, but recognize that it is just one method for calculating the life insurance need.

Here are examples of 3 additional approaches using a hypothetical family with 2 young children: John is a plumber making approximately \$50,000 per year and Jane recently became a full-time 4th grade teacher. They have a monthly income of \$6,500. John, age 36, earns \$4,100 and Jane earns \$2,400 per month. They have 2 children ages 6 and 8. Their debt includes a \$125,000 mortgage and a \$12,000 car loan. They estimate the total cost of college at a state supported school (in today's dollars) is \$60,000. They estimate final funeral and medical expenses of \$25,000. Jane has created a budget for the family, so she has a good feel for the family's fixed expenses. In the event of John's premature death, she estimates that she would need \$2,000 per month (in addition to her salary) to maintain the household (after the debt is paid off and college is fully-funded). A recent Social Security benefits statement indicates that Jane would receive \$1,200 monthly for the next 10 years if John died this year.

Here is a look at the use of the three methods in determining the amount of insurance needed to protect this family in the event of John's premature death.

1. The replacement method –

This method attempts to pay off all of the debt and fixed future costs that the family will incur and provide income to the surviving spouse. Add together:

- Outstanding debt and fixed expenses (mortgage, credit cards, and car loans), estimated costs of college for your children.
- One-time funeral and final expenses (includes estimated outstanding medical bills).
- Present value of the estimated amount of monthly income needed by the surviving spouse.

This calculation results in a life insurance need of \$858,000

2. The human life value method –

This method attempts to replace the current and future earnings of the deceased. Variations to this approach are used in wrongful death litigation. This projects the person's future earnings, until retirement, and then discounts it back to the present. In this calculation we will assume that John will have a 2% increase in pay annually and the earnings rate averages 4% over the time period.

This method quantifies a life insurance amount of \$ 1,133,913.

3. The times earnings method –

This simple method attempts to use a multiple of personal earnings to determine the amount of insurance needed. The recommended amounts are 12 times earnings for couples with no children and 20 times earnings for households with children. This method would quantify the life insurance need at \$1,000,000.

Many couples enter retirement today with a substantial amount of debt and uncertainty about health care costs. The replacement method (listed as #1 above) is a good calculation for seniors to use to determine their life insurance need. Generally, the minimum amount of life insurance needed for a retired person is equal to the amount needed for final medical and burial expenses, plus a lump sum needed to replace the income of the deceased spouse.