

# Defending your snowball 1

Introducing insurance

Risk aversion and fair premiums

Life insurance

Life insurance tips

Estate planning

Wills

Will choices

Will tips

Enduring Power of Attorney



# **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**





# 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 person 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”

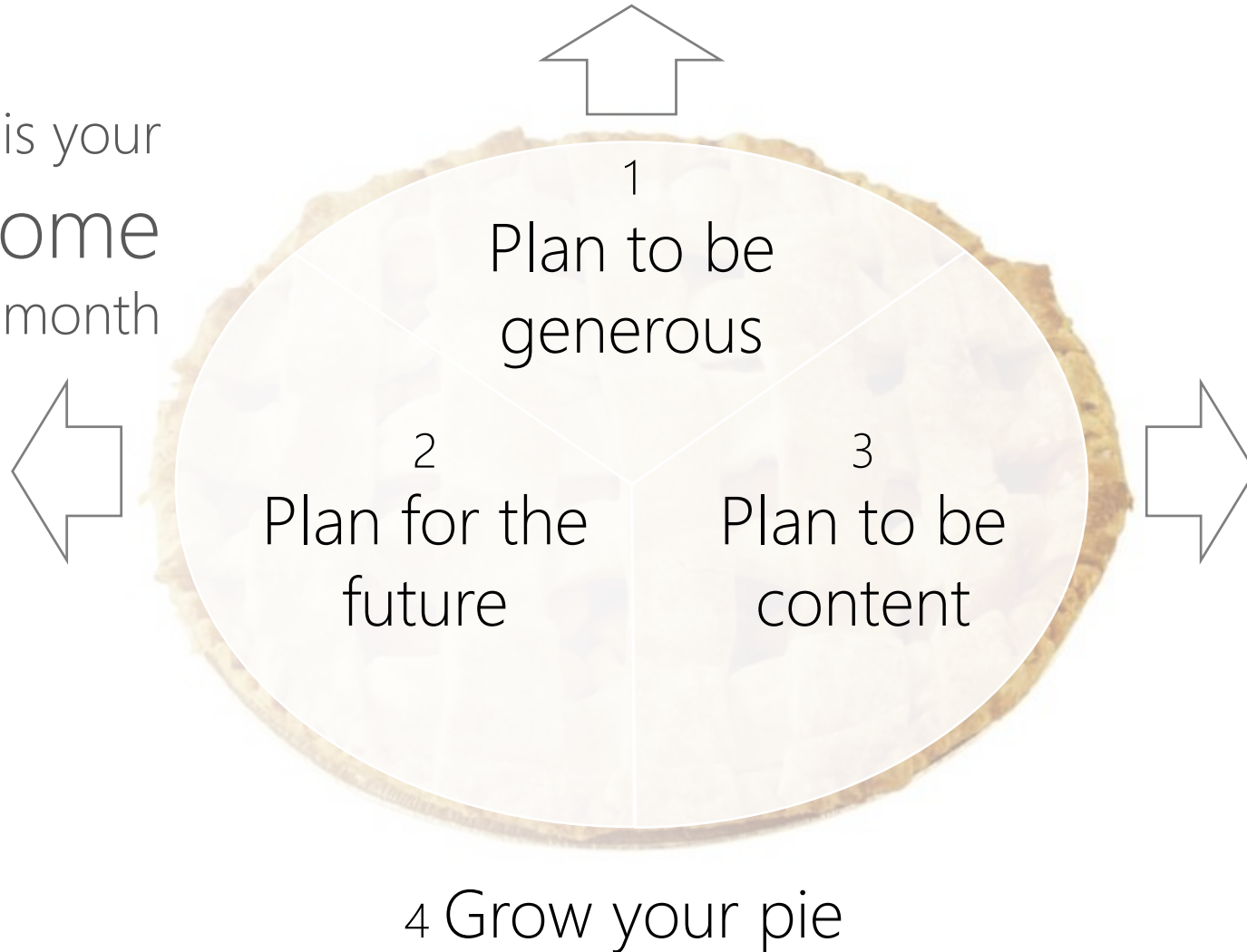
**Risk pooling doesn’t work this way:**

- 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



# 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  $0.01 \times 100,000 = \$1,000$**

**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'



# 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

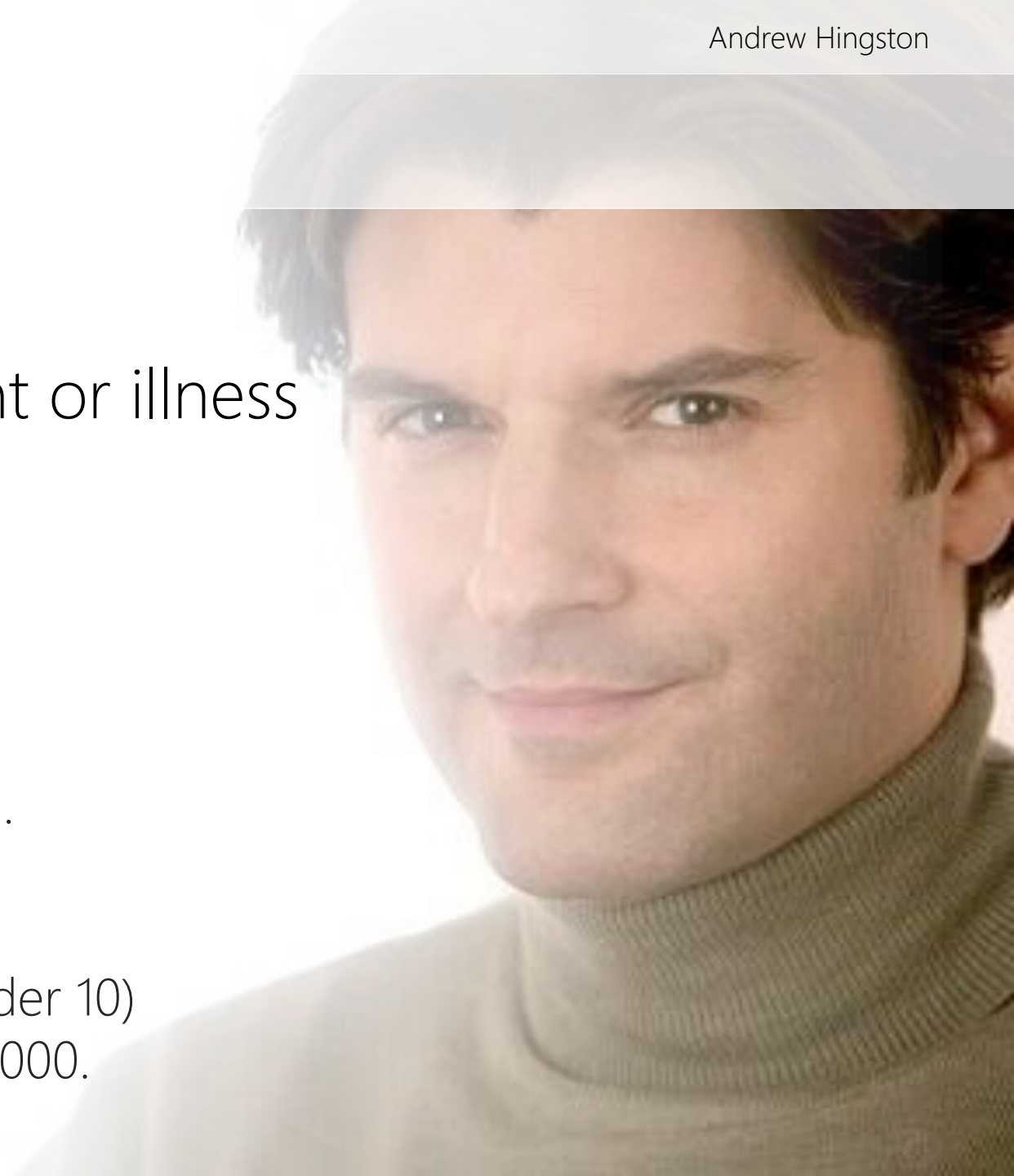
What money would you want each month if you had an accident or illness that prevented you from working:

## 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 out 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**



# 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 not 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

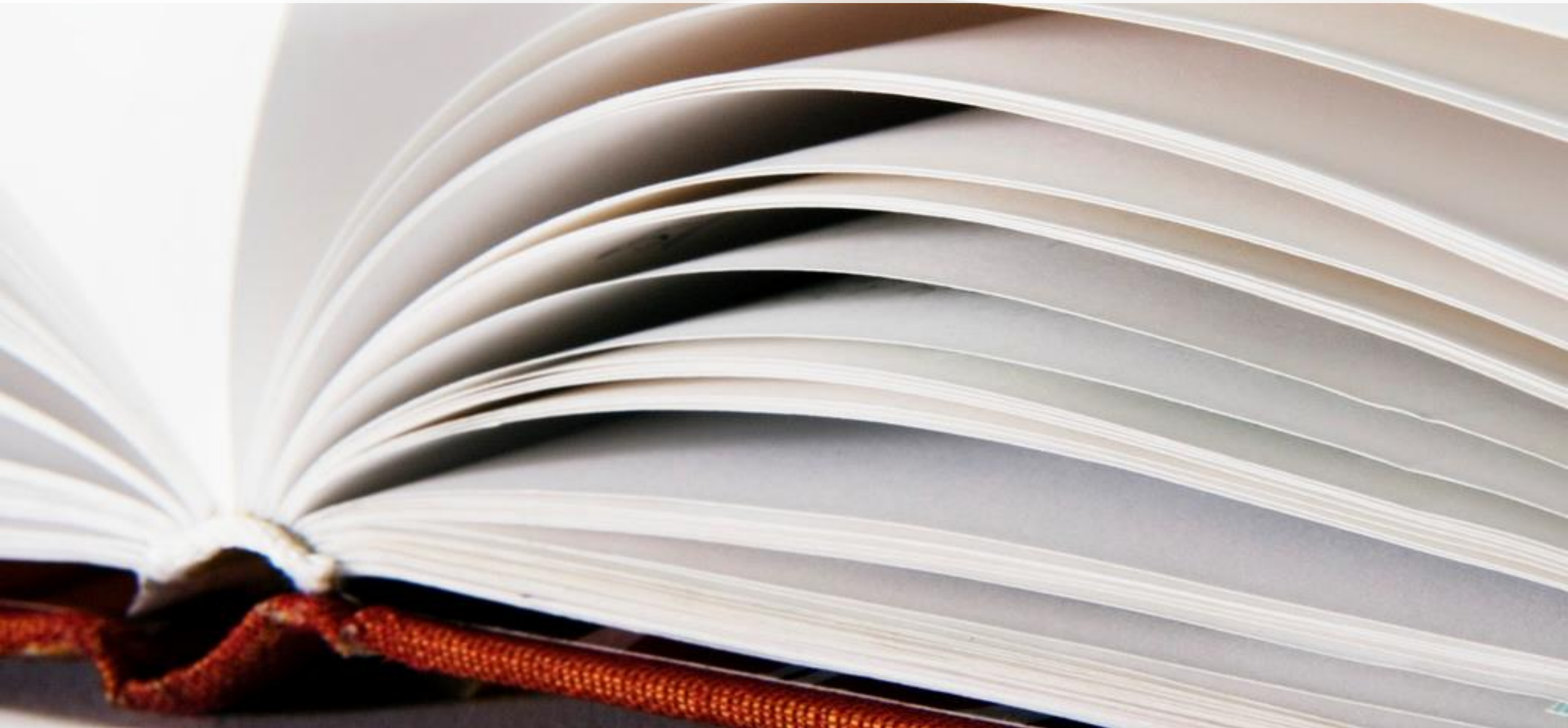
**All of Judy’s assets are left to her parents**

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**

# 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 ...**

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