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Study Chapter

Understanding Needs Analysis

A. Quick Facts

Here are some interesting statistics compiled by the American Council of Life Insurers in their 2011 Fact Book (the numbers are provided for 2010):

- Americans purchased $2 trillion of new life insurance policies, which was 3% less than the year before;
- The average face amount of life insurance policies was about $166,000;
- 39% of new individual life policies were term life insurance;
- 61% of new individual life policies were some form of cash value life insurance; and
- The most common supplementary benefit is waiver of premium.

B. Introducing Needs Analysis

A secure financial future for loved ones is built on a foundation of life insurance. Life insurance can help loved ones carry out their hopes and dreams, even after the insured is gone.

As an important part of a sound financial plan, life insurance provides a death benefit to beneficiaries and can replace some of the income that would have been earned. This can help preserve savings, investments, and other assets for their intended purposes.

The right amount of life insurance protection can help loved ones avoid selling their home or business or drastically altering their lifestyle to cope with financial obligations, such as funeral expenses, estate settlement costs, education costs, the mortgage, or other living expenses and other large personal or business obligations.

It is important to review the following considerations in determining the right amount and type of life insurance for your client's needs:

- Why does the person need life insurance?
- How much do they need?
- Which type of insurance is right?
- How can you choose the policy that's right?
- How much will it cost?
- How will you purchase the policy?
- When should you review coverage?

Figuring out life insurance needs requires a careful analysis periodically of what is needed, who needs to be protected, and how the financial future should look. This financial picture changes over time. It does not take a lot of time, and it's important

that you review all current assets and liabilities in order to know what is needed to help individuals maintain their financial well-being and protect their goals.

In building a plan for financial security, life insurance serves a number of purposes:

- **Creating wealth:** to protect dependents or to create inexpensive capital for charitable giving;
- **Preserving wealth:** to provide liquidity in an estate to pay estate taxes and settlement costs so other assets can be retained for heirs; or
- **Tax-deferred accumulation:** for future college education funding, collateral to start a business or take advantage of an investment opportunity, or for supplementing retirement income.

C. Financial Planning to Analyze Need

Life insurance is an essential part of financial planning. The main reason most people buy life insurance is to replace income that would be lost with the death of a wage earner. Cash values provided by some life insurance policies also can provide an available source of funds. Accessing these funds does require that the insured **trades a reduced death benefit in exchange for the borrowing a portion of these funds**. If the policyowner wants to access all of the cash values accumulated, they will have to surrender the policy and will no longer be covered by a life insurance death benefit.

Life insurance proceeds could mean that dependents will not have to sell assets to pay outstanding bills or taxes. An important feature of life insurance is that, in most circumstances, income tax is not payable on death benefits. In order to set future financial goals and to accurately evaluate future needs, individuals must have a good idea of current resources. This information is derived from their income tax return, checkbook records, stock and bond records, and other financial statements.

There are three time periods for which an individual needs to plan:

- The early adult years – premature death planning;
- The middle years – pre-retirement planning; and
- The later years – estate planning.

In the early adult years, life insurance can address three categories of needs: permanent, temporary, and savings.

- **Permanent needs** for life insurance are those needs that continue until death.
- **Temporary needs** diminish over time and ultimately disappear.
- **Savings needs** include the need to provide for retirement and, in some cases, the need to keep life insurance in force after term insurance premiums would be prohibitively expensive.

In the middle years, one needs to consider the legal and financial independence of children and the repayment of all significant debt, including a home mortgage. During this time period, most individuals are approaching maximum advancement in their career. This life stage might be identified as a pre-retirement planning period. This period generally begins between the ages of 45 and 60 and ends at retirement. The problem of developing financial goals for retirement is more difficult than the problem of developing financial goals during the early adult years.

Estimating the amount needed to fund retirement is indeed complex because an individual has no idea how long he or she will live. Estimates of retirement needs made by a 50-year-old may involve expenditures planned for 20, 30, or 40 years in the future. New opportunities are arising for seniors to continue to work or to participate in educational programs instead of retiring completely.

The later years usually involve three categories of goals. These goals are

- Living objectives;
- Death transfer objectives; and
- Tax objectives.

D. Objectives in Need Analysis

1. Living Objectives

Living objectives can include many concerns revolving around developing a plan to provide for the continued enjoyment of a predicted lifestyle. Such objectives may involve continuing participation in business or farming, moving to an adult community, or participating in an adult educational program.

2. Death Transfer Objectives

Death transfer objectives involve identifying the individuals or organizations that an insured wishes to receive his or her property after he or she dies. In cases where an individual has had two or more marriages – and children by each marriage – the development of death transfer objectives may prove difficult. Additionally, an individual may want to continue to fund an organization, such as a charity, after they die.

Clarity and completeness are needed in identifying all assets to be distributed. After the assets have been identified, the next step is the clear designation of the intended recipients of the assets, including the designation of beneficiaries (primary and contingent) of life insurance policies.

Death transfer objectives are usually formally structured in a will or living trust. Life insurance policies can play a key role in achieving death transfer objectives. First, policies can provide a lump sum of cash or a lifetime of income to designated beneficiaries. In the case of spendthrift children, or those inexperienced in money management, the insurance company's services can prove quite valuable, with the insurer guaranteeing a stream of income, rather than a lump sum, to such beneficiaries.

3. Tax Objectives

Tax objectives avoiding federal estate tax can be relatively simple if an individual's estate at death does not exceed $5.43 million in 2015 (double this amount for a married couple).

With some simple planning steps that utilize the marital deduction and the annual gift exclusion, even larger estates can escape the imposition of this tax. On the other hand, almost all estates incur some level of probate costs, and many states impose inheritance taxes that require cash payments during estate transfer. Both of these problems can be addressed using life insurance.

E. Computing Life Insurance Needs

Some experts say that one will need 6 to 8 times their annual gross income in life insurance. This is a general rule of thumb, but everyone has different needs. One should consider at least how much a family will need for funeral expenses, the mortgage, car loans, credit card debt, education for children, and retirement for a spouse if one should die prematurely.

Under this rule, if the primary breadwinner earns $50,000 per year, he or she should have between $300,000 and $400,000 of life insurance. A similar rule that takes immediate cash needs into account is 5 times gross income, plus mortgage, debts, final expenses, and any other special funding needs.

Financial planning professionals apply various techniques to determine the life insurance needs of a family. There are essentially three principal areas in which to calculate need. These areas are:

1. Income replacement and family needs analysis;
2. Business insurance needs analysis; and
3. Estate preservation and liquidity needs analysis.

Any method of determining a family's insurance needs will be an estimate, since circumstances will change in unexpected ways in the future, and basic assumptions about earnings, interest rates, inflation, and similar factors are just that – assumptions. Life insurance planning is best conducted with a comprehensive study of the client's financial needs and concerns.

The process of life insurance planning must begin and end with the objectives and goals of the client being paramount, even if these objectives and goals do not conform to what the adviser considers to be proper or appropriate values or concerns.

1. Considering Social Security Benefits

In determining the amount and kind of insurance that is needed, an individual must consider other sources of income or benefits, such as insurance plans, government programs, and retirement plans. These other assets will help in determining the amount and type of insurance necessary to meet current and future needs.

Most workers are covered by Social Security or other government programs that provide survivor benefits to surviving spouses with dependent children and surviving spouses after age 60. This is a form of income-replacement insurance and should reduce the family support obligation accordingly.

The amount of Social Security paid to a surviving spouse with one eligible child is 150% of the deceased spouse's primary insurance amount (PIA) at the date of death. For each additional eligible child, an additional 75% of the PIA is payable. Children are eligible until age 18 – or until age 19 if the children are in high school. If disability of the children occurs before the age of 22, eligibility continues during the duration of the disability.

A surviving spouse is eligible for Social Security survivor benefits if he or she is caring for a child younger than 16 or who is disabled before age 22. Otherwise, a surviving spouse is not eligible for benefits until age 60 (or age 50-59, if he or she is disabled). This period of time between when the youngest child has reached age 16 and the surviving spouse has reached age 60 when no survivor benefits are paid is called the "blackout period."

A spouse alone is eligible for reduced benefits equal to 71.5% of the PIA starting at age 60. If the receipt of benefits is delayed, then the spouse is eligible for up to 100% of the PIA starting at age 65. A disabled spouse is eligible for 71.5% of the PIA starting at age 50. The total amount payable to the family is subject to a limit, called the **maximum family benefit,** which is generally about 175% of the PIA. Some benefits that an individual has now may not be available when he or she retires. Social Security has been a source of controversy for quite some time. There is public concern that

individuals working today will not be able to count on this system to provide them with retirement income.

When the current generation begins to retire, there may be only two workers paying in for each retired worker needing that income. To offset this trend, Social Security taxes increase and benefits decrease. Additional changes have been enforced, such as increasing the normal retirement age. The idea of do-it-yourself financial planning may be sufficient in some circumstances, but most will benefit from the advice of a personal financial adviser.

Individuals can request estimates of the amount of Social Security retirement benefit they will receive from the Social Security Administration. It is estimated that an individual will need 75% to 80% of his or her current income to maintain a lifestyle after retirement. This means that Social Security benefits will have to be supplemented by income from other sources.

In determining how much life insurance is necessary, agents should ask clients to consider the following questions:

- *In the event of death, how much money would your family need for living purposes, including paying off the mortgage and other debts?*
- *How long would this amount of income be needed?* (It should last at least until the children are out of high school, and preferably until they finish college.)
- *How much Social Security income can be expected until the children are no longer covered?*
- *What are your goals for retirement planning?*
- *What funds would be necessary for long-term nursing home care in the future?*
- *Are they taking full advantage of employer-provided qualified retirement plans, such as a 401(k)?*
- *What funds would be necessary to provide an income during periods of disability?*

F. Consumer Application

Agent Bob is working with a couple, Bill and Sue Brown, who are both 31 years old. Both earn $40,000 a year. They have three children: twin daughters, age 4, and a 1-year-old son. The parents are both fully insured under Social Security with identical work histories.

Agent Bob helps them determine how they want things to be handled if either of them dies. Here is what they want:

1. **Readjustment Period** – The Browns would like the surviving parent to have 5 years to adjust to life. This means they would like the surviving parent to have 100% of the current household income of $80,000.
2. **Family Dependency Period** – The Browns realize that the surviving parent would likely have to sacrifice his or her career to ensure the children are able to continue with their many activities. They estimate that the survivor would need about 90% of current household income of $80,000 for 21 years until their youngest child graduates from college at age 22.
3. **Pre-retirement Period** – The Browns feel that the surviving spouse would need 70% of the current income to maintain his or her lifestyle until retirement.
4. **Retirement** – At retirement age of 67, the Browns feel that the survivor can make it on 60% of the current household income (adjusted for inflation).

Chapter Complete

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