WHY DAVE RAMSEY AND SUZE ORMAN ARE WRONG ABOUT LIFE INSURANCE IN RETIREMENT

March 6, 2015 by Tom Martin

Dave Ramsey, Suze Orman and scores of other financial pundits in the media scorn the idea of having life insurance in retirement. Their rationale seems to make sense on the surface: Life insurance is designed to replace your earnings when you die. Once you retire (and have no earnings) you are living off your investments. When you die, your investments don't die with you, so what is the purpose of using valuable funds to pay for unneeded coverage?

Life insurance clearly plays an important role for very wealthy clients to efficiently transfer their estate, but are the media pundits correct when they advise that the average family to dump their coverage in retirement? Probably not.

Let's consider the following statistics:

The average American approaching retirement has retirement assets to replace only 10 percent of his/her pre-retirement earnings.

55 percent of Americans over age 65 rely on Social Security to provide more than half of their income.

The maximum monthly Social Security retirement benefit for a person reaching full retirement age in 2015 is $2,642.

These statistics clearly show that Social Security is a vital source of retirement income. When we view our Social Security benefits statements, we tend to discount the importance of this benefit, as benefits are expressed in "today's dollars." In reality, our actual benefits will be much larger due to inflation. By contrast, when we consider how much savings we will have at retirement, we often fail to consider that the values of those dollars will be similarly reduced due to inflation. Consider the following example.

John and Jane Doe, age 50 and 45 respectively, plan on working to John's full retirement age of 67. John is making $150,000 per year and Mary earns $70,000 per year. John and Jane both contribute to a 401(k) plan and, based on their investment assumptions, they figure that they will have $1,000,000 in retirement funds by the time John reaches age 67. Assuming a 5 percent withdrawal rate, they will be able to withdraw about $50,000 per year.

John receives his Social Security statement and sees that his retirement benefit will be the maximum, which is $2,642 in today's dollars. Jane's benefit is projected to be $1,450 if she claims at age 62 (same year John retires). John and Jane incorrectly assume that Social Security will provide about half of their retirement income, which is $49,000 from Social Security and $50,000 from retirement accounts.

In reality, both will receive much larger Social Security checks, since these amounts will be indexed for inflation. If we assume 3 percent inflation, John’s actual benefit will be about $77,000 per year and Jane’s will be about $40,000 per year. In comparison, assuming a 5 percent withdrawal rate on their retirement assets, they will have $50,000 income from the retirement funds. In reality, despite a respectable retirement account balance, Social Security will actually provide about 70 percent of their income.

Since Social Security benefits continue to increase with inflation, by the time John is age 80, his Social Security benefit will have risen to $113,000, at which point Jane’s benefit will be about $59,000.

Let’s assume that John dies at age 80 and Jane lives to age 85. At John’s death, Jane will assume John’s benefit and lose her own benefit. The total Social Security benefit will drop by $59,000 per year. Since Jane will spend 10 years as a widow, this loss amounts to $590,000!

What’s more, consider if John dies at age 75 and Jane lives to age 90. John’s death would cost Jane well over $1,000,000 in lost Social Security benefits.

Even though they have a sizable retirement account, it only represents about 30 percent of their income. Such a substantial reduction in Social Security benefits is likely to cause a substantial reduction in Jane’s lifestyle.

The financial pundits would be quick to recommend that John purchases a term policy today to cover his “temporary” insurance need. They figure that once John retires, he has no earnings to protect. In reality, his death after retirement will cause a substantial reduction in household income. John should consider some form of permanent insurance for at least part of his insurance portfolio now in order to mitigate the eventual loss of the Social Security benefit. If Jane predeceases John, John would lose Jane’s benefit. Even if the permanent insurance was just on John’s life, he could still utilize his policy to replace the benefit he lost on Jane. He could use the policy to provide a tax-free income stream through withdrawals and loans. He could cash the policy in, replace it with an annuity, or even sell the policy as a life settlement. Either way, a permanent policy on John could create a useful cushion regardless of who dies first.

In summary, life insurance can play a critical role in helping couples meet their retirement goals, whether it is through utilization of the policy’s cash value or in having the death benefit replace the lost Social Security benefit.