How Much Life Insurance Should You Buy?

Most methods of determining how much, and what type, of life insurance a client needs are imperfect

NOVEMBER 26, 2014

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There are several methods an advisor can use to determine the correct amount of life insurance a client needs. It's equally important to recommend the appropriate type of insurance. However, most methods tend to fall short of what I would consider ideal. In this article, we'll discuss an alternate method which is integrated into the financial plan. I believe it will provide a more accurate assessment of the amount *and* type of insurance needed.

Traditional Methods

Here's an overview of a simplified, two-step process used to calculate the insurance needs of an individual. Again, this is very simplified.

1) Determine the lump sum needed at death to meet all immediate obligations.

2) Calculate the net present value of the future income that will be lost or needed at death.

Here's another method which is more detailed.

1) **Gather data for:**

a) Current annual income

b) Spouse's annual income

c) Retirement age

d) Expected investment return

e) Expected inflation

2) **Determine immediate needs:**

a) Funeral expenses

b) Final expenses

c) Debt balances

3) **Determine long-term income needs:**

a) Annual income desired

b) Years income will be needed

c) Other needs (e.g., college funding)

4) Subtract available resources:

a) Current investments

b) Existing life insurance

c) Social Security retirement benefit

d) Children's ages

Although this second method is more involved, it still fails to address the total picture. Let's consider a better way to make this determination.

A Better Process

The former methods are fine if the advisor is merely trying to get from Point A to Point B quickly and make a sale. Even if this approach accurately determines the amount of life insurance needed today, what about the future need? In short, does the life insurance need of clients change over time?

The answer is yes. However, to determine the life insurance needs in the future, the advisor would have to meet with the client on a regular basis and repeat the process we discussed above as "Traditional Methods." This can pose a problem.

For example, what if the client becomes uninsurable? Though I'm in favor of reassessing needs periodically, the determination of a client's future needs should be made at the onset. This will help avoid potential problems that may emerge. Let's look at the solution.

As I mentioned, it starts with a financial plan. Upon completion, the plan should forecast the individual or couple's ability to retire without running out of money. This is the starting point. To assess the client's insurance need, you'll need to prepare a survivor analysis. To do this, you'll have to modify the initial plan. Here are some issues to address:

1) Modify the budget, reducing it to compensate for the loss of one spouse.

   Note: It's best to have the client complete a revised budget to attain a more accurate assumption. Will debts be retired? How much will entertainment, gas, food and clothing expenses change? Will the surviving spouse go back to work or continue working? Are there dependent children in the home? These are just a few of the adjustments to make.

2) Modify the income sources to reflect what the survivor will receive.

   <u>Example:</u> *If the deceased had a pension, will the surviving spouse receive a survivor benefit? If the deceased was receiving Social Security (or was eligible), will the survivor receive a widow's pension? If so, how many years until it begins? What if the surviving spouse worked for an employer that did not pay into Social Security? This will reduce or possibly eliminate the survivor's Social Security benefit*

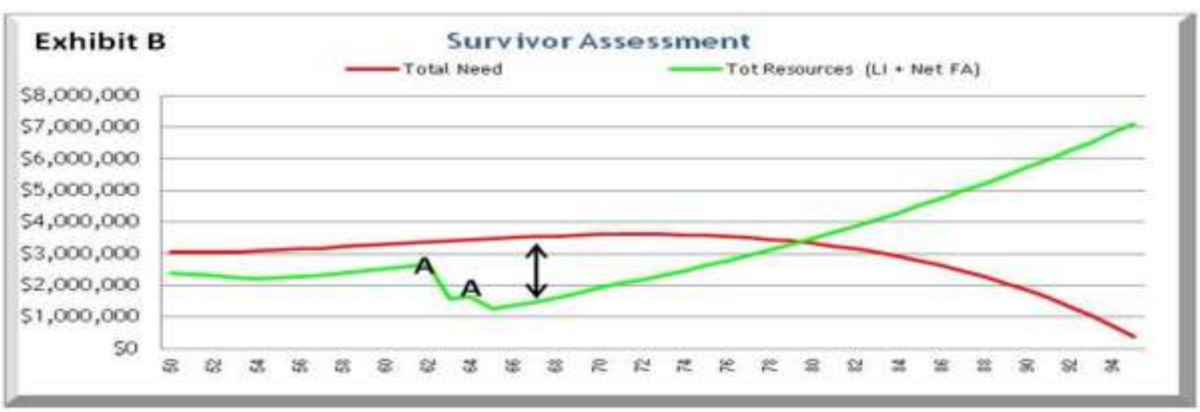
due to the Government Pension Offset. In addition, if the deceased was contributing to an employer-provided retirement plan, these contributions need to be removed from the financial plan. In short, the financial plan must be modified to reflect the death of one spouse.

After creating the survivor analysis, you should have a projection showing the cash flow in all future years. Assuming there are shortfalls, the next step is to calculate the net present value of each shortfall. This computation will produce the lump sum the survivor will need today (Exhibit A).

In Exhibit A, the shortfall indicated is $162,081 ($3,054,035 - $2,891,954). In short, if the client had an additional $162,081 today and the plan assumptions held true, they would be able to fully fund all future shortfalls. In future years, the lump sum needed will change.

For example, as the years progress, the time horizon or life expectancy of the survivor is shortened. This reduction argues for a smaller lump sum in future years. In contrast, inflation suggests the lump sum need will increase. However, in the end, the time horizon prevails. This is reflected in Exhibit B.

The green line includes the total resources such as all financial assets and life insurance proceeds. The red line is the net present value of all future shortfalls for each subsequent year. In the example below, the client has two term policies. One will expire at age 62 and the other at age 64 (point A in Exhibit B). The expiration of the term policies causes a drop in the resources available to the survivor. The gap between the green and red lines indicates a need for additional resources. This may be met with a 30-year term policy. By age 80 the resources should be adequate and the term policy would be expired.



Conclusion

This analysis compares the total resources to the lump sum needed today and each year until the client turns age 95. It factors in inflation as well. Financial planning tools have made remarkable advances in the past decade. However, I've yet to see one that does this. Perhaps we will in the future. If you have any questions on this, you may contact me through my website: www.integritywealth.us