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Life Insurance Needs: Rules of Thumb

September 13, 2016

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Life Insurance Needs: Rules of Thumb

What are the rules of thumb?

In general, a rule of thumb is a simple guideline that can be easily applied to a situation. In terms of determining a need for life insurance, there are some rules of thumb that you might use to calculate a basic amount of insurance coverage for yourself. The rules of thumb are simplistic and do not consider many of the factors used in other methods of insurance-need determination. They are, however, easy to use and will provide a starting point for your insurance-need evaluation.

Common rules of thumb for determining amounts of life insurance coverage

- Income rule--The most basic guideline for determining an insurance requirement is six to eight times your gross annual income. Under this rule, a person earning a gross salary of $60,000 should have between $360,000 and $480,000 of life insurance.

Gross Salary	X 6	X 8
$60,000	$360,000	$480,000
$80,000	$480,000	$640,000
$100,000	$600,000	$800,000

- Income plus expenses--This rule considers gross annual income along with cash needs at death and any special funding needs, such as private school or college tuition. Under this rule, the insurance requirement is five times gross income plus the total of any mortgage, personal debt, final expenses, and special funding needs, such as college funding. For example, assume the following expenses and debt:

Expense/Cash Need	Amount
Mortgage	$80,000
Personal Debt	$15,000
Estimated Final Expenses	$15,000
Estimated College Expenses	$50,000
Total	$160,000

Using the expenses assumed above, insurance requirements using this rule at various gross salary amounts are as shown:

Gross Salary	Gross Salary X 5	Expenses	Insurance Required: Gross Salary X 5 + Expenses
$60,000	$300,000	$160,000	$460,000
$80,000	$400,000	$160,000	$560,000
$100,000	$500,000	$160,000	$660,000

- Premiums as percentage of income--This rule calculates the amount to be spent on premiums instead of the amount of life insurance coverage. Under this rule, 6 percent of the breadwinner's gross income plus an additional 1 percent for each dependent should be spent on life insurance premiums. Assuming a breadwinner with a nonworking spouse and two dependents, the insurance premium allocations are as shown for various salaries:

Salary	Basic Allocation 6% X Salary	Dependent Allocation (3 Dependents X 1%) X Salary	Premium Allocation
$60,000	$3,600	$1,800	$5,400
$80,000	$4,800	$2,400	$7,200
$100,000	$6,000	$3,000	$9,000

Under this rule of thumb, you determine the percentage of your income to be spent on life insurance premiums and then buy as much life insurance as you can get for that premium amount.

When considering term insurance, the percentage of income allocated for premiums is often calculated at 2 percent or 3 percent.

- Multiples of Salary Method--The multiples of salary method requires the use of a multiples of salary chart and is based on the assumptions that the family has one income provider and that the average family can live adequately on 75 percent of the income provider's salary. Here's how to calculate the estimated life insurance need:
    1. Using the sample chart that follows, find the column showing the age of the nonworking spouse
    2. Find the factor on the chart where the nonworking spouse's age intersects with the working spouse's income from the column on the left
    3. Multiply the income amount by the multiplier factor from the chart
    4. Add the result using the multiplier chart to the estimate of final expenses and debt

See the explanation following the chart for ages and incomes that fall between columns.

Multiples of Salary Chart				
	Current Age of Nonworking Spouse			
Income	**25**	**35**	**45**	**55**
15,000	4.5	7.0	8.0	7.5
20,000	5.5	7.5	8.5	7.5
25,000	6.5	8.0	8.5	7.5
30,000	7.0	8.0	8.0	7.0
40,000	7.5	8.5	8.0	7.0
50,000	7.5	8.0	7.5	6.5
70,000	8.0	8.0	7.5	6.5

If the age or income is different than those shown on the chart, it is possible to calculate the amount of insurance needed by using interpolation. For example, if the income is $60,000 and the age of the nonworking spouse is 50, the result can be found using the amounts and ages immediately before and after the actual figures. In this case, take the multipliers for the ages 45 and 55 with the incomes of $50,000 and $70,000 and use the average, because the actual figures lie halfway between the chart figures. The factors are highlighted as shown:

Multiples of Salary Chart		
	Current Age of Nonworking Spouse	
Income	**45**	**55**
50,000	7.5	6.5
70,000	7.5	6.5

Average of multipliers = [(7.5 + 7.5 + 6.5 + 6.5) 4]

Multiplier for this income and age =	7.0
Income of $60,000 X 7.0 =	estimated starting need of $420,000

Generally, this amount would be adjusted to include final expenses, debt payoffs, and special needs, such as education funds. Using the previously assumed expenses for debt and college funding, the overall insurance need is shown as $580,000.

Expense / Cash Need	Amount	Multiplier Result	Estimated Need
Mortgage	$80,000		
Personal Debt	$15,000		
Estimated Final Expenses	$15,000		
Estimated College Expenses	$50,000		
Total	$160,000	$420,000	$580,000

Advantage of rules of thumb for determining life insurance requirement

Simple to calculate and easy to understand

The rules of thumb are simple. The calculations can be done using a basic calculator. They are useful as a rough starting point and can provide a framework for you to start with in assessing your insurance need.

Disadvantages of rules of thumb for determining life insurance requirement

Very general and fail to consider individual circumstances

While the rules of thumb can be a helpful starting point, they fail to consider the needs and circumstances of the individual. There are no considerations of the ages of the insured or the dependents or whether the family is provided for with one income or two. There are also no adjustments made for special circumstances, such as the expenses associated with a special needs child or the need for liquidity for estate planning.

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