How much insurance do you need?

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National Insurance Awareness Day is round the corner on 28 June. While insuring your health and life is always a good idea, the ongoing pandemic has only reinforced the importance of being protected. It's not enough to just buy any policy. The cover should be adequate. To help you find out whether your insurance cover is enough or not, this week's cover story helps you calculate how much of life insurance you need using the income-based and expense-based models. In the first method we use human life value (HLV) to calculate the required insurance cover. The total financial loss to the family is arrived at based on your current earnings, your personal expenses, the number of earning years left and the expected annual increase in earnings, among other parameters.

First, you need to arrive at your post-tax annual income. Only the income that will stop with your demise should be considered. Take into account the take home pay and components like contributions to the EPF by you or the employer. When calculating business income, ignore income generated by businesses managed by others and add only the part that is coming due to your active participation in it. Though an income stops with one's demise, some expenses stop too. These may be personal expenses or work related spending. Deduct these expenses to arrive at the net monetary loss to the family. The next step involves the number of earning years left. Salaried individuals can take retirement as the cut off here. "Earning potential of businessmen and professionals can go beyond 60 years and therefore, they should make a reasonable assessment about when their income will stop," says R.M. Vishakha, MD & CEO, IndiaFirst Life Insurance.

Since your income is not going to remain stagnant over the years, you can't arrive at the monetary loss to the family by multiplying your current income with the remaining number of earning years. For that you need to assume an annual growth rate. However, assume a reasonable rate because the final value will be drastically different based on growth assumptions. "While increments will be higher when you are younger, it starts moderating as you grow older. So, people should only assume around 5-7 percent increase in annual income," says Melvin Joseph, Founder, Finvin Financial Planners. Once you arrive at a reasonable increase in income, you can arrive at the total monetary loss to family (see table). The amount you arrive at may seem very big, but the loss mentioned happens in future and therefore, the same needs to be considered in present value. You can do it with the net present value (NPV) formula using a discounting factor. The value comes down drastically after discounting. This total adjusted loss to the family is the exact insurance cover you need if you go by the income replacement method. This corpus should last till the time you would have turned 60 despite a 5 percent yearly increase in withdrawals.

In the unfortunate event of the main earner's demise, does the entire loss need to be compensated? Not necessary if the family has other sources of income. "Insurance cover should be need based and not based on income. Two persons with the same income should not have the same insurance cover if one is paying rent and the other earns a rental income from a second property," says Tarun Chugh, CEO, Bajaj Allianz Life Insurance. In the expense replacement method, the gap in future expenses (total future expenses and the shortfall) is arrived at and the insurance need is restricted to that. Start by adding all your monthly (rent, school fees, grocery, electricity, etc) and annual (travelling, etc) expenses to

arrive at the total family expenses. Existing loans and insurance is taken into account at a later stage. From the total family expenses, deduct your expenses – that which will not be incurred if you are not around. The final figure you get is the family's net expenses as of today.

Calculate expenses of each dependant on your income, including yourself. Once you get each one's current regular expenses, you can calculate the future value by assuming a reasonable inflation rate – we have used 5 percent. Since these are future values, the same needs to be discounted using reasonable returns (we have assumed 7 percent) for each dependant using the net present value formula. Add all numbers to get the insurance cover you need to take. Balancing is critical. "If you want to reduce insurance cover due to financial constraints, you can calculate to the point your son or daughter would start earning. This is on a reasonable assumption that kids will take care of their remaining parent," says Rohit Shah, Founder & CEO, Getting You Rich. However, Vishakha has a different view. "Retirement planning of the remaining spouse will be big component, but that needs to be done. Though this generation is taking care of parents, it is not reasonable to expect the same from the next generation," she says.

We need to consider the level of dependency too. While a non working spouse will be fully dependant, a working spouse may be partially dependant or even fully independent. Similarly, parents with some pension income, accumulated wealth, etc may be only partially dependent. If the dependency is partial, you can reduce the required insurance by that much amount. Should a person without financial dependants take life insurance? "Insurance is only for people with financial dependants. If spouse, parents, etc are fully financially independent, there is no need to take life cover," says Amol Joshi, Founder, PlanRupee Investment Services. Kshitij Jain, MD & CEO, Exide Life Insurance concurs. "Financially independent couples need not take a big cover. They can restrict the cover only to their liabilities," he says.

Since you don't want your family to bear the burden of any outstanding liability, this part needs to be fully covered. "People need to take additional cover for liabilities. Else, dependants may be forced to use insurance receipts for paying off loans and will be left with nothing," says G. Murlidhar, MD, Kotak Life Insurance. However, you can avoid adding a liability if the loan is already covered by credit life insurance. "Ignore the loans that are already covered under credit life insurance and take additional term cover for loans without credit life insurance," says Santosh Agarwal, Head of Life Insurance, Policybazaar.com. Over and above day to day expenses, you need to provide for the future well-being of family members. What should you do if the insurance cost shoots up by including all goals? "If present finances are not great, you need to include only critical goals and not all goals," says Shah. While most people add normal assets like FDs while computing segment, they tend to ignore several other assets. "All assets including balance of PPF, EPF, etc should be considered here. While one needs to add real estate, avoid the primary residence," says Joseph.

Consider existing cover: Computing how much life cover you need is only the first step and the next step is managing it. If you already have an existing life cover, buy a policy that will cover the shortfall, if any. "A lot of people forget to account for the group term plan offered by their companies. However, please note that you lose this cover once you leave the company," says Shah. Affordability "Since affordability is an important factor, people should

opt for low cost products," says Joseph. While normal term plans are cheap, you have cheaper options, provided you are ready to buy from the company sites directly. Recycling high cost insurance policies is another option. "If you are not able to take the required cover due to lack of funds and at the same time are stuck with high cost traditional plans, surrender those traditional plans and reuse the money to pay for the term cover," says Shah.

You may even get stuck with high cost term plans. For instance, Mumbai-based pharmacy professional Sachin Acharekar initially paid an annual premium of Rs. 55,000 for a Rs. 1 crore term plan that covered him till the age of 75. Now he pays Rs. 18,500 for a Rs. 1.5 crore term plan that will cover him till he is 60. "Term cover costs shoot up once the insurance period goes beyond 60, so it is better to take the cover only till 60," says Joshi. Joseph concurs. "Opting for a return of premium (RoP) policy is another mistake people do and this also increases insurance costs significantly," he says. Nominee details While people take extreme care while selecting the right term insurance plan, they are usually not so careful with the nominee details. While nominating the spouse is common in nuclear families, it may not be that easy in joint families or when dependent parents are around. "The nomination should mirror your will and each nominee should be given the payout in the same proportion," says Chugh. Kshitij Jain, MD & CEO, Exide Life Insurance agrees. "To avoid confusion, decide now how much each nominee should get from the proceeds. You can nominate multiple people for one policy or buy separate policies for different nominees," he says.

Disbursement is critical Do keep in mind the financial acumen of your nominees. For example, if your spouse is the nominee, make sure he or she is capable of managing the corpus, which will be a large sum. If you are not sure about the financial acumen of your spouse or you don't have a reliable financial planner, opt for a staggered payout. Most financial planners are against this option because the rate of return offered by insurance companies here is low. However, it still makes sense. "The chance of a nominee with no financial acumen losing the entire corpus is high. Lower return is better than losing money," says Vishaka.