Money Mechanics

Life Insurance

THINK FOR A MINUTE—*does anyone rely on you for his or her financial well-being? If you are single or if your spouse has enough income, the answer may be "no." But in most young families, buying life insurance is the only way breadwinners can adequately provide for surviving dependents.*

Life Insurance Protects You

Life insurance protects your family's financial resources when you die. It is a contract between you and an insurance company, requiring the company to pay someone you name—the beneficiary—a certain amount of money when you die.

Unfortunately, consumers often spend more on life insurance and know less about it than almost any other purchase. This publication will help you think through your life insurance needs and make wise decisions.

How Much Is Enough?

Your reason for buying life insurance will determine the amount you need. Proceeds can cover debts, pay taxes, or go to charities. But for most young families, life insurance protects dependents from financial hardships resulting from a breadwinner's death.

If you have dependent children, you almost certainly need life insurance. If you are married, assess each person's need to replace income and homemaking services.

The *Estimate Your Life Insurance Needs* worksheet that follows will help you answer the question: "How much money would my dependents need if I died tomorrow?"

Avoid Overbuying

The worksheet provides one estimate of the amount of life insurance you need. Your family's spending plan indicates how much you can afford to spend. Remember that life insurance premiums are due regularly and should be included as a fixed expense in your spending plan.

IOWA STATE UNIVERSITY
University Extension

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Estimate Your Life Insurance Needs

Step 1.
Expenses at the time of death (include medical costs, burial expenses, legal fees, and taxes)

$ ______________________

Step 2.
Short-term income needed for immediate living expenses, consumer debts, and transition costs

$ ______________________

Step 3.
Long-term income needed

A. Average annual living expenses needed

$ ______________________

B. Spouse's annual income plus Social Security benefits

$ ______________________

C. Annual income needed (subtract B from A)

$ ______________________

D. Investment factor

____

E. Total (multiply C by D)

$ ______________________

Step 4.
Grand total of money your family needs (add amounts from Steps 1, 2, and 3E)

$ ______________________

Step 5.
Assets

$ ______________________

Step 6.
Estimate amount of life insurance needed (subtract Step 5 from Step 4)

$ ______________________

Instructions

Step 1. If the size of your estate is small, the administrative costs associated with your death probably will be minimal. Health insurance may cover most medical costs associated with a death. Burial expenses might range from $5,000 to $10,000.

Step 2. Your family will need money for immediate living expenses that were covered by your income. A rough estimate might be two times your monthly take-home pay. Your family also might have other transition expenses. For example, your spouse might have education expenses to prepare for a new job. You may want some debts to be paid off at death. You may prefer to include home mortgage payments in Step 3A, rather than provide for immediate repayment of the balance at your death.

Step 3.

A. Estimate your family's average annual living expenses if you died today.

B. Estimate the average annual take-home pay your spouse would earn until death. (Average annual earnings are estimated by dividing total earnings before retirement by remaining years of life.) Then add the average annual Social Security benefits your spouse and children would receive. Family members might be eligible for both survivor and retirement benefits. A surviving spouse's benefits stop when the child reaches age 16. Children's benefits stop at age 18. Retirement benefits for a surviving spouse do not begin until he or she reaches age 60. For an estimate of your survivor and retirement benefits, call the Social Security Administration at **(800) 772-1213.** Or use an online calculator at **www.ssa.gov.**

C. Subtract B from A to get the annual income needed. For example, say you estimate your family's annual living expenses to be $36,000. Your spouse, age 25, earns $18,000 a year (in today's dollars) and will work to age 65. Over this 40-year period, total earnings would be $720,000. To get an average earnings figure over his or her lifetime, you assume that your spouse will live to age 85. Average annual earnings over your spouse's remaining 60 years would be approximately $12,000 ($720,000 ÷ 60). Note that a spouse's lifetime earnings will be higher if you add in employment-related retirement income. If you have one child and estimate the Social Security average annual benefits to be $11,000 to family members after your death, the calculation is $36,000 – ($12,000 + $11,000) = $13,000.

D. Estimate the total number of years you would want to provide additional income for your family. This might be until children have completed their schooling or a conservative estimate of your spouse's life expectancy. For example, if you estimate that your spouse will live to age 85 and is now 25, the remaining years equal 60. You must determine how much money is required to produce the needed annual income over this period of time. Use the chart to the right to identify an investment factor. This figure considers both the yield from a lump sum invested over time as well as the impact of inflation. It assumes you would get a 2 percent rate of growth on investments after taxes and the effect of inflation. Enter the investment factor corresponding to the number of years that income is needed on line D.

Years Income Needed	Investment Factor
25	20
30	22
35	25
40	27
45	30
50	31
55	33
60 (and over)	35

E. Multiply the needed annual income figure on line C by the investment factor on line D. If you were to die today, this would be the amount needed to generate income so your family could maintain its current level of living.

Step 4. Add the figures in Steps 1, 2, and 3E. This is the grand total amount of money your family needs.

Step 5. Do you have savings or other assets that could be used to meet some of your family's expenses? Put that figure in the blank.

Step 6. Subtract assets (Step 5) from the total dollar amount listed in Step 4. This figure is an estimate of the amount of life insurance needed.

As your life changes, your life insurance needs also change.

For the same amount of protection, term insurance premiums are much lower than cash value premiums for a young person.

Recognize Changing Needs

The size of your family, the income-earning potential of other family members, educational goals of children, and your savings all affect life insurance needs. As things change, you may need to adjust your life insurance coverage.

If you decide to have children, your life insurance needs will increase. Over time, your total insurance needs will probably decrease as assets increase, debts decrease, and children approach adulthood.

Types of Policies

Life insurance can be divided into two types: term insurance and cash value insurance. They differ by savings options, periods of coverage, and cost.

Term insurance

This is pure insurance protection for a set period of time or "term"—five, 10, or perhaps 20 years. Death benefits or "face value" will be paid only if you die while the policy is in force. Since term insurance has no savings or cash value, it provides the most protection for your premium dollar.

If you will need life insurance beyond the term, seek out a "renewable" rather than a "nonrenewable" policy.

"Decreasing" term policies provide coverage that lessens each year the policy is in force. If you expect your needs to decrease (as your children grow up, for example), this coverage might make sense.

Some term policies also are "convertible." This means that up to a certain age, often 60, you may convert your term policy to a cash value policy regardless of your health status.

Cash value insurance

Cash value insurance combines insurance protection and a savings feature. For the same level of insurance protection, premiums for cash value policies will be much higher compared to term. There are three general types of cash value policies: whole life, universal life, and variable life. These policies vary primarily in the way the cash value is determined.

Decisions to Make

Term or cash value

Your choice between term and cash value insurance should be based on your financial resources and objectives. Once you have determined the amount of life insurance you need, you must decide how much (if any) of the needed protection you want to meet with term and how much (if any) to meet with cash value insurance. For the same amount of protection, term insurance premiums are much lower than cash value premiums for a young person. For example, a healthy 30-year-old might pay $150 for a $100,000 annual renewable term policy or $900 for a $100,000 cash value policy.

If you have any questions about life insurance, contact:

Iowa Insurance Division
300 Maple Street
Des Moines, Iowa 50319-0065
http://www.iid.state.ia.us
Toll-free: (877) 955-1212

Term insurance often is the choice of young families who need a lot of insurance and have tight budgets. First determine how much insurance you need, then select the policy type you can afford. All too often, consumers approach this backwards. About half of all buyers of cash value policies drop them within five years. These policies typically don't build up much cash in the early years.

Beneficiary
You must decide who will receive the insurance benefits upon your death. Name a primary beneficiary or beneficiaries to receive the benefits. Also identify contingent beneficiaries who would receive the benefits if the primary beneficiary were to die before proceeds were distributed.

Comparison Shop

It pays to comparison shop for life insurance. Purchase life insurance from a financially strong company. Several independent firms rate insurance companies' financial stability. Reports from *A.M. Best, Fitch, Moody's, Standard & Poor's*, and *Weiss Ratings* are available at many libraries, on the Web, or from insurance agents.

Always compare similar policies from several companies. Commercial websites provide price quotes. Or, independent insurance agents or fee-only insurance advisers can help you comparison shop. If you have access to group insurance through an employer or organization, include these policies in your cost comparison.

A good agent will take the time to explain policy provisions in detail.

Choosing an Agent

All states require that agents be licensed to sell life insurance. In addition, agents who sell variable products must be registered with the National Association of Securities Dealers. Choose a life insurance agent who is an adviser instead of just a salesperson. Keep in mind that an agent's income is typically based, in part, on commissions earned from the sale of policies. He or she should be willing to help you decide if you need life insurance in the first place, help you to choose a policy to meet your needs, and help you compare policies. An agent can advise you on insurance changes if there are shifts in your income and responsibilities. The initials C.L.U. (Chartered Life Underwriter) after an agent's name means he or she has passed examinations and met other requirements set by the profession.

For more information, visit **www.extension.iastate.edu/financial** *or the Iowa State University Extension office in your county.*

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