How Much Life Insurance Should You Buy?

Fox Business

How much life insurance do you need?
The answer depends on several factors, including your age, the ages of your spouse and children, your income, your mortgage and other debts, college expenses for your children and/or spouse, and the size of the last bill you'll ever incur: your funeral expenses. Bankrate's life insurance calculator can walk you through the basics.
Life insurance rules of thumb
How much life insurance do you need? Consider these factors:
Your age: Premium rates generally increase with age. If you're young, term life covering a certain number of years) is the cost-effective way to cover your risk and keep your future life insurance options open.
Age of spouse and children: This will help you estimate how many years of income replacement they'll need if you were to die.
Mortgage and debts: Wrap your home mortgage, car loans, student loans and other debts into your life insurance planning.
College expenses: Factor in future education expenses for the kids, and possibly your spouse. Tuition and fees for four-year colleges have been increasing by up to 5.2%, on average.
Your current income: If you've retired your debt and laid aside college funds, you may not need to replace your full income. Some advisers recommend 50% replacement as a starting point.
Funeral expenses: The average cost for a funeral, burial and related expenses runs more than $7,000, while cremation costs range from $2,000 to $4,000. Don't stick your loved ones with the final bill.
Sources: Etti Baranoff, Glenn Daily, Tony Steuer
The primary purpose of life insurance is to provide financially for your dependents when you're no longer around to do so. Since humans don't come with expiration dates and since life by its very nature is all about change, it can be difficult to accurately predict your family's financial need years from now.
"You want them to get through this traumatic event with some palatable options, but that's it," says Glenn Daily, a fee-only insurance adviser based in New York City. "One famous agent once said the goal

of life insurance is to let your family ‘stay in their own world.’ It doesn’t necessarily mean they have to maintain their current lifestyle. Maybe your spouse would decide to do something entirely different.”

To address this guessing game, insurance companies and financial planners have devised models to help you zero in on this perpetually moving target. Three approaches are most common.

1. Multiple of income This industry standard recommends that the death benefit, or payout amount, of your life insurance policy should be seven to 10 times your annual income.

“So if somebody is making $100,000 a year, somewhere between $700,000 and $1 million would be the life insurance amount to keep a family in good shape if this person dies,” explains Etti Baranoff, an associate professor of insurance at Virginia Commonwealth University.

But Daily cautions against putting too much faith in this rule of thumb. “How could you come up with the same number whether you have one child or 10? Or one house or several?” he wonders.

2. Shortfall calculation The shortfall approach works backward from the annual income you would want to leave your spouse and family for X number of years. After you decide on this target number, you then subtract all other sources of annual income that will be available to them, such as your retirement accounts, pension, savings, your spouse’s salary and Social Security. The resulting number is the shortfall you’ll want to replace with life insurance.

“People overlook that they’ll likely have other assets,” says insurance literacy advocate Tony Steuer, author of “Questions and Answers on Life Insurance.” “Right now, you may be just starting to save for retirement, but by the time you actually retire, you’ll have $500,000 or $1 million in your retirement plan, so you may no longer need that $500,000 life insurance policy.”

3. Income generator Some prefer to set their sights on building up a large life insurance investment that would generate earnings to provide a beneficiary with annual income. For instance, $1 million invested using a conservative average annual yield of 4% could provide $40,000 a year to a spouse or family in perpetuity.

“While the need for life insurance is temporary for most dependents, there are exceptions, such as a special needs child who will never be self-supporting, where the need lasts the rest of their life,” says Steuer, who is also the director of financial preparedness for the insurance consumer group United Policyholders.

Daily says that while no single model fits all families, everyone can benefit by test-driving one or more.

“The good thing about looking at the future and not just the present is that you’re going to get some idea of whether your insurance need goes up, down or remains about the same,” he says. “That’s going to have some relevance for what type or combination of insurance you should buy.”

Then, choose the flavor of policy

Once you arrive at a ballpark coverage figure, Steuer suggests letting your individual circumstances dictate whether to use a cash-value whole life permanent) policy, term life or a combination.
“One tactic I recommend is to separate the planning for your spouse from the planning for your children because the timeline for needing coverage may differ,” he says. “If you have a 15-year-old child, then you really only need a 10-year term policy to see the child through college. But if you’re 45 and plan to work for another 20 years, your nonworking spouse is going to need a 20-year life insurance policy, at least.”
All three experts caution against falling for the siren song of cash-value life insurance products that promise big investment returns that you might tap into while you’re still on this side of the lawn.
“That’s one of the main reasons people overbuy,” says Steuer. “You want to strip out all the distracters and address your actual need. Don’t expect something from your life insurance that you wouldn’t expect from your other insurance policies.”
Baranoff puts it even more succinctly: “Life insurance is for widows and orphans.”