

MASTERING THE FUNDAMENTALS

How Much Do I Need?

Help your clients determine how much coverage they need by examining and testing the assumptions in any financial calculation.

Estimating a client's life insurance need relies on logical assumptions. Consequently, understanding the nature of each assumption makes the estimate more accurate. Here is a different perspective on a few of these assumptions to help stimulate your thinking about this important matter.

The main assumption of life insurance planning is that death occurs today. Usually this assumption works well, because many life insurance needs decrease over time. For example, Tasha and Marquin own a home with a \$250,000 mortgage at 6 percent. They buy a \$250,000, 30-year term policy for the mortgage. If Marquin were to die 20 years into the term, the mortgage balance would be \$135,009. The excess of \$114,991 would be available for other needs.

However, some needs, such as final expenses, increase over time. The inflation rate on funeral expenses (not including cemetery costs) has averaged 4.8 percent from 1960 to 2006, according to the National Funeral Directors Association. Likewise, the rise in medical costs has exceeded general inflation of 3 percent to 4 percent. A 5 percent inflation rate for final-expense needs is quite reasonable. It is equally logical to assume death occurs at life expectancy.

Tasha and Marquin, both age 40, have a 50 percent probability of living to 81 and 78, respectively, according to the Social Security Administration Period Life Table. A \$15,000 final-expense need would increase to \$111,000 for Tasha and \$96,000 for Marquin, assuming a 5 percent inflation rate. Final-expense needs are usually met best with permanent life insurance. With participating policies, a paid-up additions dividend option can be selected and a lower face amount can be purchased.

Using equivalence scales

A second assumption is the amount of replacement income to meet basic needs of surviving dependents, typically children. One method of determining this need is to subtract the estimated expenses related to the deceased income earner. Unfortunately, for many clients this would be difficult.

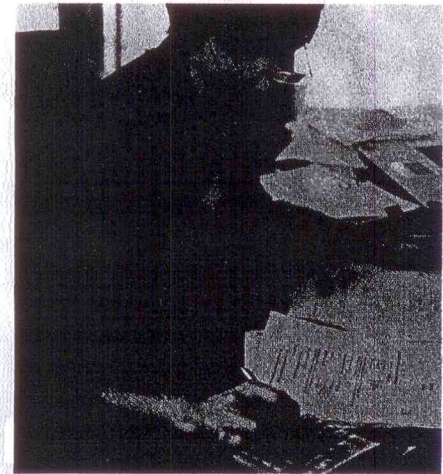
Equivalence Scale

2 adults	0.71
1 adult	0.45
2 adults, 1 child	0.79
1 adult, 1 child	0.64
2 adults, 2 children	1.00
1 adult, 2 children	0.80
2 adults, 3 children	1.13
1 adult, 3 children	0.92

Source: BLS, Monthly Labor Review, May 2001

A reasonable alternative is the use of equivalence scales, which estimate the adjustment of expenses to reflect that household expenses do not shrink (or grow) proportionately when there is one less (or more) member in it. Even for a couple, if one partner dies, the survivor's expenses are typically not cut in half due to the economies of scale that existed when there were two of them. Significant fixed costs, such as rent, mortgage and real estate taxes, remain constant regardless of the number of people in a household. They will not change dramatically, at least in the near term.

To use the equivalence tables, divide the survivor's situation by the current situation. For example, if Tasha and Marquin have three children, they would use an equivalence scale of $0.92 \div 1.13 =$



0.81. Multiply this factor, adjusted for the client's situation and preferences, by the gross household income. Then, subtract any expenses that are eliminated (FICA taxes on deceased's earnings, mortgage, credit card and so on). Finally, add any new expenses the survivor may incur.

A third assumption is the rate of return on the invested life insurance proceeds. Determining the survivor's risk tolerance and risk capacity will help select an appropriate rate of return. Keep in mind that at least the first three to five years of income should be invested in cash and cash equivalents.

Due to the critical nature of the needs supported by the income, a more conservative investment approach should be considered. For example, one possible approach for very conservative investors is to assume that all investments are in cash and cash equivalents for the income needed for the dependency years of any child. Thus, the rate of return could be assumed to equal inflation. To produce \$50,000 for 10 years would require an initial sum of \$500,000.

Each assumption in the life insurance need estimation should be examined in a similar manner. Adjustments should be made based on the client's individual situation and needs. □

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ANNUITIES

From Lump Sum to Income

Create a better retirement for your clients by helping them adopt an “income” mindset.

Whether planning for life insurance or retirement needs, it seems our clients are fixated on a magic sum—the number they are pretty sure will be enough for them to maintain a desired lifestyle after they stop receiving a paycheck. But will it be enough to preserve the lifestyle they have worked so hard to build?

We don't live on lump sums; we live on income. Once we stop earning paychecks, knowing how much income a lump sum can reliably generate is of crucial importance in deciding how much lump sum—be it life insurance proceeds or retirement savings—is enough for us to meet our future income needs. But understanding the “lump-sum-to-income” conversion math is not second nature for most clients.

In fact, some senators think this lack of understanding by many is so significant that they have taken action to address it. The “Lifetime Income Disclosure Act” (S2832), introduced last year by Sens. Bingaman (D-N.M.), Isakson (R-Ga.) and Kohl (D-Wis.), would amend the disclosure provisions of ERISA to require administrators of ERISA plans to provide, at least annually, a lifetime-income disclosure to plan participants.

For example, the lifetime-income disclosure would translate the participant's current account balance in his 401(k) plan into an annuity equivalent provided by the Department of Labor at his full retirement age. So a 45-year-old with a six-figure annual income but no pension, who thinks he's on a glide path because his 401(k) is worth \$500,000, might be surprised to learn that it generates

about \$35,000 per year at full retirement age. Armed with that information, he might decide it's time to save more.

The issue this bill is meant to address—empowering people to make good retirement-planning decisions by educating them on “lump-sum-to-income” conversion realities—doesn't have to be limited to retirement-planning issues; it can extend to life insurance planning decisions, too.

Case in point

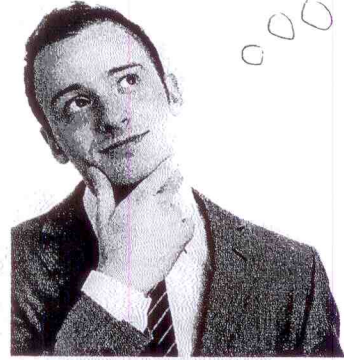
Consider a family of four with a single earner making \$100,000 a year, with \$500,000 in life insurance coverage and modest retirement savings of \$100,000. Viewed through the lens of sustainable

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income, the life insurance coverage is exceedingly modest. For example, if the breadwinner dies at 40 and his non-working spouse of the same age uses that \$500,000 death benefit to buy a lifetime-income annuity on her life, it would generate about \$25,000 a year.

Even with the addition of Social Security survivor benefits for the wife and two children (which will help but will cease once the youngest child is older than 18), the total income for the survivors will be far less than before the breadwinner died, and the lifestyle of the survivors will be at risk.

And whether it's planning for life insurance or retirement savings, it's



helpful to have your clients understand the finite range of cash flows that can be reliably and sustainably squeezed from a lump sum. That range is typically going to start at about 3 percent, if one uses a bond or bank product at today's modest interest rates to generate the income. At the upper end of the range, a lifetime-income annuity will generate a cash flow of about 8 percent of the premium amount for a 70-year-old man.

You can start this change in planning mindset by simply asking your clients what their income needs are to sustain the lifestyle to which they have become accustomed. Since a lifetime income annuity generates the highest sustainable cash flow from a lump sum compared to other products and methods, it may be helpful to start with lifetime-income annuity rates first in reverse-engineering lump-sum planning decisions for life insurance or retirement accumulation.

Helping your clients think and plan with an income mindset can be beneficial for them and for your practice. They may be better positioned for the future, and the conversion math of lump sum to income may help them determine that they need to save more for retirement or buy more life insurance to meet their income-replacement needs. □

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