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Defending your snowball 1

You need to be able to …

1. **Explain how insurance generally works**
2. **Explain risk-aversion and fair premiums**
3. **Identify the various forms of life insurance**
4. **Identify which forms of life insurance are appropriate at different stages of life**
5. **Brief a solicitor on how you would like them to draft a will or to use a will kit to draft your own**
6. **Explain the benefits of Enduring Power of Attorney**

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Introducing insurance

A problem

There are 20 houses in a street

They all worry about being burgled

Each house has the same chance of being burgled

The expected amount stolen in a burglary is $10,000

Three solutions

1. **No insurance**

   “Don’t worry … Be happy!” … or “It won’t happen to me”

   Risk – burglary occurs and no funds to replace items

2. **Self insurance**

   Each house keeps $10,000 in savings account in case of burglary

   Benefit – Keep all funds if no burglary occurs

   Cost – $10,000 could have been used for something else

   Risk – burglary occurs and $10,000 isn’t enough

3. **Risk pooling**

   Each house contributes $500 each year into a savings pool

   Benefit – Risk and costs shared across many similar people

   Cost – $500 per year could have been used for something else

   Risk – total funds aren’t to cover the total claims

Think and discuss

Let’s say the 20 houses do ‘risk pooling’ and all chip in $500 per year.

What are some ways that you could ‘take advantage’ of the scheme? (Be evil!)

It is better to self-insure when …

1. **The cost of the 'event' is small; OR**
2. **Probability of event is significantly lower for you; OR**
3. **You are a good saver and have funds set aside**

Examples:

Insuring against a 'scratched' console game disk

Extended warranty on many consumer appliances

Minor once-off health issues (such as physio)

It is better to risk-pool when …

1. The cost of the ‘event’ is high; AND
2. Probability of it happening to you is low; AND
3. Premiums are reasonable given cost and premium

   A ‘premium’ is the monthly payment you pay to the insurance company

Examples:

Unexpected accident or illness that prevents you from working

Major surgery or recurring health issue

Significant property damage or injury to others from car accident

Shared pain

Insurance companies want you to behave ‘low-risk’

So they make sure it costs you if the event happens

This is called a ‘deductible’ or ‘excess’

Examples:

- **You pay first $500 of expenses if motor accident is your fault**
- **You pay first $1,000 of medical expenses for a surgery**

Screening

Insurance companies don't want 'bad apples' in risk-pool

Each personal completes detailed application forms

If you are 'high probability' of experiencing 'event' they:

1. **Won't provide you with insurance; OR**
2. **Charge a ridiculously high premium.**

Signalling

Applicants need to ‘signal’ they are low-risk and honest

Complete the detailed application forms accurately

If dishonest then:

1. **They may still collect your premiums**
2. **Your claim is rejected and no payout occurs**
3. **You go onto a ‘black list’ and can’t get insurance**

Insurance is not a ‘discount club’

Some people treat insurance like a ‘discount club’

“I only take insurance my expected payouts > expected premiums”

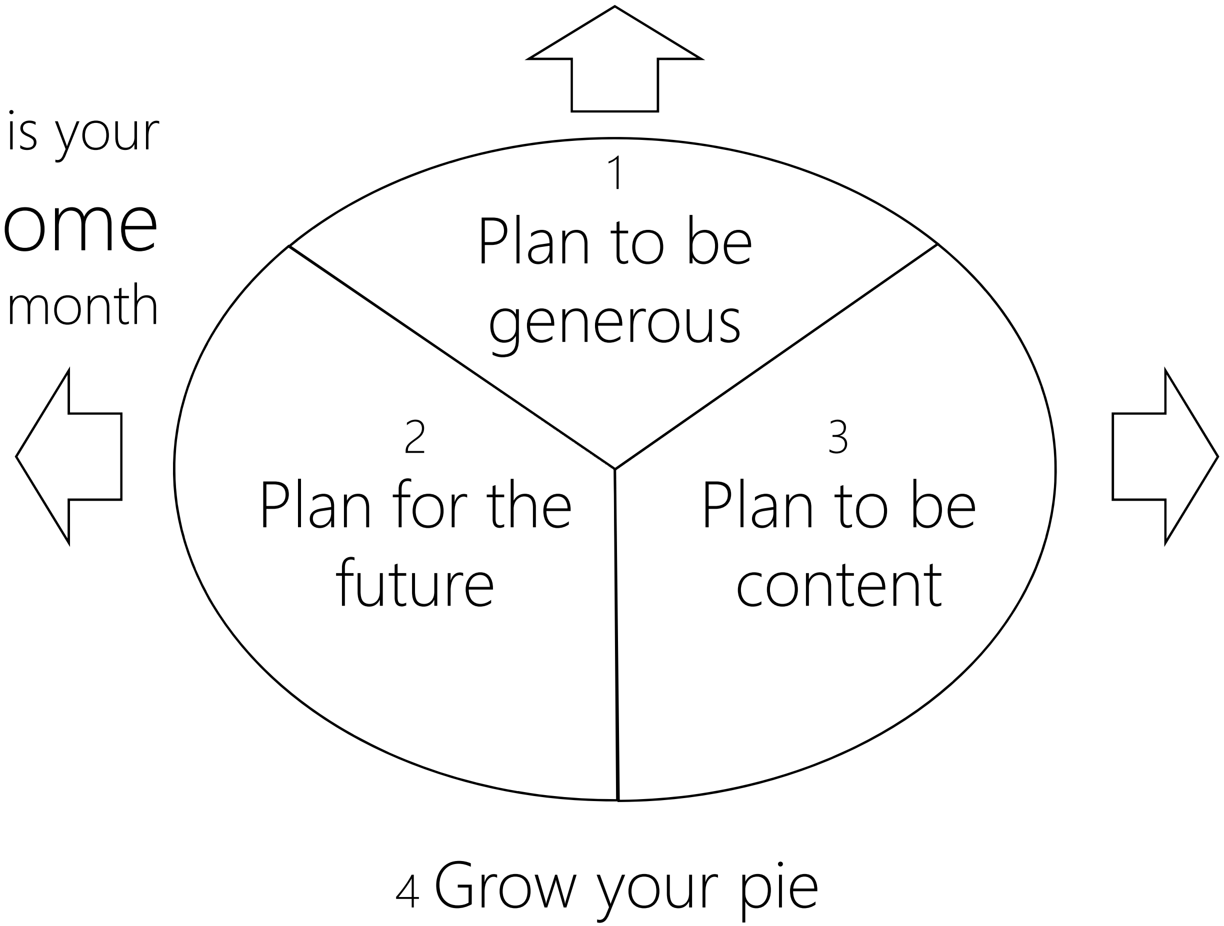
Risk pooling doesn’t work this way:

1. **You are high risk so excluded from risk pool**
2. **How can a risk-pool work if everyone does this?**
3. **Insurance is not just about $**

   … it’s about peace of mind

Insurance premiums and the pie

Your pie is your
total income
each month



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Risk aversion and fair premiums

A fair premium

1% probability that your house is destroyed in any year

If expected rebuilding costs are $100,000

Then fair premium is 0.01 x 100,000 = $1,000

Most rational people will pay more than fair premium!

Rational people are risk-averse

Sarah, David and Lisa each have a house with a 1% probability of being destroyed. Rebuilding costs for them all are $100,000.

Sarah will pay > $1,000 so she is risk-averse

David will pay only $1,000 so he is risk-neutral

Lisa will pay < $1,000 so she is risk-loving

… or irrational or just disorganised!

Economists think it is *usually* rational to be risk-averse

This is why insurance is not a 'discount club'

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Life insurance

Think and discuss

How much money would you want your family to receive if you died:

Situation 1

today, with no spouse or children
and a $20,000 car loan.

Situation 2

in 10 years, with a spouse, 2 children (under 10)
and a $200,000 home loan.

Death Cover

Pays a lump sum amount when you die (eg $300,000)

Also called “Term insurance”

Used by family to pay-off mortgage and debts and to cover future living expenses

Cheapest often through retirement savings account

Formula to calculate amount:

= total debts – investments – retirement savings account
+ (10 x yearly income needed to support family)

Example:

= 300,000 – 100,000 – 100,000 + 10 x 50,000 = $600,000

Total & Permanent Disability (TPD)

Pays a lump sum if you become very disabled

It is an "add-on" when you take out death cover

Eg. $300,000 death cover + TPD cover

Used for same purpose as death cover

Proving death is easy with a "death certificate" … but

Proving totally and permanently disability is difficult

Long history of litigation against insurance companies for refusing to pay TPD claims!

Is it really needed if you have income protection? (next)

Think and discuss

What money would you want
each month if you had an accident or illness
that prevented you from working:

Situation 1

As a graduate, flatting by yourself
with no spouse or children
salary of $50,000 with a $20,000 car loan.

Situation 2

In 10 years, with a spouse, 2 children (under 10)
and a $200,000 mortgage, salary of $80,000.

Income Protection

Replaces up to 75% of your salary if you have an accident or illness that prevents you from working

Also called “Salary continuance” and “Income Insurance”

Benefit waiting period between 14 and 90 days

- You choose the waiting period when you apply for insurance
- Payments don’t start until X days after the accident
- Longer the waiting period … cheaper the premiums!

Benefit period between 2 years and all the way to age 65

- This is how long benefits are paid while you can’t work
- 2 year period is cheapest … until age 65 is most expensive

Income Protection … continued

Watch out for definition of "can't work" – is it own job, own occupation or any job for which you are qualified?

- Best definition to get is "own job" … but more expensive

Premium payments can be claimed as tax deduction

- But if you get sick and receive benefits … they are taxed

Cheapest through your retirement savings account

- BUT don't get tax deductions, and
- Benefit period is normally limited to 2 years

Workers Compensation in NSW Australia

A type of basic “income protection” that all workers have!

All employees of companies are covered

The employer pays the premiums for you (required by law)

Safety-net for people without income protection or savings

Covers you for accidents at work

- After 1 July 2012, no cover for accidents travelling to and from work

Pays salary (or proportion) for 6 months and will pay medical expenses (up to a limit)

Best not rely on this and take out proper income protection!

Trauma

Pays a lump sum amount (eg $100,000) when you suffer a serious medical condition (eg cancer, heart attack)

Relatively new – started to be offered in 1980's

Used for large medical bills, house renovation & care

Cannot purchase through superannuation.

Usually too expensive for young, healthy people!

Not usually offered to people with bad family history

Not usually necessary if you have good private health insurance, some savings and income protection!

Whole of Life

A “bundled” product with “savings” and “death cover”

You receive a lump sum if you die

You receive a smaller lump sum at 65 if you don’t die

You have to pay $X per month until you turn 65!!!

If you pull out before – loose a lot of benefits!

A very old product popular in the 1970’s

Brokers love them because they get big commissions $$$

Very bad products and should be avoided at all cost!

Better to buy death cover and save into superannuation

Life insurance tips

Some tips

1. **When you are young and single:**
   save up a "savings buffer" of $10,000
   "self-insure" against small losses with your savings buffer
   choose higher excesses to save on premiums
2. **All working people should have income protection**
3. **Single people and married people with no mortgage or children usually don't need death cover**
4. **Take our death cover as soon as you have children**
   Minimum needed is usually $500,000

Some tips … continued

5. **Trauma usually isn't needed for fit young people**
6. **Beware of life insurance brokers selling you insurance that you don't need!**
7. **Application forms are often complex**

   Ask information about other insurance or workers compensation claims, family health history and/or things that you consider private and confidential (eg. sexual activity)

   You must answer them honestly

   Otherwise, they will reject any subsequent claim

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Estate planning

John and Judy

John (26) marries Judy (25)

Judy’s parents hate John and won’t attend the wedding

John’s Mum gives Judy a lot of family heirloom jewellery as a wedding gift

John’s parents also buy them an apartment as a wedding gift (rich family!!!)

On their way to the honeymoon, John succumbs to driver fatigue and both John and Judy die in a car accident without a valid will.

What happens? …

Dying intestate

Dying "intestate" means you died without a valid will

It does <u>not</u> mean that you die in a different state!!!

There is no will so the probate division of the Supreme Court appoints an administrator

The administrator applies state laws for intestacy

The laws vary from state to state

John is deemed to have died first because he is older

It doesn't matter that they actually died at the same time!

John "survived" by Judy so all assets go to her

This includes John's Mum's jewellery and their apartment

Dying intestate … continued

Judy is younger and is deemed to have died second

- She is "single" since her husband has already died
- She has no children and the only surviving family are her parents

All of Judy's assets are left to her parents

- Including John's Mum's jewellery and the beachside unit

The administrator charges lots of legal fees for distributing the assets and lawyers charge lots of fees for contesting that distribution over the next year

John's parents lose family heirlooms and the apartment to Judy's horrible parents

Wills

What is a will?

A legal document giving clear instructions about what will happen after you die

Who will receive your stuff (beneficiaries)

- **Real assets (cars, music, computers etc)**
- **Financial assets (bank accounts and investments)**
- **Until distributed, they are owned by "The Estate of John Smith"**

Who will be guardian of your children

Who will oversee the whole process (executor)

With adequate "backup" clauses in case beneficiaries or executors die before you do (predecease you)

Why have a valid will?

Banks and financial institutions don’t just “hand over” ownership of your stuff after you die!

A will makes transferring the title of your financial assets easier for your family

This is important since they will also be grieving!

A will reduces the likelihood of family arguments

A good will reduces admin and legal costs

If you are married and don’t have one, then the laws of intestacy may end up screwing your family!

Who should have one?

All graduates of this course!!!

Single and have more than $5000 of assets

Living in a defacto relationship

Married

- Note that marriage invalidates prior wills

People who are unselfish and actually care about what happens after they die!

What can’t be covered in your will?

Any assets owned jointly with someone else

- **Title is automatically transferred to the surviving person**
- **Most people purchase houses jointly with their spouse**
- **… so full ownership will automatically transfer to the spouse**

Assets that you do not directly own

- **Superannuation is owned by a trust on your behalf and so you cannot give instructions about it in your will.**
  - Instead, nominate “beneficiaries” on your super application form
- **Any assets held in a family trust**
- **Death benefits from life insurance policies**

Will choices

Choosing distribution

Normally a bad idea to leave specific assets to people because you may not have them when you die or it may be unfair.

Better to say 50% of all assets to this person, 25% to another, 25% to another and let them decide what assets they want.

If the beneficiaries can’t decide then there is an easy solution – Ebay everything and give people $$$

Make sure there is an residual beneficiary in case everyone else is dead (eg. A charity)

Choosing beneficiaries

If single, usually leave 100% to either siblings or parents

If married, usually leave 100% to your spouse

However, need to also leave instructions for if your spouse or members of your family are dead

For example:

> **I leave 100% to my spouse,**
>
> **If my spouse predeceases me then 100% to brother,**
>
> **If my brother predeceases me then 100% to parents,**
>
> **If my parents predecease me then 100% to Salvation Army charity.**

Choosing an executor

Executor oversees the whole process of distributing assets in conjunction with a solicitor

Qualities of an executor:

- **Someone who "gives a stuff"**
- **Usually a close family member (parent or sibling)**
- **Good administration and follow-through skills**
- **Good interpersonal skills if there are family disagreements**

If no one in your family qualifies:

- **Can appoint your solicitor as executor (expensive)**

Always appoint a backup executor in case they refuse!

Guardianship of children

Applicable if both you and your spouse die

Particularly important part of your will!

Need to consider their:

- Financial strength (including what your children will get from will)
- Ability to manage big family (their two children + two of yours!)
- Parenting philosophy (similar to yours)
- Religious views (similar to yours)
- Willingness to actually do it

Nominated guardians can refuse to do it

Usually best to ask permission before putting them in will to reduce likelihood of refusal

Signing the will

If incorrectly executed (signed) then it is invalid

You must sign the document

Your signature “witnessed” by two people

Witnesses cannot be beneficiaries (eg your family!)

Preferably all to sign with the same pen

Best for all to initial each page of the will (if > 1 page)

Best to then take copies and provide to executor, beneficiaries, guardian and family solicitor (charges fees)

Q: Draft the contents of a will

Imagine that you are 10 years in the future, you are married and have 2 children.

Quickly draft a will (in note form)

Who is your Executor and back-up Executor?

Who will you leave your assets to?

What should happen to your assets if they are dead?

What will happen to your children.

Will tips

Tips

Keep it flexible for your beneficiaries.

Remember that your situation changes frequently and so try to keep your will fairly general so that it does not date quickly.

Try to draft your will so that it only needs updating once every 10 years or so.

Sign several copies and leave them with the executor and various family members.

Alternatives for preparing one

- **If single and few assets then probably best to use a "Will Kit" available from post office, stationary shop or online.**
  - **But if you make a single mistake then it may be a completely useless document!**
- **If you have more than $10,000 in assets or you are married then it is better to get one drafted by a solicitor**
  - **Normally costs around $400-$700**

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Enduring Power of Attorney

A problem

What would you do if

all of your investments are in your spouse's name (income splitting)

they are hit by a bus and are in a coma

you need to access cash fast to pay for medical bills not covered by Medicare and to pay for living expenses while you are off work

you can't access any of the money because she can't sign anything!

What is Enduring Power of Attorney?

If married or aged, consider arranging Enduring Power of Attorney with the solicitor when drafting your will

“Power of Attorney” allows them to buy and sell your investments on while you are still “mentally capable”.

- **Good for temporarily granting permission if you are overseas a lot and cannot sign documents.**

“Enduring Power of Attorney” allows them to buy and sell investments even if you are mentally incapable

- **For example: if you are in a coma or are mentally ill**
- **Good for couples in the event of an accident**
- **Good for elderly people in risk of mental illness**

You need to be able to ...

1. Explain how insurance generally works
2. Explain risk-aversion and fair premiums
3. Identify the various forms of life insurance
4. Identify which forms of life insurance are appropriate at different stages of life
5. Brief a solicitor on how you would like them to draft a will or to use a will kit to draft your own
6. Explain the benefits of Enduring Power of Attorney