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Life Insurance: How Much and What Kind?

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Life insurance can be an affordable way to provide for our children, spouse, a sibling, aging parents and others if we should die while they are depending on us. Life insurance proceeds can provide extra income to help pay ongoing household bills and child care; pay off a mortgage, credit cards and other debt; pay for college; and pay funeral costs and other final expenses. (Life insurance also plays a vital role in business succession planning and it has numerous applications in estate planning.)

A simple way to determine the amount of life insurance needed for income replacement purposes is to multiply the annual income to be replaced by the number of years it will be needed. If the insured earns an income, use the amount actually contributed to the household (after personal expenses and taxes). If the insured is a stay-at-home parent and does not earn an income, determine how much will be needed to pay someone to take over those responsibilities. As an example, a dad who wants enough life insurance to replace his income for 20 years (until his children have completed college) would take the amount of annual income he wants to replace and multiply that by 20. He may want to add enough to pay for college and other expenses. The total amount is how much life insurance he needs. This is called the "face value" or "death benefit."

Basically, there are two kinds of life insurance: term and permanent.

Term life insurance provides coverage for a set number of years, or term. It is pure insurance, and is similar to insurance on a car or home. It can be a good choice when coverage is needed for a certain number of years; for example, until the kids are out of college or the mortgage is paid off. It is also less expensive than whole life, and is least expensive when the insured is young and healthy. For these reasons, term life insurance is a popular choice for young families.

Permanent life insurance, on the other hand, does not expire at the end of a specified term (assuming the premiums are paid). Generally, the coverage stays in effect during the insured's lifetime and the premium, depending upon the type of policy, can either stay the same or fluctuate based upon the financial performance of the policy. Permanent policies also build cash value over time that can be borrowed from the policy (reducing the proceeds paid at death), can be used to help pay the premiums, or can be refunded if the policy is cancelled.

The amount a family pays for life insurance must be a reasonable and manageable expense. The cost will depend on the amount, kind (term vs. permanent), and the age and health of the person to be insured. If the cost to replace income for 20 or 30 years is too much for the family budget, one option is to cover five to seven years of expenses, which will give the family time to cope and adjust after the loss.