Guide To…

Eliminating debt on death or disability

Personal loans, bridging loans, home loans, mortgages, credit cards, lines of credit, hire-purchase, interest-free purchases; it doesn't matter what you call it, it's debt and most of us have plenty of it. It has paid for our homes and often our cars, clothes, furniture, and children's education. It enables us to live a lifestyle we wouldn't be able to afford simply on cash.

In almost all cases when borrowing money, the lender will require a personal guarantee or some other form of security for the loan. Unfortunately, when we die, the debts do not die with us.

A common clause in mortgage (or loan) documents is for the loan to become immediately repayable upon the death or disability of the borrower. Generally, we simply don't have the necessary amount of money to meet this repayment immediately and could be forced to sell the asset to raise funds to repay the lender. When this asset is the family home, this leaves dependants in the unenviable position of either trying to re-finance the loan or downgrading their residence.

A cost-effective solution is to use insurance to provide a payment upon death, permanent disablement or occurrence of a serious medical condition. This can then be used to repay the loan.

How does the strategy work?

The first step is to calculate your total debts. Don't be surprised if this is a large number – it's better to know this now rather than later. This is a good starting point to identify the level of insurance cover required to clear your debts.

The next step is to determine (in conjunction with your financial adviser) for what 'events' you wish to be covered. For this strategy, the most common form of insurance is for death; however you may also want to be covered in the event of total and permanent disability and/or occurrence of serious medical conditions.

The Benefits

- Clearing your debts means the asset is debt-free and the full value can be passed onto your dependants.
- The cost of implementing a protection strategy is only a fraction of what you and your family may otherwise stand to lose.

Case Study

Wendy and Peter have three children, John (5), Michael (3½) and Belle (2). Wendy has been a full-time homemaker for the past five years, while Peter, a computer technician for a small software company, is the breadwinner of the family and earns $60,000 per annum. Their family home is valued at $290,000 and they currently have an outstanding mortgage of $218,000 repayable over 30 years. A large proportion of Peter's income is used for the mortgage repayments.

In the event of Peter's death or permanent disability, Wendy will need to find funds to continue the mortgage repayments. Her options would be:

1. Return to full time paid employment	*Issues*: Returning to work after five years may not be easy, and her income level may be less than Peter's. There would also be the added expense of childcare and household help.
2. Rely on government assistance	*Issues*: The level of Social Security payments may be insufficient to both service the current mortgage and pay the family's living expenses
3. Sell the home to repay the loan	*Issues*: As well as needing to find somewhere else to live, the level of equity in the home will more than likely be insufficient for Wendy to consider purchasing another property, therefore requiring her to rent. Would this be in the same neighbourhood, or will there be additional upheaval by having to move the family to another neighbourhood?

Had Peter and Wendy planned ahead and set up an insurance policy that would, as a minimum, clear the outstanding mortgage of $218,000 upon Peter's death or permanent disability, the financial strain on the family would have been reduced. Importantly, Wendy and the children would be able to continue to live in the family home.

Ideally, Peter and Wendy should plan to not only clear the debts but should also make provisions for day-to-day living expenses to reduce the dependence on government assistance.

Tips and Traps

- You may be able to nominate a beneficiary for benefits payable on your death. This allows the death benefit to be paid directly to the beneficiary(ies).
- In conjunction with a professional adviser, you should consider your entire estate planning position, including your Will, to ensure your wishes are carried out upon your death.
- You should ensure your levels of insurance cover are adequate for your needs. Underinsurance can present a serious problem.
- Changes in your personal circumstances (eg. taking on additional debt) often necessitate higher insurance levels. You should consider insurance policies which allow you to increase the level of cover in the future without requiring further medical evidence.
- For certain people, there may be advantages in having life and total and permanent disability insurance through a superannuation fund.

If you have any queries in relation to the content of this material, please do not hesitate to contact Kate Kimmorley the Principal Financial Adviser at Kimmorley Financial Management on (07) 5591 1725.

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