Fundamental Needs for Life Insurance

What is the financial impact of premature death?

In general

The premature death of the head of your household can leave you with unresolved financial responsibilities, including the following:

- An unpaid mortgage
- The funding of your child(ren)'s college education
- Car loans
- Credit card debt
- Financial support of dependents
- Funeral expenses
- Estate administration costs

You can use life insurance to cope with the financial responsibilities that are associated with premature death. The magnitude of the financial impact of premature death depends on your family situation.

Caution: *Life insurance policies contain fees, such as mortality and expense charges, and may contain restrictions, such as surrender periods. Please keep in mind that the primary reason to purchase life insurance is for the death benefit.*

If you are single

If you are single with no dependents who rely on you for financial support, then it is likely that your premature death will not have a financial impact on your survivors. However, if you have dependents who rely on you for financial support, your death may be a financial burden to your survivors. Life insurance can provide the needed cash to reduce that financial burden.

If you are a single parent

Your premature death as a single parent can have a serious financial impact on your survivors. Life insurance is a cost-effective way to make sure that your children are protected financially should anything happen to you.

If there are two wage earners in your home

In most homes that have two wage earners, both individuals are dependent on the other financially. Life insurance can provide income to the surviving spouse and allow your family to maintain its standard of living.

If there is one wage earner in your home

If there is only one wage earner in your home, the premature death of the wage earner could cause hardship on surviving family members. There may be a need, therefore, for the wage earner to have life insurance to ensure the surviving family's financial stability. Also, the premature death of the at-home spouse could create financial hardship for the surviving family. This loss could increase the costs of housekeeping or child care, if applicable.

If you are an adult child who supports your aged parents

If you are an adult child who supports a family of your own along with aged parents, your premature death could cause great hardship to your survivors. Life insurance will assist your spouse, who will now be responsible for aged parents and his or her dependents.

What amount of life insurance should you own?

Personal and family needs

Usually, the amount of life insurance you should own is not as difficult to determine as it may seem. A number of methods may be used to determine the proper amount of life insurance for you. The rules of thumb are extremely basic calculations. One rule of thumb indicates that multiplying your salary by a certain number (usually six to eight times your salary) will provide an adequate level of insurance, while another calculates need based on your normal living expenses. Then there are more specific calculations, such as the family needs approach, income replacement approach, capital retention approach, and capital liquidation approach. Whatever approach is used, life insurance is important to provide the needed cash to meet financial needs.

Family needs approach

One of the major uses for life insurance is to satisfy the financial obligations that the deceased will no longer be able to fulfill. These obligations can include funding a child's education or simply keeping up with day-to-day living expenses. Using the family needs approach, the basic needs of a surviving family can be divided into two groups: cash needs to satisfy specific obligations (e.g., final expenses and debt repayment) and income needs to meet the surviving family's living expenses.

Generally, a surviving family will need lump sums of cash to satisfy the following obligations:

- Final expenses: Generally, these expenses arise at the time the insured dies. These expenses can include the funeral, outstanding medical bills if the insured died of a lasting illness, estate administration costs, and death, income, and property taxes.
- Debt repayment: Cash may be needed for payment of any outstanding debts of the insured. Sometimes, creditors will accelerate installment payments, with the entire balance due in full at death. Even if a creditor does not accelerate payments, the surviving family may want to pay off the debts so that they can use income for current living expenses. In addition, by paying off a debt in one lump sum, the surviving family can save on interest charges. Outstanding debts can include car loans, credit cards, home improvement loans, and installment payments for furniture and appliances.
- Home assurance fund: If the insured owned a home, he or she might want to establish a fund that will allow the surviving family to pay off the remaining mortgage balance. If the insured was renting his or her home, he or she may want to establish a fund that is large enough to generate the current rent payment from the interest earnings at an assumed rate of return.
- Education fund: If a parent dies, an education fund will provide his or her child with the money that is needed for post-secondary education.
- Emergency fund: An emergency fund can provide the surviving family with enough cash to see the family through an emergency situation. Emergency situations can include illness, layoff, home repair, and car repair.

Generally, a surviving family will need regular monthly income to meet its day-to-day living expenses. These expenses can include food, clothing, utilities, property taxes, routine home maintenance, car expenses, routine medical care, and home, property, auto, medical, and life insurance. In addition, a surviving family will need enough income to maintain its current lifestyle. Lifestyle expenses can include vacations, new clothing, and dining out. It is important to keep in mind that the surviving family's income needs will change over time. In addition to the needs for cash and income upon the death of the income-earner, individuals may have other needs for life insurance. These can include coverage on a non-working spouse, coverage on children, retirement income, disability income, emergencies, and cash accumulation.

Income replacement approach

The income replacement approach is a method to determine an estimation of a person's human life value. The amount of life insurance needed is calculated in multiples of earned income. The income replacement calculation is based on the theory that the purpose of insurance is to replace the loss of your paycheck when you die. It assumes you have dependents who rely on your financial support. It also assumes that your level of earned income provides a satisfactory standard of living that will remain level, but it fails to consider special circumstances or financial needs.

Capital needs

There are two additional methods for estimating the amount of life insurance you should own: the capital liquidation approach and the capital retention approach. The capital liquidation approach assumes that the income is derived from both the earnings and the capital fund, resulting in the entire principal being used up. The capital retention approach assumes that the income is derived from earnings only, leaving the principal intact. Under the capital retention approach, a larger amount of life insurance is necessary to provide an adequate amount of income.

Estate preservation and liquidity needs

The estate preservation and liquidity needs approach attempts to determine the amount of life insurance needed at death for items such as taxes, expenses, fees, and debts, while preserving the value of the estate. This method considers all variables of family lifestyle and the total cash needed to maintain the current value of the estate while providing adequate cash needed to cover estate expenses and taxes.

General underwriting

In general

Underwriting is a life insurance company's method of researching and evaluating insurance applicants to determine which applicants are insurable and which are not. While an individual who either has a serious medical condition or works in a hazardous environment will be more interested in obtaining life insurance than an individual who is in good health or works in a safe environment, an insurance company wants to avoid covering risky individuals. If an insurance company does choose to insure an individual who has a risky lifestyle or is in poor health, it will most likely be at above-standard rates.

Insurable interest

While an individual can always take out a life insurance policy on himself or herself, the rules are quite different for individuals who wish to take out a policy on the life of another. In order for an individual to purchase insurance on the lives of other people, the applicant must have an insurable interest in the life of the insured. In order to have an insurable interest, the applicant must have an interest in seeing that the insured remains alive. This interest could be based on economic factors, love and affection, or a combination of the two. By requiring the applicant to have an insurable interest, an insurance company could prevent certain unscrupulous behavior. For example, an applicant could take out a policy on the life of someone he or she cared nothing about.

Tip: *In addition to having an insurable interest, the applicant must also obtain consent from the insured. Generally, the insured can consent to being insured by signing the insurance application.*

Insurability

One of the major aspects of underwriting is determining the insurability of an applicant. An insurance company determines insurability by considering various factors such as age, occupation, health, and lifestyle. In determining insurability, many insurance companies will take the following steps:

- Have the agent carefully select individuals for life insurance policies. The agent will want to seek out those individuals who are in good health and can pay the insurance company premiums. The agent can accomplish this by asking preliminary questions of the individual (e.g., How is your health? What is your occupation?). If the agent does not receive sufficient responses, he or she can immediately eliminate the individual as a prospective applicant.
- Have the agent obtain further information through field underwriting. The insurance company will either have the agent perform the field underwriting himself or herself or have an underwriter accompany the agent in the field. Field underwriting requires the agent or the underwriter to underwrite the applicant prior to submitting the insurance application to the insurance company. This allows the insurance company to rely on both the application materials and the information gathered through field underwriting when determining an applicant's insurability.
- Require the applicant to have a physical examination. This is usually done in situations where the amount of insurance requested exceeds a certain amount or if there is evidence from the application or field underwriting process that an exam is necessary.
- Conduct a personal investigation of the applicant through the use of the MIB Group (formerly, the Medical Information Bureau) (discussed below), friends, relatives, and creditors. The applicant must sign a form indicating that he or she has been informed of the investigation.

Financial underwriting

Financial underwriting is the part of the underwriting process that determines whether the amount of the life insurance policy bears a relationship to the financial loss that the beneficiary will incur upon the death of the insured.

Example(s): *Bob is the manager of a local supermarket and earns $24,000 per year. Bob wants to take out a $1 million life insurance policy with his wife, Mary, a homemaker, as the beneficiary of the policy. However, the amount of Bob's life insurance policy must bear a relationship to the financial loss that Mary will incur upon his death. As a result, it is likely that Bob will have to settle for an insurance policy for a lesser amount (e.g., $100,000).*

Facts and misconceptions surrounding the MIB Group

In general

The MIB is a nonprofit information agency that is supported by insurance companies, who use it to gain information that can help them to determine whether or not an applicant is insurable.

How does the MIB operate?

The main function of the MIB is to assist companies in unveiling the misrepresentations and fraudulent actions of applicants. Once an MIB member insurance company finds an impairment in an applicant, it is required to report its findings to the MIB in the form of a code number. The MIB then houses the information it receives about the applicant in its files. The MIB does not record insurance company actions that are taken from reports and findings. Under both state and federal law, an individual may have rights of access to and correction of the individual's personal information.

Tip: *The MIB is required to respect the privacy of the applicant at all times.*

MIB procedure

The MIB requires its member insurance companies to take the following steps when dealing with an applicant:

- The company must provide written notice to the applicant that the company may report its health findings to the MIB.
- The company must provide notice that application for coverage with another MIB company or a claim for benefits may result in the MIB supplying any information it has on file.
- The company must obtain authorization from the applicant for the MIB to disclose information to other companies.
- The company must disclose to the applicant information in its files upon written request of the applicant. However, the information is disclosed only to the applicant's physician, whom the applicant must personally contact.