Life insurance

The basics

N. Shanbhag, one of the best Indian writers on investment and financial planning, says this about life insurance:

"There is no substitute for life insurance. Life insurance is not an investment. It is a social and commercial instrument to provide financial security in the event of death of the insured. If dependents can look after themselves comfortably without the amount insured, life insurance is not needed."

"Life insurance is like a life saving drug. If you need it, you must have it irrespective of the cost. If you do not need it and you take it, it can have very bad side effects on your financial health."

Before you get life insurance, ask yourself:

Do you need life insurance?
Yes, only if you have financial dependents. If your absence is not likely to financially affect anyone, you don't need it.

How much of life insurance do you need?
Enough to keep your financial dependents in the lifestyle they are used to, ensure that they are debt-free, and provide reasonably for their foreseeable future needs. In other words, enough to compensate your dependents for the adverse financial situation your absence could cause.

Doing the math

Here's an example to help you calculate the amount of life insurance a person needs.

Let's consider the case of a family with the following facts:

- The family comprises husband, wife and two very young children.

- Their normal monthly expenditure is Rs 25,000; therefore, they need at least Rs 3 lakhs in cash, per annum, to sustain their current lifestyle.

- The husband is the sole breadwinner in the family. In his absence, the family may not have a cash flow of Rs 3 lakhs annually. Therefore, he needs to calculate the size of the corpus to be invested in a safe investment avenue such as a bank fixed deposit, to ensure that the family gets Rs 3 lakhs per annum. For instance, a corpus of Rs 43 lakhs invested in fixed deposit, with an average interest rate of say 7% p.a, could provide the family the required income stream.

Should the husband purchase insurance worth Rs 43 lakhs? Only after making some deductions from this corpus, which could be in the nature of:

- Existing financial savings – Rs 10 lakhs

- His wife's independent financial resources – Rs 15 lakhs

- Retirement benefits, existing insurance policies and other cash flows that will accrue in case of his death – Rs 5 lakhs

This total of Rs 30 lakhs must be deducted from the Rs 43 lakhs corpus envisaged earlier, since it will be available to provide the necessary income stream.

The result is an uninsured gap of Rs 13 lakhs and the husband needs to take life insurance for this amount.

If in this example, the family's liquid assets were Rs 45 lakhs, they would amount to more than the corpus of Rs 43 lakhs required to generate income for normal expenses. There would be no uninsured gap, and therefore no need for life insurance.

What you need to remember while taking life insurance:

- Do not be fooled by advisors who inflate the quantum of insurance to be taken with factors such as education, child's wedding, etc. When a breadwinner or an important earning member dies, the family is vulnerable in the short-term and needs the protection of life insurance during this period (one, two or a maximum of five years). Human beings are resilient by nature and are capable of adjusting to, and dealing with, new, adverse situations, in the medium to long term.

- Base your calculations on the normal current monthly expenses. You could increase it slightly for the purpose of insurance calculations. For instance, if your normal expense is Rs 25,000, provide for Rs 30,000 in your calculations.

- Do not substantially inflate the figures or worry about providing for 10 or 20 years hence. No one can predict the future, especially the distant future, economic circumstances, inflation, etc. For instance, 12 years ago, a phone call from Mangalore to Bombay used to cost more than Rs 26 per minute. Today, it's less than Rs 1 per minute.

- Using only normal monthly expenses for insurance calculations comes with a built-in safeguard. Practically speaking, a family's overall expenses reduce after the death of one of its members, as expenses incurred on that member on a regular basis no longer occur.

If the rest of the family is adequately insured for health, and to the extent required for life, the best you can do in life insurance is enable a corpus to take care of normal expenses for the next few years, say a maximum of five or six years.