Principles of Protection

We spend most of our lives trying to earn enough money to allow us to enjoy a comfortable standard of living whilst we are working, and also accumulate enough wealth on top to give us an enjoyable retirement.

The two major circumstances that will stop us doing this are premature death and long term sickness or disability, and although many of us insure the trappings of wealth (homes, cars, furniture, antiques, jewellery, etc.), most people don't insure the person that generates that wealth, i.e. YOU.

To summarise the main areas that should be protected and how that can be done, please check the headings below and then ask yourself how close to these recommendations are your own plans. If you feel that you are falling short in any areas, then we can advise you on how best to plug the gaps.

1) Mortgage Protection

This is the basic level of protection and all your outstanding loan(s) should be covered against death, for both you and your spouse or partner, for the full term of the mortgage. In this event, the survivor will get a tax-free lump sum to pay off the mortgage, thus ensuring that at least they (and any children) will not have to worry about maintaining a roof over their heads.

If it is affordable, you should also cover the loan against contracting a critical illness (the main ones being heart attack, stroke, cancer and multiple sclerosis, although up to 40 are generally covered).

Critical Illness Cover (CIC) will pay out a tax-free lump sum on diagnosis of a CI, which will allow the claimant to either pay off the mortgage or to carry out any modifications to the home that the illness may require (stair lifts, wet rooms, widening doorways, etc).

Note: Some people have Death in Service (DIS) benefit with their employers, which could be anything between 1 and 4 times their salary, but this should never be used for mortgage protection, for two reasons. Firstly, when you leave your employer, this benefit will cease, but your mortgage may last for 25 years or more. Secondly, if during this time you become ill, you may become uninsurable or the premiums may increase considerably. DIS can be more suitably used to top up your family protection, although the same warnings apply.

2) Family Protection

Once the mortgage is protected, the next thing to do is to make sure that your spouse or partner and your children will be able to enjoy the same standard of living as they had before your premature death. This can be covered by providing either a lump sum (single payment) or an income for a pre-determined period of time, and both of these are tax free.

If a lump sum is chosen, the amount should be based upon that required to provide an income of 5% of the lump sum when invested. So if £20,000 per annum is needed, then the sum assured should be £400,000.

If an income is preferred (and this is always the cheaper option), then you can elect to have the £20,000 paid from the time of death to a pre-determined time in the future (say your retirement age). Both the lump sum and the income can be index linked to allow for inflation.

As with mortgage protection, if finances allow, CIC can be added so that the benefit will be paid out on the occurrence of either event.

To calculate the income required, take your net income (after tax & NI), less your mortgage repayments (as this has now been paid off) and that will be the amount needed to maintain your existing standard of living. If both of you are working, then each of you should be covered.

3) Income Replacement

This is the final piece of the jigsaw, which is designed to cover you if you are sick or have an accident which prevents you from working long term (say longer than 3 months) and you don't die or contract a critical illness.

Statistics tell us that, before the age of 65, you are five times more likely to contract a CI or be off work for longer than 3 months than you are to die, so this is very important cover!

Income Protection Plans (IPPs) will provide you with a tax-free income after a waiting period (say 3-6 months), which will be paid to you until you return to work. If you are off work again for the same or even a different reason, as long as you have continued to pay the monthly premiums, you will still be covered. Premiums are paid by the insurance company whilst you are drawing benefits

People very often get confused between Critical Illness Cover, Income Protection Plans and Terminal Illness Benefit (TIB).

The main criterion for benefit payment on CIC is that you have been diagnosed with a critical illness, and the benefit can be in the form of a lump sum or an income . You do not have to be off work and the illness does not have to be terminal.

The benefit is paid on an IPP if you cannot work due to sickness or accident and, as it says on the tin, the benefit is in the form of an income (although it can be commuted to a lump sum with some providers).

TIB is a benefit added to life assurance plans (mortgage and family protection), whereby the benefit is paid immediately if the life assured is diagnosed with a terminal illness, and the life expectancy is less than 12 months.

In an ideal situation, everyone should be covered for all three benefits, but unfortunately we don't live in an ideal world and so affordability is of paramount importance.

So the question you need to ask yourself is - "Am I prepared to take the risk that one or more of these things will happen, or would I prefer to pay an insurance company to carry the risk?". If it is the latter, then you need to decide how much of your income you are prepared to pay in monthly premiums to protect the rest!

The danger is that because you may not be able to afford to do it all you end up doing nothing, and this is a recipe for disaster! May I suggest, therefore, that once you have examined your current situation, you contact an independent broker to discuss the best way of providing the level of protection that you and your family deserve.