How Much Life Insurance Should You Carry?

Life insurance coverage may depend on your financial goals and

Death, just like taxes, is inevitable though most people may not be keen to dwell on it. But ensuring that you have the right financial resources in place, including life insurance, is important if you have loved ones who depend on your income. Life insurance can help cover funeral and burial expenses, pay off lingering debts and make managing day to day living expenses less burdensome for those you leave behind. If you don't have life insurance or you do but you're unsure whether your policy is sufficient, here's how to evaluate your coverage needs.

KEY TAKEAWAYS

- Your financial and family situation will determine whether you need life insurance and if so, how much coverage you should have.
- The younger and healthier you are, generally the less you'll pay for premiums but older people can still get life insurance.
- It may be wise to carry as much life insurance as you need to pay off your debts plus any interest, particularly if you have a mortgage or you cosigned student loans with someone else.
- Your policy's payout should be large enough to replace your income plus a little to hedge against the impacts of inflation on purchasing power.

What Is Life Insurance?

Life insurance is an agreement wherein an insurance company agrees to pay a specified amount after the death of an insured party as long as the premiums are paid and up to date. This amount is called a death benefit. Policies give insured persons the assurance that their loved ones will have peace of mind and financial protection after their death.

Life insurance falls into two different categories—whole and term. Whole life policies are a type of permanent life insurance, meaning you're covered for life as long as your premiums are paid. Some permanent life policies offer an investment component that allows you to build cash value, taking the premiums you pay and investing them into the market.

Term life insurance, on the other hand, covers you for a set term. For instance, you may purchase a 20-year or 30-year policy, depending on your age and how long you need coverage. Some policies allow you to renew your coverage after a certain expiry date, while others require a medical exam to do so. Between term life and permanent life insurance, term life tends to offer cheaper premiums.

Note

A medical exam is a standard underwriting requirement for most life insurance policies, though you may be able to purchase no-exam life insurance at a higher premium cost.

Who Needs Life Insurance?

Life insurance can be a helpful financial tool to have but buying a policy doesn't make sense for everyone. If you're single and have no dependents with enough money to cover your debts as well as the expenses related to death—your funeral, estate, attorney fees, and other expenses—you may not need life insurance. The same applies if you have dependents as well as enough assets to provide for them after your death.

But if you're the primary provider for your dependents or have a significant amount of debt that outweighs your assets, insurance can help ensure your loved ones are well taken care of if something happens to you. Having a life insurance policy could also make sense if you own a business or you owe cosigned debts, such as private student loans, that someone else could be held responsible for if you pass away.

Keep in mind that life insurance by itself doesn't cover every situation. For example, a standard life insurance policy won't pay any disability benefits if you become disabled or cover long-term nursing care costs. But you can purchase disability riders or long term care insurance riders for an additional premium cost that can cover those types of scenarios.

If you're married, both you and your spouse may need life insurance coverage, even if only one of you is primarily responsible for your household income.

Age and Life Insurance

One of the biggest myths life insurance agents perpetuate is that if you've missed the boat if you fail to sign up for a policy when you're young. The industry leads us to believe that life insurance policies are harder to get the older you become. Insurance companies make money by betting on how long people will live.

It's true that insurance is cheaper when you are young. But that doesn't mean qualifying for a policy is easier. The simple fact is insurance companies want higher premiums to cover the odds on older people, but it is very rare that an insurance company will refuse to cover someone who is willing to pay the premiums for their risk category. That said, get insurance if you need it and when you need it. Do not get insurance because you are scared of not qualifying later in life.

Should You Use Life Insurance as an Investment?

It's possible to consider life insurance to be an investment if you have a policy that builds cash value. Cash-value policies are generally touted as another way to save or investing money for retirement. These policies help you build up a pool of capital that gains interest. This interest accrues because the insurance company is investing that money for its own benefit, much like banks. In turn, they pay you a percentage for the use of your money.

But it's important to consider the rate of return you might earn. If you take the money from the forced savings program and invest it in an index fund, for example, you may realize better returns. For people who lack the discipline to invest regularly, a cash-value insurance policy may be beneficial. A disciplined investor, on the other hand, could generate higher returns by putting the money they would pay toward premiums in the market.

If you're consider using a life insurance policy as an investment, check the rate of return and risk profile of the underlying investments to ensure they align with your financial goals.

What Is the Minimum Amount of Life Insurance You Need?

A large part of choosing a life insurance policy is determining how much money your dependents will need. Choosing the face value—the amount your policy pays if you die—depends on a few different factors and as such, the minimum amount of coverage you need may be very different what someone else requires. Financial experts often recommend purchasing 10 to 15 times your annual income in coverage, though your personal number may be higher or lower. Here are some of the most important considerations for choosing a minimum amount of life insurance.

Debt

Life insurance can be used to pay off outstanding debts, including student loans, car loans, mortgages, credit cards and personal loans. If you have any of these debts, your policy should include enough coverage to pay them off in full. So if you have a $200,000 mortgage and a $4,000 car loan, for instance, you need at least $204,000 in your policy to cover your debts. But don't forget the interest. You should take out a little more to settle any extra interest or charges as well.

Income Replacement

One of the biggest factors for life insurance is to replace income. If you are the sole provider for your dependents and bring in $40,000 a year, for example, you will need a policy payout that is large enough to replace your income plus a little extra to guard against inflation.

To err on the safe side, assume that the lump sum payout of your policy is invested at 8%. You will need a $500,000 policy just to replace your income. This is not a set rule, but adding your yearly income back into the policy ($500,000 + $40,000 = $540,000 in this case) is a fairly good guard against inflation. Once you determine the required face value of your insurance policy, you can start shopping around. There are many online insurance estimators that can help you determine how much insurance you will need.

Insuring Others

Obviously, there are other people in your life who are important to you, and you may wonder if you should insure them. As a rule, you should only insure people whose death would mean a financial loss to you. The death of a child, while emotionally devastating, does not constitute a financial loss because children cost money to raise. The death of an income-earning spouse, however, does create a situation with both emotional and financial losses.

In that case, follow the income replacement calculation with his or her income. This also goes for business partners with whom you have a financial relationship. For example, consider someone with whom you have a shared responsibility for mortgage payments on a co-owned property. You may want to consider a policy for that person, as that person's death will have a big impact on your financial situation.

Note

If you're purchasing life insurance to cover a business partnership arrangement, you may want to consider a keyman insurance policy versus traditional coverage.

Life Insurance Needs Example

Most insurance companies say a reasonable amount for life insurance is six to 10 times the amount of annual salary. Another way to calculate the amount of life insurance needed is to multiply your annual salary by the number of years left until retirement. For example, if a 40-year-old man currently makes $20,000 a year, the man will need $500,000 (25 years x $20,000) in life insurance.

The standard-of-living method is based on the amount of money survivors would need to maintain their standard of living if the insured party dies. You take that amount and multiply it by 20. The thought process here is that survivors can take a 5% withdrawal from the death benefit each year—the equivalent to the standard of living amount—while investing the death benefit principal and earning 5% or better.

Alternatives to Life Insurance

If you're getting life insurance purely to cover debts and have no dependents, there are alternatives. Lending institutions have seen the profits of insurance companies and are getting in on the act. Credit card companies and banks offer insurance deductibles on your outstanding balances. This often amounts to a few dollars a month and, in the case of your death, the policy will pay that particular debt in full. If you opt for this coverage from a lending institution, make sure to subtract that debt from any calculations you make for life insurance—being doubly insured is a needless cost.

The Bottom Line

If you need life insurance, it is important to know how much and what kind you need. Although generally, renewable term insurance is sufficient for most people, you have to look at your own situation. If you choose to buy insurance through an agent, decide on what you'll need beforehand to avoid getting stuck with inadequate coverage or expensive coverage you don't need. As with investing, educating yourself is essential to making the right choice.

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