Op-Ed: How much life insurance do I need?

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I’ve found that most are rarely excited to allocate any portion of their income toward life insurance. However, most understand that life insurance can provide unique benefits for a variety of scenarios. So while it’s not always fun to add new policies to your financial arsenal, it might be necessary.

But how much life insurance does a person need? Rules of thumb can sometimes be helpful as a starting point, but blindly relying on them could leave you with too much or too little life insurance. The best answer depends mostly on what you want your life insurance policy to provide in the event you become deceased. Here are a few things to think through that will help you determine how much life insurance you may need.

1. Liabilities

A liability is a fancy word for a loan. Liabilities usually come in the form of a house loan (mortgage), a car loan, a student loan, or even credit card debt. If you have loans, it's important to know what would happen to them if you become deceased. Will someone else, like your spouse or parent, be on the hook for your balance?

For example, let's examine student loans. Federal student loans are discharged if the student becomes deceased. The same is true in the case of a (parent) PLUS loan if the student or the parent becomes deceased.[1]

However, if you have a private student loan, it's likely that loan is not going away if you become deceased. In many cases, a student must get a co-signer for private loans. And, in the event the student becomes deceased, that loan is now the responsibility of the co-signer.

A common starting point for people determining how much life insurance they need is to identify the balance of your mortgage. The rationale is to allow a surviving spouse to pay off the mortgage in the event of the first spouse's death. The mistake some make is they stop there, but there are often other things that trigger a need for more death benefit.

2. College Education and Other Considerations

Do you have children or plan to have children in the future? Do you desire to pay for or assist with their college education? Would you be okay with not being able to do this if you become deceased prematurely? If the answer is no, you may want to plan for this risk by adding to your death benefit amount.

College education is not something that is pertinent to every parent, but it is very important to some. If it is important to you, you'll want to not only include the cost of college today, but what the cost would be at that time your child begins college. The increase in average tuition and fees charged by public and private colleges rose between 2.9% and 3.6% in 2017, according to The College Board's annual report, while inflation was only about 2%. [2]

Other considerations may include a desire to pay for a child's wedding or assist with the down payment of your child's first home. The average wedding in 2018 is ranging from approximately $19,000 to $32,000.[3] The median sale price for a first-time home buyer is approximately $182,500, meaning that a traditional 20% down payment would amount to $36,500 in today's dollars.[4] Again, it's important to apply inflation to these values in order to estimate what the future costs would be.

3. Income Replacement

The most significant driver of life insurance is the need to replace a portion of the deceased person's income. There is a common misconception that expenses will decrease by 50% with the death of the first spouse. However, according to the Government Accountability Office, women average a 50% decline in income, but only a 20% decline in expenses upon becoming widowed.[5]

So while your spouse may not need 100% of your income if you become deceased, they still may need a percentage of your salary. Post-death expenses should be estimated to include the potential removal of liabilities that would paid off at the death of the first spouse.

As you attempt to calculate how much income you'll need to replace, you'll also need to decide how long you would like to provide that supplemental income for. Some are in the camp that providing income for a short-term-period (ten years) is sufficient, while others would prefer to provide financial support for 20 or 30 years, or as long as possible.

To get an idea of how to address income replacement, you can steal an old rule of thumb from the retirement planning world. Assuming a 4% withdrawal rate, a $1 million life insurance policy can provide approximately $40,000/year (increasing with inflation) for a period of 30 years for a surviving spouse.[6] You can use a similar methodology to determine the need for shorter time periods as well.

4. Wealth Transfer

While life insurance can be used to pay off liabilities, provide support to children, and create a source for supplemental income, it can also be used to help transfer wealth to the next generation. For those that have accumulated enough wealth that they are projected to leave some behind at their death, they may choose to use life insurance to leave those assets behind on an income tax-free basis.

If wealth transfer is your goal, then you can predetermine the amount you'd like to leave to your heirs in the form of life insurance, and perhaps plan to spend the rest.

Bottom Line

The takeaway here is that although life insurance may not be the most exciting purchase you've ever made, it can help you manage risks that could arise when you become deceased. And, you shouldn't pick a round number or blindly follow a rule of thumb to determine how much you need. Think about what you want your life insurance policy to do for you and build your policy around those goals.

As you go through this process, you'll want to also find a licensed insurance agent that can guide you on the most appropriate type of life insurance policy. An agent that has your best interests in mind will recommend term insurance for temporary risks and permanent insurance for permanent risks.

[1] Federal Student Aid. https://studentaid.ed.gov/sa/repay-loans/forgiveness-cancellation/death

[2] CNN Money. https://money.cnn.com/2017/10/25/pf/college/college-tuition-price-2017-2018/index.html

[3] Cost of Wedding.com. https://www.costofwedding.com/

[4] The New York Times. https://www.nytimes.com/2017/04/21/realestate/first-time-home-buyers-statistics.html

[5] US News. https://money.usnews.com/money/retirement/articles/2008/02/22/planning-for-retirement-after-a-spouse-dies

[6] Investopedia. https://www.investopedia.com/terms/f/four-percent-rule.asp

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