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## Determining Life Insurance Needs

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In 1979, 86 percent of American families owned some form of life insurance.<sup>1</sup> This indicates that families consider life insurance very important for financial security. A major concern is, of these families, how many bought the programs they have and how many were sold the programs by an agent? Since it is such a significant financial decision, life insurance should be purchased like any other major item.

For example, consider a car purchase. When buying a car, a family goes out, with values and needs in mind, and does comparison shopping. When a car is found that meets the values and needs, and the price is right, the purchase is made. On the other hand, all too often, life insurance salespersons contact the family. Meetings are arranged. Agents show the families policies that they think will meet their needs. This often results in the sale of an insurance policy. This should not be the case. Consumers may well be the losers in such situations. Consumers should determine their needs and shop for insurance; they should be informed buyers, rather than uninformed "sellees." Consumers need to consider many factors to enhance their position in the life insurance market.

### **Who Should be Covered?**

In order to get an idea of who should be covered is ask this question. What financial impact would the death of any family member have on the survivors? Different answers would be given for each individual in the family. The death of a young child would result in minimal financial loss. Only burial expenses would be incurred. Also, the death would free up a large amount of resources that would have gone toward raising the child. This may sound like an insensitive way

of looking at death, but is necessary when evaluating life insurance needs.

Separate emotions and economics. Life insurance cannot replace the personal loss felt by the death of a loved one. However, it can alleviate much of the stress created by the loss of income and services of that individual.

To illustrate how families might determine a response to the question of coverage, several cases are examined below. It should be noted that the death of any family member reduces living expenses of the family.

What about a homemaker? The answer depends on whether there are children in the home. If there are not, then the working spouse could probably assume the responsibilities of the deceased person. However, if there are young children, you need to consider the replacement value of the homemaker's responsibilities in addition to funeral expenses. If these responsibilities would be above the resources available on a regular basis, life insurance coverage should be considered. The amount should be limited, however, to what would be adequate until the children reach an age when they could assume some of the homemaker's responsibilities.

Is it necessary for a single person to have life insurance? If this person has no financial dependents, the answer is almost always no. Even though insurance agents have a battery of reasons why such a person should be insured, the answer still rests upon financial dependency. Often agents argue "life insurance is needed now to insure against an uninsurable future." However, very few people are uninsurable. And it may be that a single person may never need to be insured.

Probably the person cited most frequently as needing to be insured is the family wage earner,

especially in a single-earner family. In a two wage-earner family, life insurance needs would be reduced. Need would depend upon the extent to which the family's budget relies on income from the second earner. If income from both earners is necessary to meet budgeted demands, then life insurance should be considered for both. If the budget demands could be met to some level of satisfaction without the second earner's income, then life insurance on the second earner may not be necessary. The family may have to reduce their level of living at the death of one of the wage earners. Yet, they are not as financially vulnerable as the one wage-earner family.

Be it male or female, death of the person who brings the money home is going to have the greatest financial impact in a one wage-earner family. This results in the immediate end of income in addition to death-related expenses. The severity of the impact would depend on the number of financial dependents in the family. If the family consists of only the wage earner and a spouse, there might be little impact, depending on the spouse's ability to get a job. However, in a family of two young children and a spouse, the financial impact would be greater. A multi-person family is most financially vulnerable (if the wage-earner died) at the time of conception of the last child. That is when the greatest amount of dependency exists for the greatest number of family members for the longest period of time.

Therefore, the question of who should be insured is relatively easy to answer. First, the answer depends on an answer to the question, "What financial hardship would a family suffer at the death of a family member?" According to examples cited above, life insurance should be seriously considered when there are financial dependents. The most financially vulnerable time in a family's life is at conception of the last child.

### **How Much Life Insurance Should be Bought?**

Since a few guidelines have been established regarding who should be covered, the next logical question will be, "How much life insurance should be purchased?" It seems that such a simple question should have a simple answer. Such is not the case. The answer comes in many parts. But, two general parts can give an idea of what to consider—they are projected expenses and projected income.

In terms of expenses, consider daily living expenses, balance due on mortgage and other outstanding debts, financial goals (for example, college expenses for children), and final expenses (for example, funeral and estate-transfer expenses).

With income, consider earning potential of remaining family members, a house or other real estate (which might be liquidated at the death of a family member), savings, income from Social Security, personal property, and income from any other assets. It is necessary to consider many factors before determining how much insurance will be needed.

**Yearly Expenses**—Perhaps most important are family living expenses until the youngest child reaches 18. Food, clothing, shelter, health care, entertainment, and other living expenses need to be considered. A yearly estimate should be used for each year up to the 18th year of the last child. As pointed out earlier, these family expenses will be reduced by the amount that was needed by the deceased member. Inflation should be figured into each annual amount.

Next are expenses for college education. An adequate sum of money may be needed to send children or even the surviving spouse to college. If such is the case, estimates of college expenses need to be figured into income needs. Living expenses for the surviving spouse from child-rearing until retirement should also be considered. This period begins in the year following the 16th birthday of the youngest child and continues until the spouse's 62nd or 65th birthday. A surviving spouse may not need to have financial assistance during this time. In many cases the spouse could be employed and self-supporting. If a family feels that the spouse's skills are such that an adequate living could not be made, then an annual amount (adjusted for inflation) should be estimated.

The last category of yearly expenses is living expenses after retirement for the surviving spouse. This determination should be made taking Social Security and other benefits into consideration.

**Lump Sum Expenses**—In addition to yearly expenses, life insurance proceeds may be needed for funeral expenses, uninsured medical costs, probate costs, estate taxes, and, perhaps, charitable bequests. Funeral expenses are generally estimated to be around \$2,000. In the event that death follows a lengthy illness, medical insurance may not be adequate to cover the expenses.

Consumers Union recommends that a family allow an extra \$1,000 for this.<sup>2</sup> Probate is the process by which a court validates a will and supervises the collection of assets, payment of debts and taxes, and distribution of the estate according to instructions in the will (or state law in absence of will). These fees can be estimated at four percent of an estate.<sup>3</sup> Estate taxes are not of concern to many. An unlimited amount in an estate can be passed to a spouse tax-free. Currently, an estate tax credit in the amount of \$62,800 for an individual exists, making it possible to transfer an estate worth \$225,000 tax free to other persons at death.<sup>4</sup> Therefore, if two parents died at the same time, an estate of \$450,000 could be transferred tax free.

**Income**—After you identify the expenses for programming life insurance, an effort should be made to identify income sources. First, estimate all the yearly earnings of surviving the wage-earners. Of course, these will vary from family to family. They may be zero for some years if the surviving spouse feels a need to stay in the home with young children. An accurate estimate needs to consider experience and education of the surviving spouse.

Next, Social Security benefits should be considered. These will be in the form of income for the spouse until the youngest child is 16. Also, each child is awarded a benefit until the 18th birthday. Social Security retirement benefits for the spouse should also be considered. Estimates of all these benefits can be requested at a Social Security office.

Sometimes the survivors are eligible for benefits from the deceased's pension plan. A family should determine if such benefits would be available. The company could probably estimate the yearly benefit. If there is any investment income flow, it should be figured into the estimate of total income.

Finally, if there is property owned and the sale of it is likely at the death of a member, these funds should be considered.

**Determining the Amount of Life Insurance Needed**—So, how much insurance is needed? All of the projected expenses (yearly expenses and lump sum expenses) and all of the projected income (income and other funds available at death) should be considered. Then, the present value of the difference between the future flow of expenses and income must be determined. The amount of life insurance already in force on

the individual should then be considered. This will reduce the amount that may still be needed.

The total lump sum proceeds from insurance would not be needed at one time. It would be advantageous to invest the excess lump sum into a high-return, low-risk savings instrument. Historically, the interest rate has been higher than inflation. As a result of this trend, a family is able to reduce the present value amount of the life insurance sum which is needed. Since the lump sum proceeds earn interest during the income-need period, this interest will provide a portion of the money needed. For example, assume a family needs a lump sum life insurance proceed which will provide \$5,000 a year for 10 years. One might be inclined to purchase a \$50,000 policy. But this is not necessary. The amount that should be bought depends on the rate of interest that can be earned above inflation. For instance, let's say that a decision is made to put the proceeds in an account earning five percent above inflation. If such is the case, \$38,600 would need to be deposited in the account to meet an income need of \$5,000 a year for the next 10 years. The time value of money reduces a family's life insurance lump sum needs by over \$11,000 (\$50,000 minus \$38,600). To calculate the present value of this income need, contact a person with this information, such as your local Family Economics and Management Extension Specialist. Each of these specialists have access to a computer which has been programmed to do these calculations for you.

## References

<sup>1</sup>American Council of Life Insurance, *1980 Life Insurance Fact Book*, Washington, D.C., p. 8.

<sup>2</sup>*Consumers Union Report on Life Insurance*, Consumers Union, Mount Vernon, NY, 1980, p. 48.

<sup>3</sup>*Ibid.*

<sup>4</sup>The estate tax credit for 1983 to 1987 is such that the following amounts can be transferred free of tax: \$275,000 (1983); \$325,000 (1984); \$400,000 (1985); \$500,000 (1986); \$600,000 (1987).

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