

Figuring Out Life Insurance Needs

Life insurance is an important consideration when putting together a full financial plan.

I find people tend to get this wrong, and it usually gets off the rails because people do not take the time to consider what that need should be.

There is a separate discussion to be had on various types of life insurance products, this will focus on determining if there is a need and provide an outline for figuring out how much that need is given your life.

Do You Need Life Insurance?

Every year I encounter people with life insurance who are excited about having it, but when I ask why they got life insurance, they fail to produce a good answer.

The place to start is by going over the goal of insurance which is centered around protection.

You get health insurance because medical care is expensive. The insurance is there to protect you from a massive bill that cripples your financial goals or leaves you in debt.

The idea behind life insurance is you are getting a policy that protects that value of your life. It's weird to think about the value of our own life, but when we go about determining life insurance needs, that is what we are doing.

You need to figure out who would be impacted if the worst case scenario happened.

For example, if you have a partner who relies on your support, life insurance is a consideration. The scenario could include a partner who is a caretaker for the other partner, if they were no longer around, there would be a cost to hiring someone to administer that care.

Another scenario is a younger couple who is planning to buy a home and have kids. The mortgage and childcare will be difficult for one partner to handle on their own, so the life insurance is there to protect if something were to happen to the other partner.

If you do not have someone relying on your income, and don't plan to be in that position, you may not need a life insurance contract.

Determining The Need

Once you have decided that life insurance is right for your financial plan, it's time to figure out the amount of protection to purchase.

There are a few ways to go about doing this. One is to calculate your expected lifetime income and have the payout reflect that.

If you are 34 years-old, you could try and roughly calculate with inflation how much you will bring in through retirement at age 65.

When I speak with clients, I prefer to take an approach that analyzes the need more specifically.

I want to determine how long we need the life insurance and make the calculation based on that.

For example, let's say the 34 year-old is married with two young kids and has a recently purchased home with a mortgage.

The person has a strong career with solid income, contributes aggressively to a 401(k) plan, and invests a little in a personal account.

We want that life insurance there to protect child care costs and the mortgage, but over time, the need for protection will become smaller.

Their investment accounts will grow with the savings, meaning there's larger pots to leave for the family if something were to happen.

The kids will get older and find themselves in a position where they can provide for themselves.

In this situation, the person can build a life insurance policy that handles the financial need for that specific timeframe. They do not need to calculate income from 34 to 65 years-old, but instead from 34 to 50ish years-old.

When deciding that life insurance payout, evaluate the present assets.

You should also look at what your company offers on life insurance. You can use that to supplement a policy you get outside of work.