How Much Life Insurance Do You Really Need?

Some people equate life insurance with tragedy and death. In truth, life insurance is for the living. Without it, the sudden demise of a key breadwinner could leave a family stranded without the resources to maintain their lifestyle - or even retain their home.

Not so long ago, experts recommended that families carry a life insurance policy with a death benefit of between five and seven times their annual household income. Today, however, in light of rising house prices in many parts of the country and spiraling college costs, most advisors now recommend eight to 10 times income.

Unfortunately, most American families are underinsured. According to statistics from industry research and consulting firm LIMRA International, the average American household carries just $126,000 in life insurance - approximately $300,000 less than they actually need - and only 61% of adult Americans have life insurance protection, a decline from 70% in 1984.1

A Cornerstone of Sound Financial Planning

Financial experts generally consider life insurance to be a cornerstone of sound financial planning, for two key reasons. First, it can be a cost-effective way to provide for your loved ones after you are gone. And second, life insurance can be an important tool in the following ways:

1. Income replacement - For most people, their most valuable economic asset is their ability to earn a living. If you have dependents, then you need to consider what would happen to them if they could no longer rely on your income. A life insurance policy can also help supplement retirement income, which can be especially useful if the benefits of your surviving spouse or domestic partner will be reduced after your death.
2. Pay outstanding debts and long-term obligations - Without life insurance, your loved ones must shoulder burial costs, credit card debts, and medical expenses not covered by health insurance using out-of-pocket funds. The policy's death benefit might also be used to pay off a mortgage, supplement retirement savings, or fund college tuition.
3. Estate planning - The proceeds of a life insurance policy can be earmarked to pay estate taxes so that your heirs will not have to liquidate other assets to do so.
4. Charitable contributions - If you have a favorite charity, you can designate some or all of the proceeds from your life insurance to go to this organization.

Determining How Much: A Four-Step Process

Determining how much life insurance coverage you need is a four-step process:

Step 1: Determine Your Family's Short-Term Needs

Short-term needs are financial obligations and/or expenses arising within six months of death. Examples of short-term needs include expenses you pay now such as:

- Loan balances (automobile loans, etc)
- Outstanding credit balances (credit cards, revolving lines of credit, etc)
- Mortgages (first and second mortgage, home-equity loans, lines of credit)

Add to these current expenses any death-related expenses that must be paid in the short term:

- Funeral expenses

- Final medical costs
- Estate settlement costs and probate
- Estate taxes due
- Charitable bequests you would like to make upon your death

If you don't already have one, your survivors should be left with a liquid emergency fund sufficient to get them through any unexpected financial needs. Most advisors recommend between three and six months' worth of living expenses.

Step 2: Determine Long-Term Needs

In addition to covering your survivors' short term needs, some level of monthly income will be needed to maintain their current standard of living and meet financial goals such as saving for retirement and funding college for children.

The value of these future obligations is discounted back to present value amounts to provide a dollar amount that, if invested, could provide an adequate income stream to fund all of your long-term goals.

Step 3: Calculate Your Total Available Resources

By this point, you should have a good idea of your family's total cash needs in the event of your untimely death. With any luck, you have already begun to set money aside to cover some of these costs. Other resources that may be available to your family include pensions, annuities, funds from retirement accounts, employer-provided life insurance, and Social Security.

The Social Security program offers benefits to survivors under age 17, and those whose spouses were receiving retirement income from Social Security can also count on survivorship benefits.

The total value of these future resources is discounted back to present value amounts. This gives us a single dollar amount that we can use to offset your total needs.

Step 4: Provide Funds To Cover A Shortfall

In most cases, comparing total needs to total resources will result in a shortfall. That's where life insurance comes in. Without it, your survivors will be left with the choice of either finding or creating additional resources (such as having the surviving spouse return to work) or experience a decline in the quality of their lifestyle.

Life insurance is uniquely suited for covering such a shortfall. It is a means of sharing the financial risk of premature death with many, many others who have similar concerns.

You pay a relatively small premium to an insurance company in exchange for their promise to pay your beneficiaries a specified death benefit in the event of your death. You may find it ironic that a financial need arising from death can be alleviated by a financial resource that is created after death. That's why life insurance, although something no one hopes to ever need, is indeed for the living. It's also a vital issue we can help you investigate in greater detail to ensure your family's financial future will be protected.

1. "Life Insurance Awareness Month," LIMRA International, August 2004