The Proverbial Rainy Day
# Table of Contents

**PERSONAL INSURANCE**  
- Life Insurance  
- Income Protection  
- Total and Permanent Disability (TPD)  
- Trauma  
- So, how much is enough?  

**ESTATE PLANNING**  
- First things first, make a Will.  
- Enduring Powers of Attorney  
- An important note about superannuation...  

**IN CONCLUSION**
A question first. What’s the most valuable thing you’re ever likely to have?

In spirit, if you’re one of the lucky ones, no doubt it’s your family. But we’re talking about financial assets here – although the family connect will become apparent.

Chances are, far and away your greatest asset is your ability to earn an income.

Let’s say your working life is 35 years. The table below shows what your lifetime earning capacity is if your starting pay is as shown on the top line and it increases by 3.5% per year. Which is not out of the question – average wages grew at 4.5% per year for the past 35 years, admittedly including some high inflation years.

<table>
<thead>
<tr>
<th>Starting pay</th>
<th>$40,000</th>
<th>$45,000</th>
<th>$50,000</th>
<th>$55,000</th>
<th>$60,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total earned over 35 years:</td>
<td>$2,660,000</td>
<td>$3,000,000</td>
<td>$3,333,000</td>
<td>$3,670,000</td>
<td>$4,000,000</td>
</tr>
</tbody>
</table>

If you’re a go-getter and your pay increases on average by 5% per year, the table looks like this:

<table>
<thead>
<tr>
<th>Starting pay</th>
<th>$40,000</th>
<th>$45,000</th>
<th>$50,000</th>
<th>$55,000</th>
<th>$60,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total earned over 35 years:</td>
<td>$3,600,000</td>
<td>$4,000,000</td>
<td>$4,500,000</td>
<td>$4,950,000</td>
<td>$5,400,000</td>
</tr>
</tbody>
</table>

Earning income is the backbone of every financial plan.

Clearly any interruption to the ability to earn that income – say, through sickness, accident or death – could be financially catastrophic for a person and his or her family.

And the bad news is, one of the few absolute certainties in financial planning is that one or more of those things will happen to you one day. If you’re lucky, it will be some time after the telegram arrives from the Queen. But for so many others …
So it’s odd that people don’t blink at insuring the family Camry, but ignore covering this multi-million dollar asset. For the moment, let’s shelve discussion about home and contents, car, health cover, etc. – that’s for another day. Let’s talk about what we’ll call ‘personal insurance and protection’. That is:

- Life insurance;
- Income protection insurance;
- Total and Permanent Disability (TPD) insurance;
- Trauma, or ‘Recovery’ insurance; and
- Your Estate Plan.

Each of these in their own way provides protection against the same thing – interruption of your ability to earn an income, and the impact on your family.

**PERSONAL INSURANCE**

Here is a brief description of each of the different types of personal cover and their characteristics. We’ll then look at how to determine the right level of cover and how it should be structured.

**Life Insurance**

Life insurance pays a lump sum benefit on the death of the life insured.

The purpose of the insurance is to provide beneficiaries with a capital sum to pay off debt and/or to provide an income support to your family for a period of time.

**Income Protection**

Income protection insurance pays a replacement income in the event that you become sick or disabled to the extent that you are unable to perform your normal work.

The cost of income protection insurance is **tax deductible**, and the premium payable will vary depending on the policy options you choose.

In most cases, you’re able to insure up to 75% of your insurable income with income protection insurance. Why not 100%? Because then there’s no incentive to return to work...and, understandably, insurers aren’t too keen on that!
Total and Permanent Disability (TPD)

Total and Permanent Disability (TPD) insurance provides a lump sum payment in the event of an illness or injury that prevents you from ever again engaging in gainful employment for which you are reasonably suited by education, training or experience. The actual definition of TPD varies significantly amongst policies, so adequate research is required to find the one that’s right for you.

It is likely that, in a TPD event, you would also be paid by your income protection insurer. However, additional TPD cover may help to meet the remaining portion of your salary that is not covered by income protection insurance. It can also help in meeting some of the extra medical and/or rehabilitation expenses that might be incurred as a result of the event.

Trauma

Trauma insurance provides a lump sum payment in the event of you suffering a major health ‘trauma’ (such as a heart attack, cancer or stroke).

The lump sum is intended to assist with medical and rehabilitation costs and to avoid financial stress during recuperation.

So, how much is enough?

This can be a tough call, as the answer depends on individual circumstances. However, here are some points to bear in mind:

- Income protection insurance can only cover a maximum of 75% of your insurable income, so your answer is pretty much set in that respect. In most cases, for most people, this will simply be a matter of calculating 75% of their salary and insuring for that amount. The only reason you would insure for less is if your living expenses did not warrant it.
- The way to determine the most appropriate amount of life and TPD cover is to assess how much income you and your beneficiaries would require, deduct how much could be generated by the financial assets you already have, plus your income protection cover and insure for the difference.
- Trauma insurance is generally applied for as a nominal amount – based on how much extra you feel would be necessary for medical and/or rehabilitation costs, cash flow permitting.
To put this into some context, consider the following:

John works full time. He earns $160,000 per annum and has $500,000 in superannuation.

Liz, his wife, is a stay-at-home Mum.

They have two children – twins in year seven. They have a mortgage of $450,000 over their home.

John and Liz are currently spending every cent that John earns – their annual living expenses amount to $110,000 (being John’s NET salary, or, the amount he takes home after tax), including mortgage repayments of $3,500 per month ($42,000 per annum).

As it stands, John does not have any personal insurance in place.

As the family breadwinner and, in this situation, the only source of income, it is of the utmost importance for John to ensure that his beneficiaries are taken care of in the event that something were to happen to him. It could be financially devastating for Liz and the kids otherwise.

Let’s take a look at how best to determine an appropriate amount of cover for John.

**IN THE EVENT THAT JOHN DIES:**

It is assumed that Liz will inherit John’s super of $500,000 as a lump sum. This is because his super fund held a Binding Death Benefit Nomination at the time of his passing. More on that to come.

This money can be used to clear the mortgage.

Following debt repayment, we assume that Liz will require $68,000 per annum in order to maintain lifestyle and amenity:

$110,000 (living expenses) - $42,000 (mortgage repayments) = $68,000.

In determining an appropriate amount of life cover, a handy rule of thumb is to multiply the amount you think your beneficiaries will need to live on by 16. This assumes that the lump sum paid out by the insurance company is invested to earn an income and then drawn on at a rate of 6% per annum.

$68,000 x 16 = $1,088,000
The Proverbial Rainy Day

This would be paid to Liz on John's passing in conjunction with his super benefit.

<table>
<thead>
<tr>
<th>LIFE INSURANCE REQUIRED:</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1,088,000 (lump sum)</td>
</tr>
</tbody>
</table>

**IN THE EVENT THAT JOHN IS OFF WORK TEMPORARILY – I.E.: SICK BUT NOT DISABLED:**

With income protection insurance, John can insure up to 75% of his insurable income.

$160,000 x 75% = $120,000 per annum, or $10,000 per month.

<table>
<thead>
<tr>
<th>INCOME PROTECTION INSURANCE REQUIRED:</th>
</tr>
</thead>
<tbody>
<tr>
<td>$120,000 per annum, or $10,000 per month</td>
</tr>
</tbody>
</table>

Note: there will be circumstances where 75% of an individual's insurable income actually exceeds their needs. In these situations, in order to keep premiums in check and to avoid paying for insurance that is not required, it is more than acceptable to apply for an amount that equates to less than 75% of insurable income.

**IN THE EVENT THAT JOHN IS PERMANENTLY DISABLED (TPD):**

In a TPD event, it is likely that you would also be paid by your income protection insurer. In John's case, this would provide $10,000 per month.

However, this is only 75% of his pre-disability income. He will therefore need to insure the gap:

$160,000 - $120,000 (income protection benefit) = $40,000

If we apply our handy rule of thumb as above:

$40,000 x 16 = $640,000

This would be paid to John in the event of TPD.

<table>
<thead>
<tr>
<th>TPD INSURANCE REQUIRED:</th>
</tr>
</thead>
<tbody>
<tr>
<td>$640,000 (lump sum)</td>
</tr>
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</table>
Note: John would also likely gain access to his superannuation in the event of TPD. However, he will need this intact to draw on in retirement, so should aim to live off his income protection and TPD benefit (and perhaps even continue making super contributions, where possible) until the income protection insurance policy expires – which is generally between age 65 and 70.

**IN THE EVENT THAT JOHN SUFFERS A HEALTH TRAUMA (I.E.: HEART ATTACK OR STROKE):**

Trauma is one of the more expensive forms of cover as, unfortunately, it is currently one of the most frequently claimed.

Again, in some instances, in suffering a health trauma, you may also be paid by your income protection insurer. However, the additional lump sum can be used to assist with medical and rehabilitation costs, to cover any alterations that might need to be made to the home (for example, wheelchair access) and to reduce financial stress during recuperation.

While there are many approaches to calculating an appropriate amount of Trauma insurance, one rule of thumb is to insure for an amount equivalent to one year’s salary. This will provide flexibility in recuperation for a period of 12 months.

John and Liz therefore opt to insure for an amount of $110,000 (i.e.: John’s annual NET salary).

<table>
<thead>
<tr>
<th>TRAUMA INSURANCE REQUIRED:</th>
</tr>
</thead>
<tbody>
<tr>
<td>$110,000 (lump sum)</td>
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</tbody>
</table>

This is a simplistic example. It is designed to give you an idea on how you can determine the right level of insurance cover, but it is important to understand that individual circumstances will vary.

*NOTE: some superannuation funds issue automatic insurance cover upon joining, so it may be worthwhile checking a recent statement to see whether you have any – and what you’re paying for it. This cover should be checked and reviewed regularly to ensure it meets your needs and circumstances.*
ESTATE PLANNING

For the most part, personal insurance provides protection for those situations that arise while we're still alive. However, ensuring that your family is cared for in the event that you pass away is just as important.

First things first, make a Will.

This allows you to nominate someone to administer your Estate upon your passing – referred to as the ‘Executor’ of your Estate, or your ‘Legal Personal Representative’.

This person will be charged with the task of distributing the assets of your Estate to whom you want them to go.

While you do not necessarily have to nominate someone who is also a beneficiary of the Estate, your Executor should be someone you trust and whom you believe will uphold your wishes.

The alternative, dying without a Will, or dying ‘intestate’, means that the intestacy laws of the state in which you lived will determine how your Estate is distributed upon your passing. Depending on your circumstances, this might not be devastating, but it’s a lot to leave to chance.

Enduring Powers of Attorney

These are legal documents that allow you to nominate an individual (or, where appropriate, more than one person) to make certain decisions on your behalf.

Unlike a Will, Enduring Powers of Attorney come into effect during your lifetime and become important if you lose mental capacity or the ability to make sound decisions in relation to your legal, financial, personal and medical affairs.

In Victoria, there are two different types of Enduring Power of Attorney that a person can (and should) grant:

1. Enduring Power of Attorney (commonly referred to as the Financial Power of Attorney)

   This allows the nominated person/s to make financial, legal and personal decisions (excluding medical decisions) on your behalf – ranging from payment of a telephone bill to buying and selling shares to deciding where you’re going to live (and everything in between).
2. Appointment of Medical Treatment Decision Maker (previously, Enduring Power of Attorney (Medical Treatment))

As you might expect, this allows the appointee to make decisions regarding your health care on your behalf (including medical, critical care and life support decisions).

The Appointment can include instructions on whether certain types of medical treatment should be allowed or refused, as well as a reference to the values which should be considered when making medical decisions.

An important note about superannuation...

Under normal circumstances, superannuation does not automatically form part of your Estate.

In the first instance, it is the super fund trustee’s legal obligation to ensure your benefit is only paid to your dependents. So you don’t need to be concerned about the residual being siphoned off to the State or the lost cats’ home.

Naturally though, the trustee would appreciate any assistance you can leave behind as to who gets paid and how. This generally takes the form of a Binding Death Benefit Nomination that you lodge with the trustee while you’re still breathing. Depending on your super fund, this may be in the form of a lapsing or a non-lapsing nomination.

Where the former is concerned, the nomination is valid for three years only, meaning that regular review is important.

Note, however, that choosing to make a non-lapsing nomination instead is not necessarily bullet-proof. Should your circumstances change (be it as a result of divorce, death, etc.), the nomination will still need to be reviewed and updated as a matter of importance.

John made a binding nomination to Liz in our previous example. It should be considered an important part of your Estate Planning.

Providing the nominated beneficiary is an eligible dependent, or the member’s legal personal representative (i.e.: the executor of their estate), then the trustee is legally bound by that nomination.
IN CONCLUSION

While protecting the family Camry in the event of an accident or theft is a good thing to do, protecting your family in the event that you can no longer earn an income is an even good-er thing.

Your ability to earn an income is the most valuable financial asset you have and protecting against inability should be your highest priority when making financial plans.

Because, unfortunately, for all of us, the proverbial rainy day will come – in one form or another.

You want to be sure you have your umbrella when it does.