Chapter 14

INSURANCE — LIFE, INCOME AND OTHER

Solutions to Questions

Question 1: Life expectancy tables are used to estimate the period of time that a dependant’s needs are to be met. What problems arise in relying solely on these figures?

There are two aspects that need to be taken into account:

• The life expectancy tables give historical data. If you look over the life expectancy for a number of years you will see that the life expectancy is increasing. This can be attributed to improved and healthier lifestyles and advances in medical science.

• The life expectancy tables show the average age. This means that 50% of the people will live longer than the figures produced.

In using these figures to calculate a sum insured a longer life expectancy should be considered, especially when a person has a family history of longevity.

Question: What are the differing needs that you would expect to find with:
  a a single person;
  b a married couple with a young family; and
  c a mature couple approaching retirement?

Single person
They would normally have no dependants, although this cannot be assumed so inquiries should be made. There may be a child or relative that is dependent on them.

The needs that exist would be to pay out any debts such as amounts owing on a house or other asset, credit card etc; make provision for final medical and funeral expenses.

Married Couple
There will be a need to provide for dependants until the dependency ceases. This could be children, spouse or dependent relatives. In addition, are there any debts — mortgages, loans or credit cards etc — that need to be paid out? Provision needs to be made to meet any legal expenses, final medical costs and funeral expenses.
Mature couple

These would include the same items as the married couple except that the dependency would probably have ceased or be near ceased. Debts also may have reduced considerably as they are moving into a time when saving is predominant.

What may arise at this time is, where there is a family business, the need to develop a business succession plan. Apart from deciding who will take over the business, there will be a need to cater for the beneficiaries who will not participate in the business. A life policy can be arranged so that the beneficiary’s share of the business can be bought out.

Question 3: When calculating a sum insured for TPD cover, what different aspects need to be considered compared to life insurance cover?

With TPD the person is still living. They will be totally disabled, so provision for their dependency needs must be included. In addition, provision needs to be made for any medical expenses. Health cover should be in force so this would provide for costs outside that area. If there is no health cover then provision needs to be made for the major type of operations that can arise. An amount also needs to be included for the cost of artificial limbs, house alterations (to allow for a wheelchair or other alteration), special medical equipment and the like.

Funeral costs would not need to be included.

Question 4: What is the difference between a stepped and a level premium?

A stepped premium is one that increases each year in line with the increased risk of death (or disability).

A level premium provides an average premium over a specified number of years so that during the specified period of time the premium remains unchanged. The effect of applying a level premium is that in the early years of the policy a higher premium than the stepped premium is paid. The surplus over the stepped premium amount is invested and the investment return along with the surplus amount is used to reduce the higher premium (that would be paid as a stepped premium) in the latter period of the policy.

Question 5: When would you consider the use of stepped and level premiums appropriate?

The main factor to consider is how long it is expected the policy will be in force for. Whilst people take cover intending it to last for many years, often this does not turn out to be the case. With the level premium, if the policy is only in force for a short number of years then ceases, the insured would have paid more than what the stepped premium would have been.

Question 6: Discuss the optional extensions available under a life policy and indicate when you think they would be appropriate to use.
Travel assist. This benefit is an extension of a TPD cover taken with the life policy. It provides cover for travel expenses when the insured is away from home at the time of disability. If the insured travels, the cover may be of value.

TPD premium waiver. This benefit waives premium payment under the policy in the event of total and permanent disablement. The premium would be small and the cover is of value. It means where there is a successful TPD no further premium is paid under the policy.

Question 7: John Camaller is a heart surgeon. An accident resulted in the loss of his right hand and he is no longer able to continue operating. Which of the three definitions would need to be in a TPD policy for John to be able to make a claim?

The three definitions to consider are:

Any occupation
The loss of a hand would not stop John being able to get work. It would restrict the type of work available. There would be no claim.

Similar occupation
Probably no cover with this extension also. John could teach medical students, work in a parts division or other like occupation.

Own occupation
If any of the definitions would apply it would be this one. But, this may be doubtful also. John’s situation would prevent him being able to work as a surgeon. As only having one hand would restrict him considerably, the prospect of obtaining work would be extremely unlikely so the cover would apply.

Question 8: Why is life insurance an important element to be considered in devising a financial plan?

While making and saving money is an important aspect of your finances, it is equally important to insure and protect these things as well.

Insurance basics
Accidents and disasters can and do happen, and if you aren’t adequately insured it could leave you in financial ruin. You need insurance to protect your life, your ability to earn income, and to keep a roof over your head.

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.

**Life insurance**

Life insurance is really fairly simple — the policy owner receives the insurance proceeds if the insured dies.

A premium is paid for the selected level of cover and is based on the insurance company’s risk; for example, the older the person, the higher the risk and the higher the premium; or, if the person is a smoker or pursues hazardous leisure activities, the higher the risk and the higher the premium.

Life insurance can be taken out inside or outside of superannuation. Premiums are tax deductible inside superannuation; however, they are not deductible outside superannuation. The most appropriate option for you should be discussed with the aid of your financial planner.

Among the reasons why people take out life insurance are to pay out debts, to buy the full share of a business if your business partner dies, to pay for funeral costs and to provide for your family after you have gone. The sad fact is that the majority of Australians are significantly underinsured or do not have any life insurance at all.

After realising you need life insurance, the question then becomes — how much? There are various formulas that can be used and most take into consideration your age and the ages of your dependants, your current income and lifestyle and debts, including a mortgage.

Generally, younger people require more life insurance as older people typically have less debt and their dependants have grown up and moved out of the house.

The question of how much life insurance depends on your own circumstances and should be considered with the aid of your financial planner. How would your family or your partner cope financially if you died?

**Question 9:** Discuss the purpose and role of TPD insurance and the reasons you might use to justify its purchase to a client.

Total and permanent disablement (TPD) insurance covers you for a disability that stops you from ever working again. It is a lump sum payment that is generally payable when your doctor(s) are able to state that, in their opinion, you will never be able to work again. It is important to examine the details of the policy, as the definition of TPD can vary markedly from one insurer to another. For example, some provide cover for disablement that prevents you from working in your current job and others only cover you where you cannot work in any job.

Premiums for TPD insurance are affected again by factors such as age, health, smoking habits and your occupation. This type of insurance can be obtained inside or outside of superannuation.

You may wonder what the difference is between TPD and trauma insurance. The key difference is the fact that trauma insurance will pay out if you suffer a medical
emergency, regardless of how well you survive. However, TPD insurance will only be paid if you are unable to ever work again.


**Question 10:** The definition of ‘own occupation’ or ‘any occupation’ is an important element in TPD insurance. Discuss the impact of these definitions as to the successfulness of a claim under TPD and give examples to demonstrate your understanding.

TPD definitions do vary between companies, but the differences between the two types of TPD cover can be broadly described as follows:

**Own occupation** — you will be paid if by reason of accident or injury you are unable to work ever again in your own normal occupation.

**Any occupation** — you will be paid if by reason of accident or injury you are unable to work ever again in any occupation for which you are reasonably suited by education, training or experience.

‘Own’ occupation definitions are generally preferable given that an injury such as loss of one hand may disable a surgeon under such a definition, but an ‘any’ occupation definition may leave him or her able to perform the duties of a GP and therefore not qualify him or her for the benefit. However, the ‘own’ occupation definition is more expensive and may not be available for all occupations. Some companies offer other ‘home duties’ and ‘modified’ definitions of TPD.

**Solution to Problems**

**Problem 1**

The costs to be taken into account are:

- The final expenses associated with the insured person’s death. These would comprise the funeral expenses, final medical expenses, legal costs such as probate and the like.
- Repayment of any debts such as mortgages, credit cards and loans as well as any outstanding accounts.
- An emergency fund. The purpose of the fund is to provide an amount as backup during the period of time the dependants are adjusting to their new standard of living and unexpected expenses that may arise in the period following the death of the insured person.
- Provision for the ongoing maintenance of the dependants. This will comprise the major portion of the sum insured.

**Problem 2**

The multiple approach comprises a lump sum that, if invested at a given rate, would produce the current income the insured person is receiving. The problem with this approach is that with the effects of inflation the income declines in ‘real’ terms. If inflation is averaging 3% pa over 10 years, the cumulative effect would be about 35%. This means the buying power of the income stream would drop by 35% over 10 years.
The ‘needs’ approach calculates the actual amount needed to cover the dependants’ expenses and their ongoing support. This amount becomes the sum insured. The portion of the funds to meet the ongoing support is invested and the investment income is used to offset the effects of inflation.

**Problem 3**

A term life policy provides cover only in the event of the death of the insured person. With a Whole of Life (WOL) policy they acquire a value over time. This value comes because of the way in which the premium is calculated. The premium under the WOL policy is a level premium; that is, it remains constant over the life of the policy. The premium paid does not rise each year in line with the corresponding death risk.

In the early years of the policy, the premium paid exceeds the death risk and the surplus that exceeds the death risk is invested and is used to offset the death risk in the latter period when the premium is below the death risk rate. In calculating the premium, the insurer needs to estimate the investment rate. A conservative figure is used and in time a surplus develops. This surplus is returned to the insured by way of bonuses. In this way the policy acquires an investment value. In practice, the return is not high and the policy as an investment vehicle is not regarded as a good one.

The term policy has a cheaper premium and is better suited to almost all clients’ needs.

**Problem 4**

The three definitions are:

- ‘Own occupation’ — that replaces the words in the definition above in italics with ‘your own occupation’.
- ‘Own or similar occupation’ — which is the wording set out above.
- ‘Any occupation’ — that replaces the words in the definition above in italics with ‘any occupation’.

The ‘any occupation’ definition is the most restrictive and will pay in the fewest number of cases. It means that a client may be disabled and unable to follow the occupation that he/she is currently undertaking but is not able to claim under the policy, as the client is able to do some type of work. The income from that work may be very low compared to what is currently being enjoyed. Had the higher premium been paid for one of the broader definitions then a claim could have been made.

**Problem 5**

A trauma policy provides a lump sum amount in the event the client is incapacitated from any one of a number of listed conditions. Included in the conditions are those that result in the majority of the most seriously disabling situations. The policy defines the conditions and the degree of severity that must exist for a claim to be made. The funds from the claim can be used for any purpose. Possible needs that exist are:

- medical related expenses not covered by health insurance;
- home alterations;
- prosthetics;
- emergency funds.

Where there is a family history of a particular condition covered by the policy, a stronger need to take the cover exists as the likelihood of suffering the condition is increased.

**Problem 6**

Some issues for discussion would include:

- health checks;
- whether cover is possible;
- cost of such cover due to increased risk;
- cover within superannuation.

**Problem 7**

Some issues for discussion would include:

- health checks;
- whether cover is possible;
- cost of such cover due to increased risk;
- cover within superannuation;
- prostate cancer may be excluded from cover.

**Solution to Case Study 14.1**

The sum insured is made up of a number of fixed items as well as an amount to provide for dependants.

The lump sum amounts that need to be included are: $  

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<thead>
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<tbody>
<tr>
<td>Funeral and associated expenses</td>
<td>10,000</td>
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<tr>
<td>Final medical expenses</td>
<td>25,000</td>
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<tr>
<td>Mortgage</td>
<td>200,000</td>
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<td>Emergency funds (assumed)</td>
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<tr>
<td>Legal costs, probate etc (assumed)</td>
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<tr>
<td>Education</td>
<td>90,000</td>
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<tr>
<td><strong>Total one-off expenses</strong></td>
<td><strong>350,000</strong></td>
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**Dependant living expenses**

If James dies prematurely, Jane is 38. Super pension available from age 65 therefore 27 years of dependency.

![Jane's calculation](image)

![Julie's calculation](image)

![Peter's calculation](image)

![Martha's calculation](image)

**Total Dependants** 1,224,000
Total one-off expenses + dependants  
350,000+  
1,224,000  
1,574,000

Minus existing cover  
- 250,000+  
1,324,000

Cover needed on James’ life  
approx $1.4 Million

If Jane dies prematurely $350,000, being the one-off expenses, should be covered. Since James would still be working the dependants’ living expenses could be met from his income.

Solution to Case Study 14.2

1. Risks faced:
   - inability to service debt;
   - limited information re health etc;
   - risk that the practice fails, hence no income;
   - risk of professional negligence;
   - illness for Mr or Mrs McArthur;
   - risk of the premature death of either client, particularly the male since he is the sole breadwinner;
   - disablement and not being able to work (him) or inability to care for children (her);
   - terminal or critical illness;
   - business overhead risk;
   - insufficient superannuation at age 50;
   - loss of income due to sickness;
   - damage to or loss of motor vehicles.

2. Possible strategies:
   - regular health checks and good lifestyle;
   - life insurance;
   - TPD insurance;
   - trauma cover;
   - business overhead cover;
   - professional indemnity cover;
   - income protection insurance;
   - increase savings to superannuation salary sacrifice;
   - motor vehicle insurance;
   - private health insurance to avoid the Medicare surcharge.

3. Needs covered:
   - mortgage;
   - living expenses;
   - education costs;
   - funeral expenses;
   - housekeeper costs;
   - pay out debt.