TOPIC **16**

Financial protection and planning

LEARNING OBJECTIVES

By the end of this topic, you should have an understanding of:

- people's income and capital protection needs;
- reasons for and consequences of underinsurance;
- differing protection priorities depending on circumstances;
- considerations in prioritising protection needs.

THINK ...

Before you start work on this topic, take a moment to think about what you already know about financial protection.

For instance:

- What societal factors make it crucial for people to protect themselves?
- Why do some people have little or no financial protection?
- Consider the situation of your close friends and family. How might their lives be affected financially if they suffered a death, disability or serious illness?
- Are there differences in the potential implications among people you know? If so, why?

16.1 Income and capital protection needs

A death or serious illness in a family can have many consequences, not all of which can be alleviated by financial means. No amount of money can bring back a loved one who has died or ease the feelings of a family member caring for someone who is seriously ill. However, the effects of a death or serious illness can be worsened by financial difficulties that arrive when those affected feel least able to cope with them.

CHECK YOUR UNDERSTANDING

Think back to when you looked at protection products in your UKFR studies.

a) What type of life insurance product is usually best to support a mortgage?

b) Why would we not normally use the other type of life insurance to protect a mortgage?

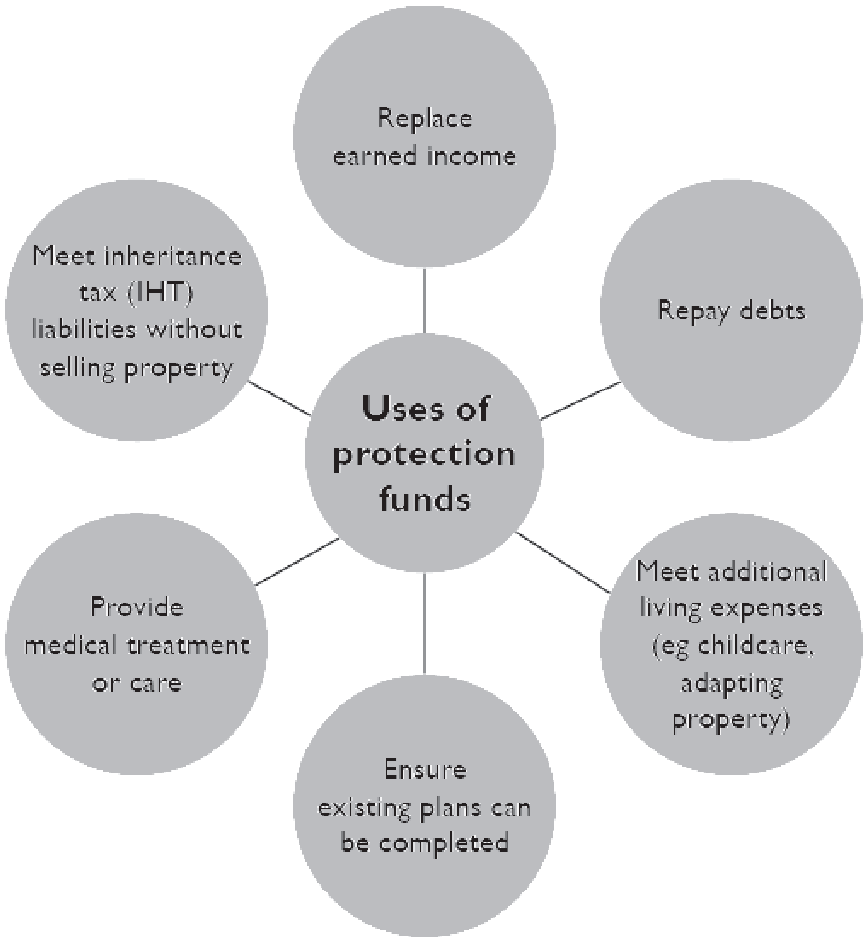
Check your answers against those in the back of the book before continuing with this topic.

There are almost always financial consequences for the family if a person dies or suffers a serious illness.

- This is most evident when that person e**arns an income on which the household depends.** A serious illness can also prevent further earnings or reduce earning capacity, while increasing outgoings due to treatment costs and the expenditure of visiting the loved one.
- A person who does not earn an income is likely to make a **key contribution to looking after children or the home.** If they die or become seriously ill, it may be necessary to employ someone else to do that work.
- People may also require **additional capital**, ie a lump sum, to cover costs beyond income such as mortgages, loans or other debts, or funeral costs.

By making adequate financial provision through various protection policies, people can mitigate the adverse financial consequences arising from death, sickness or disability (see Figure 16.1).

FIGURE 16.1 USES OF FUNDS FROM A PROTECTION POLICY



IN BRIEF

PROTECTION FOR MORTGAGE PAYMENTS

There is a vital need to protect repayment of outstanding interest and capital on a mortgage (ie property loan) in the event of death, illness, accident or redundancy. A person's loss of earnings might arise from any of these causes and the effect can be devastating for the family, who may have to sell their property and move elsewhere.

Unemployment and redundancy are, alongside divorce and separation, the major causes of arrears and subsequent repossession of mortgaged properties.

Certain situations would lead to immediate difficulties in the event of death or illness:

- little or no savings;
- inability to replace earned income;
- unprotected debts;
- financial dependants (often, but not exclusively, a young family).

If one or more of these criteria apply, there will likely be a need to protect against the financial effects of death and long-term inability to generate income.

CONSIDERATIONS: FINANCIAL PROTECTION FOR ILLNESS OR DISABILITY

In some ways, the need to provide adequate protection against the financial effects of illness or disability is greater than protecting against the effects of premature death.

- On the **death** of an individual, those left behind have to cope with a changed situation. Death may bring many adverse financial outcomes but the need for large financial outlay is unlikely to be one of them. On death, replacement income is likely to be required, as well as funeral costs and possibly replacement of employer-provided benefits.
- In the event of **illness or disability**, the consequences may be more acute: not only is there the possibility that an income earner can no longer work or that a homemaker can no longer do household jobs; they may also need medical care, personal care and adaptations to the home. In lots of cases, the care may not be funded.

Defining the amount of cover required

There is no universal rule for calculating the amount of cover required but it is usually based on quantifying the shortfall in income that dependants would suffer.

The shortfall can be expressed as the difference between the:

- amount of protection that **would be needed** if the risk event happened; and
- amount of protection that the client **currently has.**

An amount of protection may already be in place from savings or investments, existing protection policies, or state provision.

16.1.1 Underinsurance and its consequences

There is a considerable amount of underinsurance for life cover and illness or accident protection in the UK. The main reasons are as follows.

- **'It won't happen to me'**: some people perceive that the chances of them needing protection are low, but in reality many people of working age die or fall ill every day.
- **Misapprehension of needs**: many do not fully appreciate the magnitude of their protection needs and may believe they have sufficient cover. It is the adviser's responsibility to help the client recognise the nature and size of their need, so they can understand the potential financial impact.
- **Affordability perception**: many clients believe they cannot afford to provide full protection, not realising how affordable protection policies can be, especially if taken out when relatively young. The adviser's responsibility is to help the client prioritise their needs and to allocate resources accordingly.
- **State provision**: other clients may feel confident in the provision of state benefits. However, state benefits are unlikely to support more than a threshold standard of living.
- **Unhappy subject**: the topic is not pleasant; who would want to discuss death, illness and the potential financial consequences of either?
- **Consumer trust and product complexity**: consumer trust in the insurance sector is the lowest in financial services, and price is customers' main driver. Complexity of products is also an issue, with "almost half of income protection customers [finding] policies hard to understand" (FCA, 2020). More than half of customers without life assurance say they would be encouraged to take out "simple, low-cost cover" (FCA, 2020).

EXAMPLE: CONSEQUENCES OF INADEQUATE PROTECTION

Rebecca and Leo are young parents who earn £19,000 and £17,000 gross (ie before deductions) respectively in trainee roles. They currently have no financial protection in place except buildings insurance for their home.

- If Rebecca could no longer work due to accident, illness, disability or death, Leo would have a monthly shortfall of about £1,400.
- If Leo could no longer work or died, Rebecca would have a monthly shortfall of about £1,300.

The couple budget to use most of their earnings on essential spending with a modest amount saved each month, so a shortfall would cause immediate problems. If the healthy or surviving partner could not make up the shortfall, such as through a loan from family, they would struggle to make ends meet.

There would be additional considerations and expenses depending on the event that occurred.

16.1.2 How do mortgages affect consumer attitudes?

Many people first take out a protection policy when they take on a mortgage. The mortgage debt tends to focus their minds on the problems that would arise if the debt were not repaid on death, or if serious illness led to a reduction in earning capacity.

The death of a property owner is traumatic enough for family and friends, but if the property is mortgaged there could be additional problems.

- If the property was **registered in the deceased's sole name**, the deceased's executor or personal representative will have to pay off the mortgage before anybody can benefit from the property.
- If the property was r**egistered as a joint tenancy**, the survivor will still have an outstanding mortgage on the property, even though they become the sole owner. This could cause problems with mortgage repayments, because only one party is contributing to the mortgage whereas both likely contributed in the past.
- If the property was **registered as tenants in common**, the deceased's equitable share will pass according to their will. The survivor will be jointly and severally liable for the mortgage, so could end up with the whole mortgage but effectively only own half the value of the property.

Protecting the mortgage is relatively simple, with the type of product dependent on the type of mortgage. However, although the mortgage offer may recommend life cover, it is up to the mortgagor to arrange it. Lenders assume that the property would provide them with security in the event of a mortgagor's death.

People tend to grasp how inadequate protection may affect their ability to continue paying a mortgage. They may find it harder to understand the broader impact of death or serious illness on the household, even though this represents by far the greater need.

Other life events can also spur people to consider the adequacy of their financial protection, such as the birth of a child or the death/illness of a parent or close friend.

16.1.3 Risk and underwriting in insurance

Once the decision to purchase a protection plan is made, an application must be completed according to legal processes. The application then goes through a process of underwriting – a different process than for mortgage underwriting – to assess the risk involved in insuring the applicant.

The insurance underwriter considers relevant factors related to the health, lifestyle, occupation and environment of the person being insured. If the underwriter is wildly wrong in their predictions, the company will suffer a serious loss.

Insurance companies average out the uncertainties by spreading the risk over a large number of clients, while also considering risk probability. The underwriters then decide for each client whether the premium (ie monthly or yearly amount paid) should differ from the standard rate and by how much.

IN BRIEF

RISK PROBABILITY IN INSURANCE

The premium paid for an insurance policy depends on a risk estimate carried out by actuaries, who use past statistics to assess the probability of the risk occurring. The greater the probability of the risk occurring in a particular case, the higher the premium.

16.2 Protection priorities

Consumer priorities differ depending on a person's circumstances. Let's outline typical client characteristics that may indicate a need for protection at various generic life stages. These generalisations are only a guide; every client is different and their exact needs should be understood.

Young, single person

Protection is primarily intended to protect against the consequences of financial loss. For a young, single person, there may be no adverse financial consequences in the event of their death, even if they have a mortgage or other loans.

Any outstanding mortgage or debts might be repaid from the sale of the property and by the use of savings. So, financial protection through life assurance is unlikely to be a priority.

- Protection in the event of **illness or accident** is, however, likely to be important to maintain standards of living if the person is unable to work.
- Protection against the financial effects of **critical illness or unemployment** is also likely to be significant.

Younger couple without children

For a married couple, civil partners or partners who live together, the needs are likely to be more diverse. The guiding factor remains the extent of potential financial loss in various situations.

> **EXAMPLE: STRAIGHTFORWARD PROTECTION NEEDS**
>
> Farida and Niraj both work. They have no joint liabilities and no dependants.
>
> Their main need is income protection in the event of an inability to work, and protection against the additional costs resulting from one of the parties suffering a serious illness.

A joint mortgage or unsecured debts may require protecting to the extent that each partner would be unable to afford repayments in the event of death or illness of the other.

A young couple may also have an interest in private medical insurance (PMI). Planning for long-term care is another area of need but, psychologically, may be too far away to worry about at this life stage.

The need to plan for IHT in expectation of receiving future legacies is a possibility, depending on the situation.

IN BRIEF

PRIVATE MEDICAL INSURANCE

PMI provides cover for medical expenses and allows an individual access to private medical treatment, so they are not entirely reliant on the NHS and can avoid NHS waiting lists. PMI is aimed at covering acute conditions, which develop rapidly and respond to treatment.

Younger couple with children

The situation of a young couple with children is similar to that of those without, but their needs are magnified. If both parents work, with children in paid childcare or being looked after by other family members, the couple is likely to rely on both incomes. So, protection in the event of death and illness is crucial.

If one of the parents looks after the children full-time, the protection needs are not likely to be much diminished. Someone would probably need to be employed to carry out that role if the parent were to fall ill or die.

Middle-aged couple, children have left home

Many of the protection needs from earlier in life may have disappeared by middle age.

As children leave home and become financially independent, the need for financial protection in the event of death and illness decreases, although it is unlikely to disappear.

Mortgages and other debts may be reduced, or perhaps paid off, and this will reduce the need in some areas of protection.

However, other needs may come to the fore:

- ensuring that the costs of medical treatment are protected through PMI;
- planning to fund long-term care needs;
- IHT planning, depending on the size of the couple's estate and their plans for its future distribution.

Retirement

Reliance on earned income will have ceased by retirement. This reduces the need for protection in the event of death or illness, because the individual no longer relies on their ability to work to generate income. However, the nature of needs may change.

Benefits from pension plans will continue to be paid if the pension holder becomes ill. However, if the member dies, benefits are likely to be reduced and may even be wiped out.

EXAMPLE: ANNUITIES

If the scheme member has bought an annuity (which pays an income in retirement), this will cease on death unless there is annuity protection or a guarantee period.

A scheme pension may cease or pay only reduced dependants' benefits on the member's death. Ensuring that a spouse/partner and dependants are adequately protected may be a major area for planning at this stage in life. Other priorities are likely to be IHT mitigation and care provision.

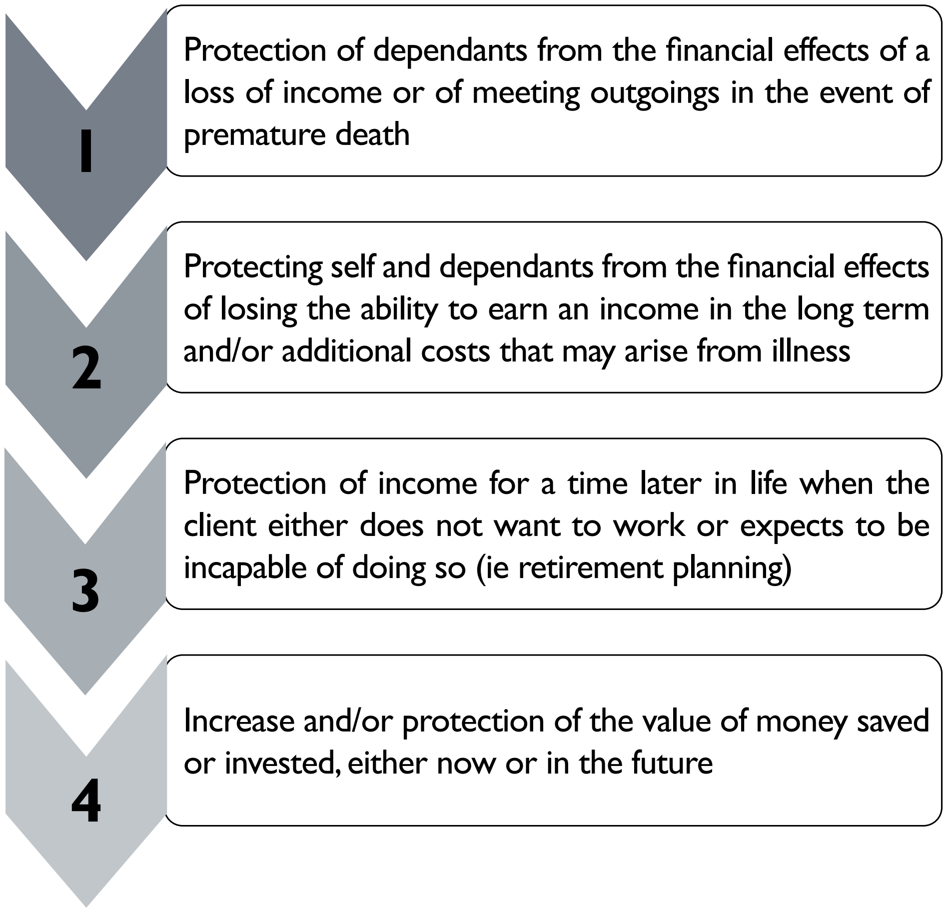
16.2.1 Prioritisation of needs

The need to protect against the effect of illness or accident does not sit in isolation: there is a strong connection to protection needs in the event of death. Some of the policies that protect against the event of death have options that allow a degree of protection against the effects of illness.

With such a diverse range of possible needs, budget is likely to be a major constraining factor in protecting against the consequences of illness. It is crucial that the adviser agrees the client's protection priorities.

A good starting point is to think about where a client's protection needs sit in comparison with their other financial needs. Protection of current and future income levels is often assumed to be the highest priority. One method of ranking individual financial needs is to order them as in Figure 16.2.

FIGURE 16.2 RANKING FINANCIAL NEEDS



The overriding consideration is to ensure adequate protection of what the client currently has before looking to improve things for the future.

However, it is difficult, and perhaps inappropriate, to generalise about how various protection needs should be prioritised because much depends on each client's situation and objectives.

Issues to consider include the following.

- The amount and duration of sick pay provided by an employer may be an important factor in prioritising income protection needs.
- Family medical history may be a factor in determining the priority of cover such as critical illness cover (CIC).
- Support from family or friends may mitigate the costs associated with illness, disability or premature death.
- The need for long-term care can be addressed later in life if finances do not permit immediate action.

- Life cover is likely to be less important for someone who is single with no dependants than it is for a client with a family.
- Where a client lacks practical or financial support, income protection insurance (IPI) and CIC are likely to be particularly important.
- For a family, protection needs are likely to exist across several areas.

CLIENT AWARENESS VERSUS ABILITY TO ACT

Even if a client accepts that they need financial protection and understands the extent of the need, they may not commit to taking all or any of the recommendations. Often, this is a result of budgetary factors and competing financial demands.

Where cost is an issue, there needs to be a degree of compromise, and the client must be aware of the best options for them. Part of this process may involve developing a portfolio of protection policies with different plans over different terms that aim to meet each of the client's needs.

FACTFIND

Visit the websites of some life and illness protection companies and make notes on what guidance they give on:

- the factors to take into account in setting an amount of cover;
- which areas of financial protection should be seen as priorities; and
- other areas of financial planning that link to financial protection.

THINK AGAIN …

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- explain the need for financial protection at various life stages?
- list reasons why people may be underinsured?
- discuss how taking out a mortgage affects people's attitude towards protection?
- outline how a person's circumstances can affect their protection priorities?
- summarise factors to consider in prioritising protection needs?

Test your knowledge before moving on to the next topic.

Reference

FCA (2020) *Sector views* [pdf]. Available at: www.fca.org.uk/publication/corporate/sector-views-2020.pdf

Test your knowledge

?

Use these questions to assess your learning for Topic 16. Review the text if necessary.

Answers can be found at the end of this book.

1) Protection for dependants in the event of death or illness is likely to be most crucial at which life stage?

   a) Young, single person.

   b) Younger couple with children.

   c) Middle-aged couple, children have left home.

2) Private medical insurance may become a priority at which life stage?

   a) Young, single person.

   b) Younger couple with children.

   c) Middle-aged couple, children have left home.

3) Financial protection through life assurance is unlikely to be a priority for which of the following?

   a) Young, single person.

   b) Younger couple with children.

   c) Middle-aged couple, children have left home.

4) "I find income protection policies hard to understand." This customer is voicing which reason for underinsurance?

   a) It won't happen to me.

   b) Product complexity.

   c) State provision.

5) If a mortgaged property owner dies, the survivor might end up with the whole mortgage while owning only half the value of the property if it was registered:

   a) as tenants in common.

   b) as a joint tenancy.

   c) in the deceased's sole name.

6) If a person has an amount of protection already in place, they are likely to have no shortfall. True or false?

7) Protection funds may be used to meet what liabilities without selling property?

8) The shortfall in protection cover can be expressed as the difference between the amount of protection that would be needed if the risk event happened, and the:

   a) amount of protection the client desires.

   b) amount of protection the client currently has.

   c) amount of protection the client will have in five years' time.

9) The mortgagee will both recommend and arrange life cover. True or false?

10) Which of the following protection needs is generally prioritised highest?

   a) Protection of dependants from the effects of loss of income in the event of premature death.

   b) Protection of income for a time later in life when the client does not want to work.

   c) Protecting self and dependants from the effects of losing the ability to earn an income in the long term.