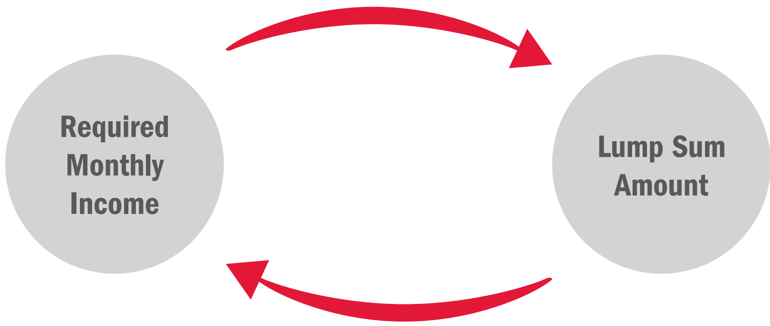
Using Lump Sum Disability to secure future income? Think again!

What kind of cover do you use to insure against permanent disability? Many people choose Lump Sum Disability cover. They assume that, if they are disabled, they will need a lump sum pay-out to replace their future income until they retire. Research shows that individuals tend to intuitively over-value lump sum pay-outs. This makes the decision to use a Lump Sum benefit to secure future income a risky one.

1 Why do you need permanent disability cover?

To provide you with essential income if you cannot work

PLANNING STAGE: Convert a future income stream into a lump sum amount



CLAIM STAGE: Convert a lump sum into a future income stream

2 What are the risks at PLANNING stage of using LUMP SUM DISABILITY to insure future income?

The main problem with planning future income cover using a fixed Lump Sum Disability benefit is **the difficulty in calculating the correct lump sum amount required.**

Risk	Implication
Uncertainty of timing of disability (indicates the period of income that needs to be replaced)	It is difficult to plan with what is required today for a future income stream. This could result in over- or under-insurance
Inflation and investment returns are not predictable therefore it is difficult to decide what amount of income needs to be invested	
Life is not static – an individual's income needs change over time	

LUMP SUM premiums are not tax-deductible

While the pay-out is tax-free, any interest earned on the invested lump sum would be taxable income

FMI™
Income Protection Specialists

Considering these uncertainties, **is it possible to accurately calculate the lump sum needed to cover an individual's future income?**

Consider Ben. A working professional, Ben is 35 years old and he has 30 years to retirement. He earns R25 000 per month gross. The amount of lump sum he would need to invest to ensure that his income is covered could vary dramatically depending on inflation and rates of return.

Net of tax and investment fees

Inflation	Net investment return	Lump sum needed to generate same net monthly pay-out
6%	9%	R4 627 360
6%	7%	R5 991 150
8%	8%	R6 894 150

Calculations assume that nothing gets paid out in the first 6 months to allow for consistency with standard Lump Sum Disability waiting period

Income grows in line with inflation each year

Given the uncertainty of inflation and future investment returns, how does Ben choose the correct lump sum amount for full cover? This example clearly illustrates the difficulty in selecting the correct amount of cover at planning stage.

3 What are the risks at CLAIM STAGE of using LUMP SUM DISABILITY to insure future income?

The biggest risk at claim stage is taking the lump sum pay-out and turning it into an income stream.

Risk	Implication
INVESTMENT returns not being as expected at planning stage	The chosen lump sum might run out before retirement age or may not be sufficient to fit the Insured's requirements at claim stage
INFLATION is higher than assumed at planning stage	
LONGEVITY – the individual might live longer than expected at planning stage	

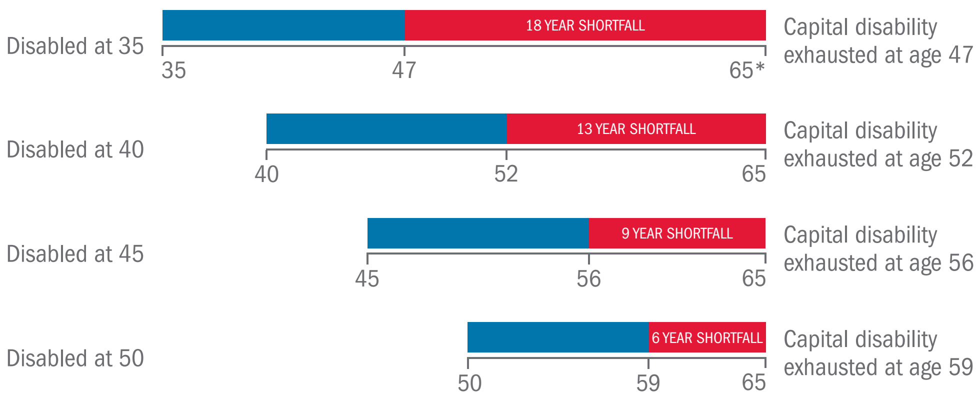
After the lump sum has been paid out, the risk of securing a future income lies solely with the Insured

How long will a Lump Sum benefit last?

Consider Matt. He earns R25 000 per month. We worked out how much it would cost him to buy Permanent Income Protection to ensure that he would have an equivalent income per month, linked to inflation, until retirement age. We then worked out how much Lump Sum Disability cover he could purchase for the same premium.

Assuming investment returns (net of fees and tax) at 9%, how long would this lump sum be able to provide Matt with the equivalent required income? In every case below, there is a shortfall between the end of the lump sum investment and retirement age.

Lump Sum benefits only pay out on establishment of permanence of disability. This can often be much longer than the selected waiting period.



* Retirement age of 65

In all cases PIP payments continue to age 65

FMI™ Income Protection Specialists

4 Why is PERMANENT INCOME PROTECTION a better choice than Lump Sum Disability for insuring future income?

Most individuals believe that with Lump Sum Disability they are properly covered for permanent disability. The truth is that a once-off lump sum benefit is not suited to replacing a future income stream. **Permanent Income Protection**, in contrast, is a much better fit for this kind of cover. Permanent Income Protection has been designed to ensure continuity of income over time, in line with inflation.

Permanent Income Protection pays out a monthly income, until the Insured's retirement or death (whichever is sooner). This means that the inflation, investment, and longevity risks for this kind of cover are held by the Insurer and the premiums are tax deductible. Permanent Income Protection has established waiting periods and pays out for long temporary disabilities. Therefore, it is designed to replace future income, sustaining the Insured's lifestyle until the selected retirement age.

A Lump Sum Disability benefit, in contrast, means that the client will receive a once-off lump sum pay-out for permanent disability only. The premiums for this cover are not tax deductible. Lump Sum Disability cover should be used for once-off events such as repaying debts, business assurance, or making necessary lifestyle changes.

ACCELERATED LUMP SUM reduces your Life benefit which might result in compromised estate planning

5 But, isn't Permanent Income Protection more expensive than Lump Sum Disability?

Lump Sum disability is often sold on an own/similar occupation definition. This increases your risk at claim stage!

Many people believe that Permanent Income Protection is more expensive than Lump Sum Disability but this is not the case! Consider the following comparison:

COMPARISON OF LUMP SUM DISABILITY AND PERMANENT INCOME PROTECTION (PIP) PREMIUMS

Age	NRA	PIP cover	BPE 2012 PIP premium	BPE premium net of tax	Equivalent Lump Sum cover	Leading competitor own occupation stand-alone disability cover
35	65	R25,000	R409	R286	R4,627,360	R565
40	65	R25,000	R581	R407	R4,085,161	R727
50	65	R25,000	R931	R652	R2,745,023	R1,029
55	65	R25,000	R1,035	R725	R1,920,946	R1,061

Lump sum needed on disability in order to generate the same pay-out as Permanent Income Protection benefit to age 65

Equivalent lump sum amount takes into account the fact that lump sum benefit is paid out tax-free

Own occupation, 6 month waiting period, Claim Escalation set at 10%

Assumption is that (after tax assumed at 30% and admin fees) investment return is 9% and inflation is 6%

6 The best permanent disability solution: Combine LUMP SUM DISABILITY and PERMANENT INCOME PROTECTION!

Just because Lump Sum Disability is not suited to insuring future income does not mean that clients should have only Permanent Income Protection in place when it comes to permanent disability cover. FMI believe that a COMBINATION of Permanent Income Protection and Lump Sum Disability is required to ensure complete permanent disability cover.

It is important to understand that Lump Sum Disability and Permanent Income Protection are different products with different functions and they should be used in conjunction rather than as replacements for each other. FMI advocates a holistic approach that combines both products (both with 'own occupation' definition), drawing on the strength of each product to ensure comprehensive cover for permanent disability.

FMI™
Income Protection Specialists

Consider John: What would he need to ensure that he is completely covered for permanent disability?

45 years old, non-smoker

Own occupation definition

Income: R40 000pm

After tax income: R30 000pm (25% effective tax rate)

Retirement age: 65

Monthly expenses: R30 000pm

Debt: R1 million

Monthly cost of servicing debt: R12 000 pm

Monthly expenses (excl debt servicing): R18 000pm

Lump sum required (assuming disability at age 45): R5.4 million

FMI's holistic scenario not only provides better cover, it's more affordable!

In each scenario below, John has different types of cover. Each type of cover will cost John a certain amount and provide him with certain benefits.

7.5% claim escalation for Permanent Income Protection and 5% increasing premium pattern

Does not include a policy fee

		PERMANENT DISABILITY ONLY			FMI'S HOLISTIC SOLUTION
		Scenario 1	**Scenario 2**	**Scenario 3**	**Scenario 4**
		Lump Sum Disability Only R5.4m cover	**Permanent Income Protection only** R40k cover	**Combination of Lump sum and Permanent Income Protection** LUMP SUM R1m PIP R24k	**Scenario 3 PLUS Temporary Income Protection** LUMP SUM R1m PIP R24k TIP R40k
Before Tax	LUMP SUM DISABILITY	R 1 044.84	R 0.00	R 197.98	R 197.98
	PIP	R 0.00	R 970.00	R 582.00	R 582.00
	TIP	R 0.00	R 0.00	R 0.00	R 197.26
	Total	**R 1 044.84**	**R 970.00**	**R 779.98**	**R 977.24**
After Tax	**Total**	**R 1 044.84**	**R 727.50**	**R 634.48**	**R 782.43**

Temporary disability is more likely than permanent disability and can have devastating financial consequences

Assuming 9% investment return net of taxes and inflation of 6% on the Lump Sum Disability benefit

TIP cover based on 30 day waiting period and 6 month benefit term

25% effective tax rate

Visit www.fmi.co.za to learn more about FMI's Temporary Income Protection benefit

FMI's complete disability solution!

With FMI's holistic approach to disability, it is possible to offer clients complete disability cover while still saving them money and ensuring they get tax back.

FMI recommends putting in place Temporary Income Protection for temporary disability, and then a combination of Permanent Income Protection and Lump Sum Disability to cover permanent disability. This means that individuals like John can remove investment and longevity risks, and cover themselves for temporary disabilities shorter than 6 months or during the waiting period before permanent disability is established. The result? Their income is completely protected should they become disabled.

For more information please contact our FMI Financial Advisers Distribution Team on 0860 10 52 08, sales@fmi.co.za or www.fmi.co.za

Underwritten by Lombard Life Ltd. FMI Ltd is an authorised Financial Services Provider FSP 2717

FMI™
Income Protection Specialists