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The insured pays the premium regularly to the insurance company and once the policy is accepted, in lieu of this, the insurer promises to pay a fixed sum of money at the time of the death of insured or on the expiry of a specified period of time, whichever is earlier. The payment for life insurance is certain but the event for which insurance is taken is not certain. A Beneficiary can be a Person, Business, Trust or Estate. The Owner of the policy is the Person or Organization who pays the premiums and has ownership rights : The right to name the beneficiary. The right to receive dividends and to surrender the policy for cash. The right to change ownership. The right to assign a policy as collateral for a loan.' Death is certain, but when it occurs is not'Life insurance is of utmost importance for all individuals, businesses, communities, society and general public at large. It offers protection against loss of income and compensates the titleholders of the policy. It has other principal functions besides making cash payments on death of a life insured. Life is unpredictable. As the head of the family, everyone wants a secured life for their family members. The nightmares about your family's financial protection keep haunting you. You need life insurance because typically the need for income continues for those who are financially dependent on you, but there is no guarantee of your ability to earn consistently and for the rest of your life. Life insurance can help you safeguard the financial needs of your family. To replace your income, the family would need to maintain their standard of living after the death of a wage earner. Life insurance insures your life and reduces any hardship your family may have to bear in the unfortunate event of your death. Refer exhibit 1 and 2 for the data which indicates * life expectancy at birth (years) and life expectancy by age, both for the country India.* Life expectancy at birth contains the average number

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of years to be lived by a group of people born in the same year, if mortality at each age remains constant in the future. The entry includes total population as well as the male and female components. Life expectancy at birth is also a measure of overall quality of life in a country and summarizes the mortality at all ages. It can also be thought of as indicating the potential return on investment in human capital and is necessary for the calculation of various actuarial measures. Insurance can provide an emergency cash reserve. It can provide capital to pay 'last expenses' and operating capital during a family's readjustment period. to pay off a mortgage loan and other personal and business debts or to create a rent fund. To create a fund for children's education. To create a family emergency fund or a fund for a family member with special needs. Life insurance proceeds generate a financial lump sum that can be used to cover a family's current and long-term operating expenses. It (policy) facilitates savings for old age to enjoy secured and peaceful life as the earning capacity of a person is reduced after retirement. It encourages people to save money by making them obliged to pay premium regularly when a life policy is taken. It helps to mobilize savings of the public to channelize it for investment and thus promote economic development of the country. It can be used as a security to raise loans and thus improves credit worthiness of an individual or a business. It also has tax benefits under Income Tax Act 1961, premiums paid are allowed as a deduction from the total income. In order to analyze the risk of premature death, the first aim of the agent should be to distinguish between the goals of the family of the insured. These goals are qualitative and quantitative in nature. Firstly, while discussion with the client; he should calculate approximately which costs would be faced by the survivors

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resulting from the premature death of the proposed life insured. Secondly, how much it would cost to maintain the similar standard of living. Once the quality of life has been planned and discussed then this figure can be assigned to meet those objectives. Let us now define the goals as under :

Qualitative Goals - These are ' quality of life' goals. They reveal lifestyle choices that have a direct bearing on expenses, risk tolerance and investment choices. For example; a family chooses a one month vacation each year within the country has made a qualitative decision.

Quantitative Goals - These goals assign figures to the qualitative goals. For example; the family who vacations for a month needs approximately Rs. 50, 000 to pay for their holiday.

What Is Life Need Analysis ?

" It is the actual amount that would be needed to maintain the surviving dependants for the period they remain dependants". By considering all offsetting resources and benefits, the aggregate need for insurance can be trimmed to the unmet need for insurance - the gap to be filled in order to satisfy the established goals. This net estimate may be used as the basis for a specific sales proposal. The nature of the unmet needs might also suggest the amounts and combination of types of insurance to recommend, such as a specified amount of whole life or other form of level coverage and a specified amount of decreasing term coverage. There are three basic methods for measuring life insurance needs : The Human Life Value (capitalization of income) Approach and The Needs Approach The Capital Retention Approach Protection from permanent loss of income due to premature death of the bread earner is provided by the life insurance. Each approach

mentioned above is a tool which determines the amount of life insurance needed by an individual or family. Life has an economic value, is the basic principle of each approach. This value is called 'capitalized value of life' which may be represented in cash and/ or in kind; whereby the loss of sum earned as salary is cash value and expenses such as costs of day-care or nanny services and other expenses will be a cost in kind for the survivors to pay. 'Capital' represents cash and assets that can be used or invested for financial gain. The objective here is to substitute the capitalized value of the life insured with a sum of money that will provide an annual income stream equivalent to the annual lost earning power of the life insured. This capitalization of income determines the amount of insurance needed to replace that lost income. This can be expressed as :

Annual Income Need ÷ prevailing Interest Rate = Lump Sum insurance required

Needs analysis can help in determining the right amount of life insurance that is appropriate for the needs of the survivors keeping in view particular client's needs and circumstances. Firstly, it explains the principle behind, estimating the costs associated with the death or disablement of an income earner and the provision of ongoing support for any dependants and/ or the insured. Secondly, it outlines the factors which are to be considered while planning the amount of cover for short term disablement or illness. Thirdly, it explains how the value of assets in the form of property should be estimated for insurance purposes and develops a comprehensive and integrated set of insurance policy options. These other assets will help in determining the amount and kind of insurance necessary to meet the applicant's current and

future needs. On the other hand, capital retention approach broadly determines the amount of insurance needed to pay capital costs of survivors by providing a lump sum amount; the interest earned on the lump sum provides the income. For example; if today's interest rate is 3.5%, the capitalized value of a life insured who earns Rs. 70,000 annually is Rs. 70,000 / 3.5% i. e. Rs. 20,00,000. This means Rs. 20 lacs would have to be invested at 3.5% so that Rs. 70,000 could be used annually for expenses that would have been paid by the income earner. Majorly there are three types of financial dependencies that the survivors have : Readjustment/ Last ExpensesDependency/ Ongoing ExpensesSurvivor Life Income Needs/ Future Expenses(all explained later in this chapter)When estimating the potential contribution of Social Security benefits to survivor's income, you should be aware of something known as the ' blackout period', during which no benefits will be paid by Social Security to a surviving spouse. Time interval between the date benefits end under Social Security and the date these benefits resume. For example, survivor benefits are paid only as long as the parent (if less than age 60) cares for a child less than age 16. Once that child reaches age 16, the surviving parent must wait until age 60 before survivor benefits resume. Offsetting benefits may reduce or even eliminate some of the items in the needs list. If existing medical insurance has a large lifetime benefit, any uninsured exposure related to a last illness may be limited to the deductibles and coinsurance, if any. Existing life insurance may substantially reduce a number of needs. Group life insurance will not provide a retirement income, but it will reduce the need for insurance by a working parent working with minor children in the family. An unpaid mortgage may already be fully insured by a credit life policy. Social Security and other

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available benefits might cut the remaining need for retirement income considerably.

A General Concept - How much Life Insurance ? or Determining the need for Life Insurance

Well, the answer isn't really how much life insurance you need... actually your life insurance needs, often depend on a number of factors, including whether you're married, the size of your family, the nature of your financial obligations, your career stage and your goals. This typical and a very important question has many answers, in fact as there are number of people to ask. This issue deals with how to value a life; therefore, it becomes a very complex proposition. There is no 'one-size-fits-all' approach, in fact no method is perfect, as you are trying to hit a moving target. The method that makes the most sense to you is probably the one that may work the best for you. The needs of a person keep on changing, the more assumptions one makes, the more complex will be the planning. The significant part is to actively participate in all of your planning, fully understand it and constantly monitor it. It is to be noted that as your other assets grow, such as retirement plans and investments, your need for life insurance will decrease. There are multiple approaches by which one can figure out how much insurance you should actually have. What determines your life insurance need ? Methods of calculating life insurance need Insurance mistakes

What determines your life insurance need ?

Life Stages and Circumstances - When determining your life insurance need, you should first consider your life stage and circumstances. Marital status, number of dependents, size and nature of financial obligations, your career

stage and your intentions to pass on your property are all factors to consider. Your need for life insurance changes as the circumstances of your life change. Starting Out - In the "Starting Out" stage of life, you may be just beginning your career or family. You may not have children or other dependents at this stage, but that doesn't mean you have no obligations. For example; if you paid for your college education with student loans, you likely had a cosigner for your loan—may be your parents or a grandparent. The same may be true of your car loan. If you were to die before the loan is paid, your cosigner would be obligated to pay the debt. Under law, a cosigner is responsible for full payment of a debt in the event of default. Death doesn't erase the debt obligation.

single Adult - A growing percentage of the population now falls into the single adult demographic group. This group covers a broad spectrum of ages, lifestyles and obligations.

Family Obligations, Parents - Although you may not have a spouse, your death could have a serious financial impact on other family members. If, like many adults, you are supporting your parents (either financially or with care), your death could have a major impact, both emotionally and financially. They would not only lose the support you have been providing to them, but they would also need to come up with the money for your final expenses.

Family Obligations, Children - If you are a single parent, the primary financial support for your children would die with you. If you are lucky, you may have family members who would step in and help your children in case you die. If you are even luckier, they will be able to provide your children with the education and lifestyle you had hoped for them to have. Your need for life insurance as a single parent is even greater than that of a dual-parent, dual-income household, which would still have one income if one parent died. Life

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insurance is a cost-effective way to make sure that your children are protected financially should anything happen to you. Debt Obligations - In this stage of life, you may still be paying for or even still accumulated education loans. You may have purchased a house or condo with a cosigner. If you died, your cosigner would be legally liable for the payments on the debt. Protect Your Insurability - Another reason to buy life insurance at this stage of your life is to protect your future insurability. Once you buy a permanent, cash value life insurance policy, it remains in effect for your entire life (assuming the premiums are paid), even if your health changes. If you were to experience a serious change in health, you might not be able to buy additional insurance coverage, but you would still have the permanent coverage you already own. Dual-Income Couple or Family - If you and your spouse both earn an income, it is possible that if one of you die, the other may be able to cope financially on the remaining income. If there are mortgages, joint credit cards or other debt or children in the picture, the loss of one income could be much more difficult to overcome. The more people who depend on your income while you are alive, the more life insurance you should own. If you died today with insufficient or no insurance, your mate could be forced to give up the residence or lifestyle for which you have both worked. When there are children involved, the loss of one breadwinner could mean a setback in the daily way of life, not to mention any plans for private school or college. Parent of Grown Children - Just because your children have grown up and left the nest does not mean you have no need for life insurance. you may have spent your entire adult life building an estate that you intend to pass on to your children, grandchildren, or favorite charity. You can use life insurance to ensure that the bulk of your estate passes to your

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heirs or designated charitable organization subject to certain tax advantages. Part of Overall Financial Planning - Determining your life insurance needs should not be done in isolation. Instead, it should be looked at as part of your overall financial plan, with consideration given to your goals for savings and retirement, as well as tax and estate planning. As your life changes, your financial goals may change, as well as your need for life insurance, making it important to also periodically review your coverage.

Methods of Calculating Life Insurance Need

Several methods are used to calculate the appropriate level of insurance for you and your situation. While they all share common features, some methods strive to be more simplistic, while others involve more sophisticated calculations. You may want to determine an amount on your own, using one of the simpler methods. This can provide a basis for your discussions with your financial planner. Insurable Interest - Before you begin calculating your insurance needs, it is important to determine insurable interest. Basically, having an insurable interest in a person's life means that you would suffer emotional or financial harm or loss if that person were to die. It is always assumed that you have an insurable interest in your own life. However, to prove an insurable interest in someone else's life, you must have a relationship to that person based on blood, marriage, or monetary interest. You must have an insurable interest before you can purchase an insurance policy. Family Needs Approach - The family needs approach is one of the more comprehensive methods of calculating your life insurance needs. It assumes that the purpose of life insurance is to cover the needs of the surviving family members. This method takes into account the immediate

and ongoing needs of the surviving family members, as well as income from other sources and the value of assets that could be used to help defray the family's expenses (such as bank accounts and real estate).

Capital Retention Approach - The capital retention approach is one of two calculation methods under the family needs approach. This approach assumes that life insurance principal will support the family indefinitely into the future. Because you will purchase more life insurance under this method, you will be in a better position if the surviving spouse lives longer than expected.

Capital Liquidation Approach - The capital liquidation approach is the second of two calculation methods under the family needs approach. This method does not provide as much continuing capital for the surviving spouse or for heirs after the death of the surviving spouse. However, it does allow you to spend less money by purchasing a lesser amount of life insurance coverage.

Estate Preservation and Liquidity Needs - The estate preservation and liquidity needs approach attempts to determine the amount of insurance needed at death for items such as taxes, expenses, fees, and debts while preserving the value of the estate. This method considers all the 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.

Income Replacement Approach - 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. This analysis determines an economic or human life value and factors in salary increases and the effects of inflation in determining the appropriate level of coverage. While more comprehensive than the rules of thumb, this method still fails to consider special circumstances or financial needs and operates on the premise that the

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current level of income provides a satisfactory standard of living that will remain level throughout the future. Rules of Thumb - The rules of thumb are extremely basic calculations. They provide a starting point but fail to recognize special family circumstances or needs and focus only on the most basic components. One rule of thumb dictates that multiplying your salary by a certain number will provide an adequate level of insurance, while another calculates need based on normal living expenses.

Insurance Mistakes

No Insurance - The worst mistake you could make concerning life insurance is having a need and not having any insurance at all. Very often, people can find all sorts of excuses for not buying life insurance. It's no fun to plan for your death, for one thing. For another, there's the tendency to think that dying won't happen to you, only to some person you read about in the obituaries. But how many times have you heard about a young, apparently healthy person dying suddenly in a car accident, leaving behind a spouse, a young child, and no insurance? Sadly, it happens, and when it does, the family faces not only emotional trauma but possibly an extremely difficult financial situation, as well.

Not Enough Insurance - The majority of people with insurance are underinsured. Insufficient coverage can occur as a result of buying what is affordable instead of what is needed. Failure to review your coverage periodically could also result in insufficient insurance, even if you started out with adequate levels. Inflation rates, your career, and your lifestyle may have changed. Your family could be faced with a large financial gap and left unable to maintain the current lifestyle if you died today. Consequences could include loss of the family home, scaling back of college

plans, and possibly years of financial difficulty. Too Much Insurance - If you purchased a large policy during one point in your life but forgot to adjust the coverage when your insurance need was reduced, it is possible that you have too much life insurance. This is another good reason to periodically review your coverage with your financial planning professional. Periodic reviews of your insurance coverage can highlight opportunities to adjust the levels of insurance coverage to match the current and projected needs.

HUMAN LIFE APPROACH

"The present value of the family's share of the deceased breadwinner's future earnings". The human life value (HLV) concept deals with human capital. Human capital is a person's income potential. The HLV approach uses mathematical computation to determine how much life insurance is needed by valuing a human life. The HLV approach considers the human being to be an "income-producing machine." It is a device that mathematically converts your output into an amount of cash, your expected income until retirement. It determines the value today of cash that is flowing out in the future. This method focuses on an individual's future stream of income. It considers such things as annual salary and expenses, years remaining until retirement, and the future value of current rupees and translates this into an amount of insurance needed to replace the income stream in the event of premature death. What is your Human Life Value? Beyond all doubt, your life is invaluable. Yet, there is a certain worth that can be attributed to the financial support you offer your parents, spouse or children. This worth is referred to as HLV. In the future, if your family does not have the protective blanket of your presence, they will no longer be able to enjoy the benefits of the

income you earned. Put simply, HLV is the present value of your future earnings. Why should you calculate your Human Life Value ? You should calculate your HLV so you can accordingly invest in insurance plans that provide your family with adequate finances and hence security even in your absence. The HLV concept goes beyond numbers and considers the entire impact caused by the loss of a human life and the value to a person's loved ones. How much are your tomorrow's worth? What is your Potential Earning Power (PEP) For better understanding of HLV, let us see some illustrations.

Illustration 1

' Mr. X' :- Age-40 yrs, Retirement age-60 yrs, Current salary-3, 00, 000 per annum (expected to remain same), Personal expenses-1, 25, 000, Net contribution to family-1, 75, 000 (300000 - 125000). Suppose he dies at the age of 40. Income lost by the family-175000 * 20 yrs (60 - 40) * discount rate for 20 yrs (Present value factor): 19, 00, 000.

Illustration 2

' Mr. Y' :- Age-30 yrs, Age of spouse-27 yrs, Life expectancy of spouse-70 yrs, Age of child-3 yrs, Child's share of monthly household expenditure-10 %, Child will remain dependant till-22 yrs, Monthly household expenditure Rs. 40, 000, Out of this, amount spent on Mr. Y Rs. 10, 000. Expected inflation in household expenditure 5 %, Money to be set aside for child's education (in present value terms) Rs. 10, 00, 000. Money to be set aside for child's marriage/ other needs (in present value terms) Rs. 7, 50, 000. Outstanding loans Rs. 15, 00, 000. Other liabilities Rs. 5, 00, 000. Medical expenditure/ emergency fund Rs. 5, 00, 000. Rate of return on low risk securities/ deposits 8 %. Hence, HLV will be Rs. 1, 66, 45, 475. If the rate of return on low risk <https://assignbuster.com/what-is-life-need-analysis-economics-essay/>

securities/ deposits is 7 %, Revised HLV will be Rs 1, 81, 83, 996. How do you determine your Human Life Value ? This approach is about determining how much insurance is needed and is based simply on how much income the proposed insured earns. " All individuals who have financial dependants need life insurance." Factors to be taken into consideration while calculating HLV are age, current and future expenses and current and future income. The formula is;

Annual Income / Interest Rate = Lump Sum (The Human Life Value).

Illustration 3

If the annual income of the primary wage-earner is Rs. 30, 000, the total amount of insurance needed would be (assuming a nominal rate of interest of 8% and a long-term inflation rate of 3%, the real rate of interest is 5%):
 $\text{Rs. } 30,000 \div .05 = \text{Rs. } 600,000$ (human life value = amount of insurance required) If Rs. 600, 000 is invested at 5%, the return will be Rs. 30, 000 annually. Thus, the family of the insured has, in economic terms, would replace the income-earning value of the life lost through a policy with a Rs. 600, 000 death benefit.

Illustration 4

An insured makes Rs. 42, 000 a year and the current interest rate is 3. 4%. She has a generous policy plus disability benefits that pay 70% of her salary. How much life insurance does she need based on capitalization of income? A. Rs. 1428 B. Rs. 12352. 94 C. Rs. 1, 42, 800 D. Rs. 1, 235, 294. 10 There are different school of thoughts and approaches for purchasing and calculating the needs of life insurances, which say as under : One should purchase
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insurance worth 5 to 10 times the current annual income. " This is an old thumb rule that does not take into consideration current assets and any special needs the customer or their family may have". Thus, When one's annual income is known, the insurance need is calculated simply as annual income multiplied by the number of years to service left. One's yearly outgo towards Insurance premium should be 10% of one's annual Income. Thus, Life insurance need is, the financial need analysis approach. This is an approach which can take care of specific needs of an individual. Here, the basic objective is that the insurance coverage should be sufficient to provide for the dependants' needs in case the breadwinner dies early.

Steps for Calculating Human Life Value Approach

In the human life value approach, the first step is to find the amount of annual income that is surplus to the individual. The surplus is the amount above what the insured would consume himself; which provides the overall standard of living for the individual and the family. The surplus includes amounts spent on education for children, automobiles, vacations, clothing, and food for everyone in the family except him. The items to include in costs of self-maintenance are any money spent on his portion of housing, his clothing, food, the portion of his salary that goes for FICA, federal, state, and local taxes, and all other expenses to maintain the insured as a productive asset. The next part of the human life value approach involves plugging the given information into the mathematical model and calculating the answer. To determine the surplus, subtract the self-maintenance expenses from the average income.

Exhibit 2 : Steps for Calculating Human Life Value Approach

Weaknesses of the Human Life Value Approach

Other sources of income are ignored, (e. g., business earnings), it is calculated by using a constant income stream over the life of the insured since it is difficult to know what increase in income is probable. It ignores the number of years that income (mentioned above) will be required; a person aged 25 and a person aged 65 would appear to require the same amount of coverage. In its simplest form, work earnings and expenses are assumed to be constant and employee benefits are ignored. The amount of money allocated to the family can quickly change because of divorce, birth of child, or death of a family member. The effects of inflation on earnings and expenses are ignored.

Points to Ponder :

HLV is a moving target, review it once a year. Do not chase the revised HLV year after year, instead, set the broad trend right with the expectation that in the long-term, the actual and estimate will converge one day. Do not get scared by the HLV numbers thrown up when calculated. The 'number' is just the beginning, the aim is to put into the context of your present ability to set aside money. Remain disciplined; at any point in time you should have planned in such a manner that in your absence, your family will not need to compromise on their yet-to-be fulfilled needs.

NEEDS APPROACH

" It is a method of calculating how much life insurance is required by an individual/ family to meet their needs (expenses) if the family head dies".

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These include things like funeral expenses, legal fees, estate and gift taxes, business buyout costs, probate fees, medical deductibles, emergency funds, mortgage expenses, rent, debt and loans, college, child care, private schooling and maintenance costs. This approach contrasts the human-life approach. The needs approach is a function of two variables: How much will be needed at death to meet obligations? How much future income is needed to sustain the household? When calculating your expenses, it is best to overestimate your needs a little. By doing this you will be buying and paying for a little more insurance than you need, but, if you underestimate, you won't realize your mistake until it's too late. With the needs approach, you divide your family's financial needs into three main categories: Cash Needs/ Immediate Financial Needs Multi-Period Income Needs/ Ongoing financial Needs

Special Needs

Cash Needs/ Immediate Financial Needs - 'Lump-sum needs at death require immediate cash'. The financial needs analysis approach estimates the family's financial needs if the insured were to die today. It identifies survivor's immediate cash needs and ongoing income needs and assumes that the life insurance proceeds will be liquidated to meet them such as final illness costs that insurance does not cover, funeral, burial, cremation expenses, repayment of outstanding debt, estate taxes and settlement costs, credit card and an emergency fund for unexpected costs, probate and attorney expenses, funds to cover survivors' ongoing expenses and education expenses for children. As the purpose of life insurance is to fund the unfunded portion of these objectives, all existing funds that can provide

part or all of these needs should be considered. For approximation, you can consider using 70 percent of the insured's current income as the target level, rather than calculating each anticipated need. Depending on the family's circumstances, a higher or lower percentage may be more accurate.

Probable sources of income include social security, employer-provided plan benefits, group life insurance and the surviving spouse's earnings. Multi-

Period Income Needs/ Ongoing financial Needs - ' Continuing income until the dependents are self-supporting'. Ongoing income needs approach estimates the expenses related to food, clothing, shelter and transportation.

These income needs will vary in amount and duration depending on a number of factors, such as age of your spouse, age of children, surviving spouse's capacity to earn income, your debt (including mortgages) and whether you want to provide funds for your surviving spouse's retirement.

Some financial journalists recommend that people should have life insurance and liquid assets in amounts ranging from five to seven times of their annual income. This is a simplistic approach, but, possibly he sometimes ignores specific information about the insured like assets accumulated and other sources of funds such as trusts and inheritances, as a result, over or

underinsures them. More refined approaches translates the insured's needs into estimated costs, evaluate assets and existing coverage to determine the amount of funding which is already in place. Any deficit between the planned goals and current financial sources is usually a candidate's additional

coverage. The possible monthly income that the dependents will need after the earning member's death : Readjustment period income needs - It is a period of one or two years following the insured's death in which the family should receive the same income as when the breadwinner was alive. This

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income provides a cushion for the spouse as he/ she tries to adapt to the new situation. Children's income needs during their dependency period – It is a period between the breadwinner's death until the children reach the age of 18. During this period, the family needs income and it varies within families depending on whether the spouse is working or planning to work or plans to remain at home to look after the children. The surviving spouse's income needs - for a spouse who is under the age of 60, who has been unemployed for years together and whose youngest child has reached 16, the need for income in this case is particularly urgent. This is especially true if the insured dies during the ' blackout period' (explained above in the chapter). The spouse's retirement needs - Adequate retirement needs for the surviving spouse should be considered.

Special Needs – ‘ Any additional family needs that are not covered by any of the above categories’.

Special needs such as college funding, charitable bequests, funding a buy/ sell agreement or business succession planning. Different funds can be established to cater for these needs, including an education fund, an emergency fund, a mortgage-repayment policy.

Analyze various ‘ Family Needs’ if the family head dies !

The aim of the needs approach is meeting the total needs of the household after the death of a breadwinner, both at the time of his/ her death and in the future. In order to calculate the amount of necessary life insurance according to this approach, you are supposed to add up all of your funding needs to determine the total needs of the beneficiaries. Include immediate needs, transitional funds, dependency funds, debt elimination, spousal life

income funds, spousal/ children's education funds and retirement income funds. Subtract current insurance coverage and other available assets from this total amount. The difference, if any, represents the amount that life insurance proceeds and the income from future investment of those proceeds can cover. Amount of money needed to meet these needsXXXXLess : Total amount of existing life insurance and financial assets XXXXAmount of new life insurance that should be purchasedXXXX

Illustration

Rohit and his wife, Saroj, are estimating the appropriate amount of life insurance to buy on Rohit's life. They first estimate their immediate needs as follows : Final medical expenses: Rs. 5, 000Estate settlement costs including funeral expenses: Rs. 37, 500Debts, including credit cards and mortgages: Rs. 317, 000Emergency fund: Rs. 100, 000Subtotal: Rs. 4, 59, 500Next, they estimate ongoing income needs, such as: Providing for their dependent children's needs for a period of time: Rs. 500, 000Saroj's income needs until her retirement: Rs. 450, 000Saroj's retirement income needs: Rs. 380, 000Subtotal: Rs. 13, 30, 000Adding the sub totals together, Rohit and Saroj estimate that, should Rohit die, their family would need Rs. 17, 89, 500. They then determine that assets available to offset their needs include: Bank savings: Rs. 40, 000Investments: Rs. 2, 20, 000Retirement assets: Rs. 2, 50, 000Existing life insurance on Rohit's life: Rs. 3, 00, 000Subtotal: Rs. 8, 10, 000The difference between their family needs (Rs. 17, 89, 500) and their available assets (Rs. 8, 10, 000) equals their life insurance need (Rs. 9, 79, 500).

CAPITAL RETENTION APPROACH

" The Capital Retention Approach is based on the end-needs analysis, followed by the analysis to determine if current assets are sufficient to meet current and future income requirements". It begins by valuing the assets of the individual's estate at death and determining whether survivor's needs can be met from the existing resources. Determining the obligations and meeting them with the earnings on a principal sum without liquidating that sum or using a combination approach, liquidating some of the capital and retaining some of it. This is much like the needs approach, but provides the surviving family with capital that earns income over time. This generally requires much more life insurance. If the owner of the policy cannot afford the capital retention approach, then it makes more sense to pay off debt, since debt usually incurs greater interest than can be safely earned from investments. In fact, paying off debt is like earning the interest that would otherwise be paid tax free. Unlike the Needs Approach, which assumes liquidation of the life insurance proceeds, this approach preserves the capital needed to provide income to the family. Prepare a personal balance sheet. Determine the amount of income-producing capital. Determine the amount of additional capital needed (if any). Preserving capital requires a substantially larger capital sum than consuming it during the survivor's remaining lifetime, therefore, much higher insurance is recommended than the capital needs analysis approach'. For example; lets assume on interest of 5 percent, Rs. 10, 00, 000 capital sum will provide a monthly income of about about Rs. 10, 500 for 120 months under the financial-needs approach. At the end of that period, the capital sum will have been liquidated. Under the capital-needs approach, a \$1 million capital sum will provide a monthly

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income of about \$4, 200, but the income will continue indefinitely. To provide a monthly income of \$10, 500 would require a capital sum of about \$2. 5 million. With the capital-needs method, how will you determine the amount of life insurance proceeds as in the financial-needs approach ? Prepare a personal balance sheet for the client. All the liabilities, immediate cash needs and assets that do not produce income, such as the residence are subtracted from the total assets. The remainder is the client's present income-producing capital. Compute the amount of additional capital needed to achieve the desired income objective i. e. net of all other income sources. Determine the amount of additional capital needed to meet the income objective by dividing the amount of additional income desired by the applicable interest rate representing the after-tax rate of investment return anticipated on the capital sum. for example; If Rs. 1, 00, 000 per year of additional income is desired and the capital sum generating those income payments can realistically be expected to generate a 5 % return after taxes, Rs. 20 lacs fund will be at least required ($\text{Rs. } 100,000 \div 5\% = \text{Rs. } 20,00,000$). It is to be noted that there is no compulsion to choose between capital liquidation and capital retention approach, a combination of the two approaches can also be used i. e. liquidating some of your client's capital and retaining some of it, as a compromise approach to filling the gap between the income needs of the survivors and the other available sources of income.

Exhibit 4 : Needs Analysis Tools Available

According to a LIMRA (Life Insurance and Market Research Association) study, too many people today are under insured and life insurance

ownership continues to decline. Nearly 1/3 of all women and more than 1/4 of all men have no life insurance at all. To support our strong advocacy for meeting the need for life insurance among the middle market, certain websites provide a fundamental needs analysis tool for brokers. Online calculator is available asking, " How Much Life Insurance Do You Need?". In addition to the calculation tool, they also offer a corresponding fact finder that helps you gather the important and necessary information about the client to help estimate their life insurance needs. The fact finder can be emailed as a PDF document and printed for easy use. Each section of the fact finder has been structured to match the input fields on the calculator tool, providing for easy transfer of the data. The end result is a printable, consumer friendly report summarizing the client's current assets, estimated expenses at the death of the breadwinner, and their potential life insurance shortfall.

Points to Ponder

The amount of life insurance needed depends on the family and their situation. There are various methods at estimating the amount of life insurance to purchase. The Human Life Value method simply calculates the present value of all earnings of the breadwinner that would have gone to the dependents. The amount of these earnings would be the estimated amount earned from work or other sources, minus the amount that would be paid in taxes, and minus the amount that the breadwinner would keep for himself. While the human life value method is one way to calculate the amount of life insurance needed, it is not very valuable. It makes more sense to calculate the amount that the financial dependents will need rather than what they

would have gotten if the breadwinner had lived. The needs calculation would involve estimating and providing a fund for all known expenses, and paying off all debt; then determine the amount of financial need after all debts have been paid off. It can be paid as a lump sum, or as income using a "Capital Retention Approach". Some needs are temporary; others are permanent. As temporary needs are eliminated, the total amount of life insurance can be reduced. Final Expenses, which include funeral expenses and unpaid medical bills. A Debt Retirement Fund to retire all debt, including mortgages, credit card bills, and auto loans. Being debt-free will allow a family to live with less income. An Income Fund provides an income to the surviving members of the family, which would be especially helpful if the surviving spouse would have to stay at home to care for children, or to pay for their care while the surviving spouse works. An Education Fund to pay for the future education of children. The cost for a 4 year college education can easily be more than Rs. 1, 00, 000, and this will no doubt continue to increase, probably faster than inflation as it has in the past. An Estate Preservation Fund may be desirable for those with substantial estates that may incur high attorney fees, court costs, and taxes. Once the needs have been determined, then other sources of income should be considered that would reduce the amount of life insurance needed. These would include social security benefits; benefits from other insurance policies, such as from work; investment income; and other possible sources of income, such as from a business that the deceased had an ownership interest.
