

# Optimising Your Personal Risk Management Plan

In the course of our work as independent financial planners, we are often awarded mandates to review client's existing portfolio of insurance policies. Very often, we noticed many consumers are paying very high insurance premiums but not getting the proper and adequate insurance coverage. Why is this so? Is getting ourselves fully covered against all insurable risks really that expensive?

In this article, we shall unravel this mystery and share with you a strategy for you to optimise your insurance portfolio.

## Personal Risk Management

In life, there are some risks that that can cause great financial hardship to us and our families. These risks include hospitalisation due to illness and injury, critical illness, premature death, total permanent disability (TPD), vocational disability and long-term care. Personal Risk Management begins with identifying the risks that an individual and the family face and quantifying the financial impact of these risks, which we term as "insurance needs". (Please refer to Chart 1 below). The insurance needs of an individual differ according to one's age, financial situation and lifestyle. A young accountant, who has a huge mortgage and car loan, has very different insurance needs, compared to that of a debt-free audit partner whose children have already completed their tertiary education.

To manage the financial impact of these risks, we can either retain them or transfer them. For a high networth individual, he has the option to retain some of these risks. For example, in the event of a critical illness (e.g. kidney failure), a high networth individual can use some of his liquid assets to settle the hefty hospitalisation bills and

still afford to meet the family expenses. This method of managing risks by retention is termed as "self-insurance".

Another more popular approach where we can manage risk is to transfer the risks to a third party, i.e. the insurance company, by paying a fee (premium). With insurance coverage, the policyholder can enjoy financial protection against various risks and have a peace of mind that one's financial objectives like children's education and retirement plan will not be derailed.

After identifying and quantifying the different insurance needs, the next and final step in personal risk management is to select the right type of insurance that can address each type of risk efficiently.

## Finding the right type of insurance

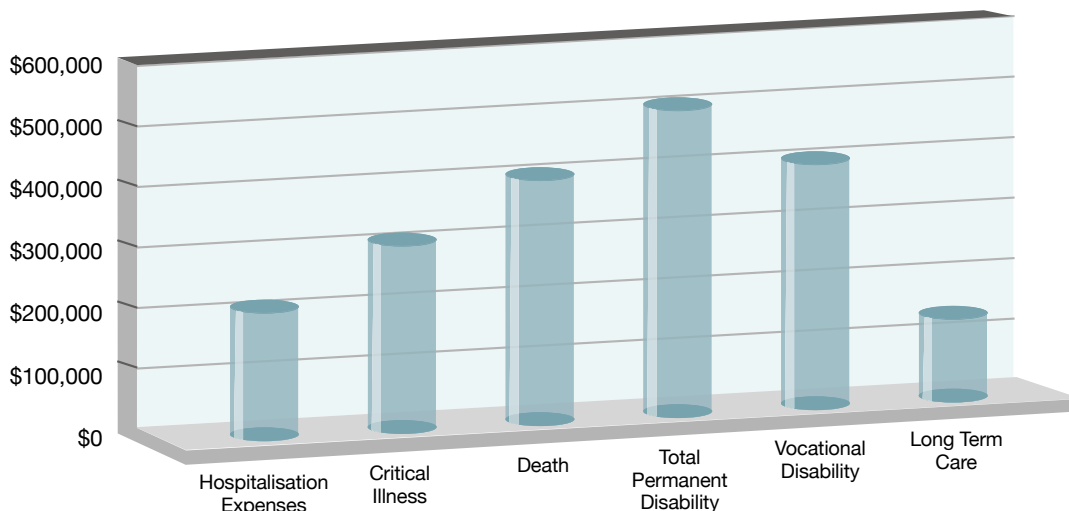
Life insurance comes in two basic forms:

- Cash value plans (i.e. whole life, endowment, investment-linked policies)
- Term plans

For cash value plans, part of the premium you pay goes to cover the protection and part of it goes towards the savings component (which forms the cash value). For term plan, the entire premium you pay goes towards the protection and there is no savings component.

Let's refer to an example below (Chart 2) to see how these plans differ in terms of annual premium.

**Chart 1: Typical Risks Faced by an Individual (Insurance Needs)**



Source: New Independent Pte Ltd

## FINANCIAL PLANNING

**Chart 2: Comparison of Insurance Products for \$500,000 of Coverage Against Death & TPD**

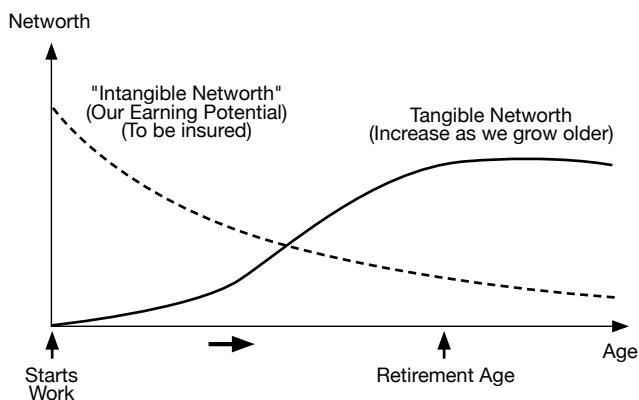
Different Types of Policies from the Same Insurance Company	Estimated Annual Premium for Male Aged 35
Whole Life Policy (Coverage increases as one ages)	\$11,221
Level Term Policy - covers till age 65 (Coverage remains level)	\$3,075
Decreasing Term Policy - covers till age 65 (Coverage decreases over time)	\$1,067

Source: New Independent Pte Ltd

As shown in the example above, a whole life policy costs 3.6 times more than a level term policy and 10.5 times more than a decreasing term policy! From the cost perspective, term insurance certainly looks more attractive for someone who just wants pure protection. To see if it makes sense for us to include decreasing term insurance as part of our insurance portfolio, let us ask ourselves this question: do we need more life insurance coverage against death and disability when we are younger or when we are older? Let us look at the illustration below for the answer.

**Chart 3: Growth of Network and Insurance Needs Over One's Lifetime**

The need for coverage against Death & Total Permanent Disability actually declines as we grow older



Source: New Independent Pte Ltd

Chart 3 above illustrates the growth of a typical working adult's network over time.

Over time, our network will increase with regular disciplined savings and investments (as shown by the solid line - Tangible Network). The dotted line shows the amount of death and TPD insurance coverage that one requires. Our insurance needs against death and disability decline along with the decline in our financial commitment, as we are nearer towards retirement. At retirement, we would have already amassed a sizeable amount of retirement funds that we can use as "self-insurance" against the risks of death

and TPD. Therefore, the reality is: *as we grow older, and as we have already turned our earning potential into real wealth, the need for life insurance coverage against death and disability actually declines.*

**Buying Term and Investing the Difference**

Today, most of the insurance policies owned by consumers are usually high premium whole life plans (that covers death and TPD) designed with increasing death coverage. That explains the phenomenon why people are paying a lot in insurance premium but are still under-insured against risks like hospitalisation, critical illness, vocational disability and long-term care.

If one had used a decreasing term insurance to cover the risks of death and total permanent disability, one can generate substantial savings in insurance premium. Part of these savings can be then be used to address other risks like health insurance (e.g. hospitalisation, critical illness, vocational disability and long-term care insurance). The balance of the savings could then be channelled into a diversified portfolio of global equities and fixed income which could generate higher returns than cash value policies over the long term.

This strategy, known as "Buy Term and Invest the Difference", is very popular among mature economies like US, UK and Australia. In Singapore, one reason why this concept is still not widely known is probably due to the compensation structure of the insurance distribution channel - which is largely commission based. As the commission derived from selling a whole life policy is substantially higher than that of a term insurance with the same coverage, insurance advisers may tend to focus their marketing efforts on recommending high premium whole life policies rather than low premium term plans to their customers.

Nevertheless, whole life policy (with critical illness coverage) is still useful and should be included in one's insurance portfolio, to provide lifetime protection against the risks of critical illness like cancer and stroke. However, to address the risks of premature death and disability, using term insurance as part of your personal risk management plan is recommended due to its cost effectiveness!

Last but not least, it is good practice to review your personal risk management plan as insurance needs changes over time. If you feel that you are paying too much in insurance premiums, it may be time for you to consult an independent adviser to help you evaluate your current insurance needs and insurance portfolio. With a proper risk management plan and the right insurance portfolio to address each type of risk effectively, one could then deploy the savings into investments with higher expected returns and possibly retire more comfortably.

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This is the third in a series of articles on financial planning.

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