Strategy Paper: Risk Management

The Importance of Personal Insurances

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Overview

- Risk management and in particular personal insurances are a vital ingredient of any comprehensive financial plan:
  - Just as you insure your house, car and other property against loss, so too you should ensure that you hold suitable personal insurances that may include life and income protection insurances
- Risk management and personal insurances must be considered as an integral part of the financial planning process:
  - For example, have you thought about how your family or your partner would cope financially if you died?
  - Personal insurances can help to ensure that those who depend on you will not be financially disadvantaged in the event of your death, a medical crisis or your disablement
- Most people purchase house, car, and health insurance without giving it much thought, but it is a well-known fact that most people are either underinsured or uninsured for events such as death, trauma or disablement
- This Strategy Paper explores the main types of personal insurances:
  - Income Protection insurance can provide a monthly payment of up to 75% of your income to replace lost earnings if you are temporarily unable to work due to disability
  - Life insurance can provide a lump sum in the event of your death while TPD insurance can provide a lump sum if you suffer a total and permanent disability and are unable to work again:
- If the insurance cover is held within a super fund, the benefit may also be paid in the form of an income stream
  - Trauma insurance can pay a lump sum if you suffer or contract a critical condition specified in the policy (e.g. a heart attack, stroke or cancer)

Strategy 1

Protect your greatest asset... Your income

Many people insure their home and contents, even their life. Yet, all too often, they don't adequately protect what is potentially their greatest asset – their ability to earn an income.

Think about it this way. If you are unable to work for an extended period due to illness or injury, how will you meet your mortgage repayments and other bills and expenses? Without an income, you could run down your savings very quickly and face financial difficulty.

Rather than putting your family's lifestyle at risk, by taking out Income Protection insurance, you could receive a monthly benefit of up to 75% of your income to replace your lost earnings while you recover.

Most Income Protection policies offer a range of waiting periods before you start receiving your insurance benefit (with options normally between 14 days and two years).

You can also choose from a range of benefit payment periods, with maximum cover generally available up to age 65.

What is your future earning capacity? How much will you earn by age 65?

If you're in any doubt about the importance of protecting your income, the table below shows how much you could earn by the time you reach age 65. For example, if you are currently 35 and earn $80,000 pa, you could earn around $3.8 million before you turn 65[1]. Isn't that worth protecting?

Current income (p.a.)	Age now			
	25	**35**	**45**	**55**
$40,000	$3,020,000	$1,900,000	$1,070,000	$460,000
$60,000	$4,520,000	$2,850,000	$1,610,000	$690,000
$80,000	$6,030,000	$3,810,000	$2,150,000	$920,000
$100,000	$7,540,000	$4,760,000	$2,690,000	$1,150,000

The Benefits

- Receive up to 75% of your pre-tax income if you are unable to work due to illness or injury
- Maintain your family's lifestyle while you recover

[1] Assumes the lump sum of $460,000 earns an after-tax return of 6% pa, the income required increases at 3% p.a. to keep pace with the rising cost of living and the capital is exhausted over the 18 year period.

Tips and Traps

- When choosing a waiting period for your Income Protection insurance, it's important to take into account any sick leave and related benefits provided by your employer.
- Income Protection insurance premiums will generally be lower if you choose a longer waiting period and a shorter benefit payment period.
- If you take out Income Protection insurance in a super fund, you can arrange to have the premiums deducted from your investment balance without making additional contributions to cover the cost. This can help you afford insurance if you don't have sufficient cashflow to pay for it outside super.
- If you are the primary income earner, you should also consider insurances that can provide a payment to clear your debts in a range of circumstances and enable your family to meet their ongoing living expenses if you pass away
- If your partner is not working, you should consider insurances that can provide a payment to cover medical, childcare and housekeeping expenses, if they become critically ill or die.

Case study

Leanne works full-time and earns a salary of $90,000 p.a. She owns a home worth $500,000 and has a mortgage of $350,000. If she's unable to work due to illness or injury, she wants to be able to meet her living expenses and mortgage repayments without having to eat into her limited savings.

Leanne takes out Income Protection insurance to cover 75% of her monthly income. Shortly after taking out the insurance, Leanne is involved in a bad car accident and is unable to work for six months.

Because Leanne had Income Protection insurance, she receives the full benefit of $5,625 per month for five months after her initial one month waiting period (where she's covered by sick leave from her employer). As a result, Leanne receives a total income of $35,625 during the six months she's off work – consisting of a combination of sick leave and Income Protection benefits.

If Leanne had not taken out Income Protection insurance, she would only have received a sick leave payment of $7,500 and would have struggled to meet her living expenses, mortgage repayments and out-of-pocket medical costs.

Strategy 2

Eliminate debt on death or disability

If you're like most people, you've used debt to fund a range of purchases, including your family home.

However, if you die, become totally and permanently disabled or suffer a trauma (such as cancer, a heart attack or a stroke), the loan repayments will still need to be made, even though the salary your family has relied upon is temporarily or permanently unavailable.

In the event of your death, your lender may even require the outstanding loan to be repaid immediately, and sometimes the only way to do this is to sell the family home.

To avoid these potential problems, you should consider Life, TPD and Trauma insurance. These insurances can provide a lump sum payment that could be used to clear your debts.

When determining how much cover you may need, you should:

- Add up all the debts that would need to be repaid (including your mortgage, personal loans, credit cards and hire purchase arrangements)
- Deduct any existing insurance and other financial resources that could be accessed (such as your superannuation balance), and
- Add any legal and other expenses that could be incurred.

The Benefits

- Provide a lump sum payment to clear your debts
- Pass on the full value of your assets to your dependants

Tips and Traps

- Because changes in your personal circumstances (e.g. taking on additional debt) often necessitate higher insurance levels, it's important to select a policy that lets you increase the level of cover in the future, within certain limits, without requiring further medical evidence.
- If you are the primary income earner, you should also consider insurances that can enable your family to meet their ongoing living expenses in the event of your illness or injury and your death.
- If your partner is not working, they should consider insurances that can provide a payment to cover medical, childcare and housekeeping expenses if they become critically ill or die.
- There may be some advantages in taking out the Life and TPD insurance in a super fund:
  - However restrictions do apply to who can be nominated as a beneficiary and taxation liabilities may apply to certain eligible persons when a death benefit (including insurance proceeds) is paid in the form of a lump sum, pension or a combination of both from a super fund.
- To ensure your wishes are carried out upon your death, you should consider your entire estate planning position, including which assets will (and won't) be dealt with by your Will. The best way to do this is to seek professional estate planning advice.

Case study

Vanessa and Peter have three young children. Vanessa has been a full-time homemaker for the past five years and Peter earns a salary of $95,000 p.a. Their home is valued at $500,000, they have debts totalling $320,000 and the repayments are $2,797 per month.

Peter is concerned that, if something happened to him, Vanessa would struggle to meet the loan repayments and may even need to sell the family home to clear their debts.

If Peter becomes totally and permanently disabled or (dies), he (or Vanessa) could receive a lump sum payment from his super fund of $120,000. This includes his existing account balance and an insurance benefit provided by his fund.

Whilst this money could be used to reduce the debts to $200,000, Vanessa may still find it difficult to meet the repayments. This is because, even though she could return to the workforce, she would probably have to meet some additional costs from her salary, such as childcare and household help.

To ensure enough money becomes available to clear the debts, Peter takes out $200,000 in Life and TPD insurance to supplement the $120,000 that would be paid from his super fund.

Furthermore, because Peter is unlikely to receive a benefit from his super fund if he becomes critically ill, unless the illness is terminal. Peter uses Trauma insurance to cover their total debts of $320,000. This will enable Peter and his family to focus on his recovery without the financial stress of having to meet loan repayments.

Strategy 3

Maintain your family's lifestyle

In the previous strategy, we explained why you should consider using insurance to clear your debts if you die, become totally and permanently disabled or suffer a trauma.

However, it's also important you have enough Life insurance to enable your family to meet their ongoing living expenses in the event of your death.

As a starting point, you need to:

- Work out what your family spends each year on groceries, education, household bills and other living expenses, and
- Decide how long you'd like your family to be financially supported in your absence.

Once you know these two things, a financial adviser can calculate how much Life cover you will need to provide the required income over the desired time period.

When doing this, a financial adviser can take into account the tax that may be payable on the investment income your family will receive and allow for the impact of inflation.

With the right insurance advice, your family can receive enough after-tax income to meet their ongoing living expenses and avoid financial difficulty.

The Benefits

- Generate an ongoing income
- Help your family maintain their standard of living.

Tips and Traps

- When determining the amount of Life insurance you require, it's also important to take into account any funeral and estate costs that may need to be met when you die.
- You may want to decrease the amount of Life cover over time as the period over which you need to provide income support for your family declines.
- If you are the primary income earner, you should also consider insurances that can enable your family to meet their ongoing living expenses in the event of your illness or injury.
- If your partner is not working, they should consider insurances that can provide a payment to cover medical, childcare and housekeeping expenses if they become critically ill or die.
- There may be some advantages in taking out the Life and TPD insurance in a super fund:
  - However restrictions do apply to who can be nominated as a beneficiary and taxation liabilities may apply to certain eligible persons when a death benefit (including insurance proceeds) is paid in the form of a lump sum, pension or a combination of both from a super fund.

Case study

Peter, from the previous strategy, also wants to make sure his wife (Vanessa) and three young children will be able to maintain their living standard if he dies.

Peter works out his family currently needs around $34,000 p.a. (or $650 per week) to meet their regular bills and expenses, excluding loan repayments.

Peter would also like to ensure his family has enough money to meet these financial commitments for the next 18 years, until their youngest child reaches 21.

After assessing their goals and financial situation, their adviser recommends Peter take out an extra $460,000 in Life cover. This is in addition to the Life, TPD and Trauma cover he needs to clear their debts.

Should he die, the additional lump sum payment of $460,000 can be invested to generate an after-tax income of $34,000 p.a. over the 18 year period[2].

[2] Assumes the lump sum of $460,000 earns an after-tax return of 6% pa, the income required increases at 3% p.a. to keep pace with the rising cost of living and the capital is exhausted over the 18 year period.

Strategy 4

Protect the homemaker

In the previous strategies, we outlined the financial risks a family faces if the primary income earner doesn't have enough insurance. However, it's also potentially dangerous to overlook the insurance needs of the person who is mainly responsible for looking after the home and raising the children. If something should happen to the homemaker, the primary income earner usually has a limited number of options.

They can reduce their working hours to look after the household and children, or they can hire someone else to do it. But both options can have a negative impact on the household's disposable income.

A simple way to avoid putting a big dent in the household budget is to get the homemaker to take out insurances that can provide a lump sum payment if they suffer a trauma, die or become totally and permanently disabled.

When deciding which of these insurances to buy, Trauma cover is potentially the most important. This is because you need to be employed or self-employed if you want to take out Income Protection insurance.

However, the homemaker should also consider Life and TPD insurance. This is because the death or total and permanent disability of the homemaker could have a devastating financial (as well as emotional) impact on the family.

The Benefits

- Cover the medical expenses associated with the disablement, serious illness or death of your spouse
- Pay for additional expenses, such as child care, nursing or housekeeping

Tips and Traps

- There may be some advantages in taking out the Life and TPD insurance in a super fund:
  - However restrictions do apply to who can be nominated as a beneficiary and taxation liabilities may apply to certain eligible persons when a death benefit (including insurance proceeds) is paid in the form of a lump sum, pension or a combination of both from a super fund.
- However restrictions do apply to who can be nominated as a beneficiary and taxation liabilities may apply to certain eligible persons when a death benefit (including insurance proceeds) is paid in the form of a lump sum, pension or a combination of both from a super fund.
- If the cover is taken through superannuation, it may be possible to make a binding nomination to ensure any death benefit is payable to a particular dependant (eg the working partner). TPD benefits in super are always payable to the disabled member.
- Insuring the primary income earner and the homemaker under the one policy may save on policy ees.

Case study

Nicholas is married to Rebecca, who is taking time out of the workforce to look after their twin three-year-old boys.

Nicholas is employed, earns a pre-tax salary of $100,000 p.a. and has already arranged a comprehensive package of insurances for him. However, they hadn't recognised the importance of insuring Rebecca and the financial impact of this oversight hit home when she was diagnosed with breast cancer.

During the three years it took Rebecca to make a full recovery, they spent a total of $92,400 on childcare (net of Government rebates and benefits) and help around the home.

Also, things were particularly tough in the first two years, where these costs amounted to $38,400 p.a. This represents a little over 50% of Nicholas's take-home pay, leaving him with little money to pay the mortgage and meet their day-to-day living expenses.

The financial impact of Rebecca's trauma could have been reduced (or eliminated) if she had taken out Trauma insurance to cover these and other costs.

Strategy 5

Purchase life and TPD insurance tax-effectively

If you buy life and TPD insurances in a super fund, you may be able to take advantage of a range of upfront tax concessions generally not available when insuring outside super. For example:

- If you're eligible to make salary sacrifice contributions, you may be able to purchase insurance through a super fund with pre-tax dollars (see case study).
- If you earn less than $46,920[3] p.a. and you make personal after-tax super contributions, you may be eligible to receive a Government co-contribution that could help you cover the cost of future insurance premiums.
- If you make super contributions on behalf of a spouse on a low-income, you may be able to claim a tax offset of up to $540 p.a. that could be put towards insurance premiums for you or your spouse.
- If you earn less than 10% of your income[4] from eligible employment (e.g. you're self-employed or not employed), you can generally claim your super contributions as a tax deduction – regardless of whether they are used in the fund to purchase investments or insurance.
- These tax concessions can make it cheaper to insure through a super fund. This will usually also be the case if the sum insured is increased to make a provision for any lump sum tax that is payable on TPD and death benefits in certain circumstances.

Another benefit of insuring in super is that you (or certain eligible dependants) have the option to receive the TPD (or death) benefit as an income stream, rather than a lump sum payment. Where this is done:

- Because lump sum tax won't be payable when the income stream is commenced, there is no need to increase the sum insured, and
- The income payments will be concessionally taxed.

However, receiving the insurance proceeds as an income stream will generally not be suitable if the money is required as a lump sum to clear debts or meet any other one-off financial commitments.

The Benefits

- Reduce the premium costs considerably
- Purchase a higher level of cover

[3] Includes assessable income, reportable fringe benefits and reportable employer super contributions (of which at least 10% must be from eligible employment or carrying on a business)

[4] Includes assessable income, less business deductions, reportable fringe benefits and reportable employer super contributions

Tips and Traps

- Insurance cover purchased through a super fund is owned by the fund Trustee, who is responsible for paying benefits subject to relevant legislation and the fund rules. When insuring in super, you should be clear on the powers and obligations of the relevant Trustee when paying benefits.
- When making contributions to fund insurance premiums in a super fund, you should take into account the cap on concessional and non-concessional contributions.
- When insuring in super, you can usually arrange to have the premiums deducted from your account balance without making additional contributions to cover the cost. This can enable you to get the cover you need without reducing your cash flow.
- While Trauma insurance is generally not available within super, it is possible to purchase Income Protection (or Salary Continuance) insurance in super with a choice of benefit payment periods up to age 65

Case study

Jack, aged 45, is married to Claire, aged 41. Claire is taking a break from the workforce while she looks after their young children. Jack works full-time, earns a salary of $100,000 p.a. and they have a mortgage.

Jack takes out $700,000 in Life insurance so Claire can pay off their debts and replace his income if he dies. The premium for this insurance is $805 in year one.

It will be more cost-effective if he takes out the insurance in super. This is because if he arranges with his employer to sacrifice $805 of his salary into his super fund, he'll be able to pay the premiums with pre-tax dollars[5].

Conversely, if he purchases the cover outside super:

- He'll need to pay the premium of $805 from his after-tax salary, and
- After taking into account his marginal rate of 39.0%[6] , the pre-tax cost would be $1,320 (i.e. $1,320 less tax at 39.0% [$515] equals $805).

By insuring in super he could make a pre-tax saving of $515 on the first year's premium and an after-tax saving of $314, after taking into account his marginal rate of 39.0%.

[5] Because super funds generally receive a tax deduction for death and disability premiums, no tax is deducted from the salary sacrifice super contributions. The government announced in the 2012 Federal Budget that if an individual earns $300,000 or more, they will pay an additional 15% tax on concessional super contributions. Affected individuals will incur an additional 15% tax on their concessional contributions. A concessional contribution cap of $35,000 (2013/14) applies. If contributions exceed this cap, excess contribution tax of 31.5% is payable.

[6] Includes Medicare levy of 2.0%.