

Life events that may derail a financial plan

The BMO Wealth Institute provides insights and strategies around wealth planning and financial decisions to better prepare you for a confident financial future.

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When polled after the 2012 election, most Americans were very concerned about their retirement and health care costs. Many Americans feel largely unprepared financially to deal with these events. In fact, nearly three-fourths agreed that they were worried about having enough money to retire and about being able to afford unexpected health care costs.¹

Financial Concern	Men	Women
Having enough money for retirement	71%	77%
Being able to pay for health care costs when I retire	69%	77%
Being able to afford unexpected health care costs	67%	74%

Source: Retirement and Health Care Costs Weighing Heavy on Americans' Minds, HarrisInteractive.com, November 5, 2012

Significantly, according to the 2009 National Consumer Survey on Personal Finance 64% don't have a written financial plan.² However, just having a financial plan is not enough. One of the biggest mistakes individuals make is just having a plan that meets their goals without really stress testing that plan to make sure that it withstands not only a major decline in financial markets but against the major life events that keep Americans awake at night. The most significant derailments to a financial plan are the death or disability of a spouse, partner or family member and divorce, particularly later in life.

All of these major life events can have a dramatic effect on the family's financial plan. These disruptions can result in a loss of income and lead to additional unplanned spending.

While the financial impact caused by derailments can be very hard, there are ways that families can plan for and insulate themselves from the worst of the financial impact. Taking a practical and proactive approach to these potential risks allows families to implement changes to their financial plan that can help put them in a more secure financial position going forward and provide some peace of mind.

Don't let a disability ruin your financial plan

Many individuals are in the position that if they work through to their retirement day and follow their financial plan they will be able to fulfill the retirement they envisioned. But, consider the impact that a devastating injury or illness could have. What if an individual was forced to retire at age 55 instead of at the planned age of 65? Loss of income, drawing down on savings and medical costs over and above what is covered by the family's medical coverage can quickly add up and become a burden on a spouse or family. The impact can be even more devastating if you are single and have no one else to rely on for financial support.

There are potentially many sources of income to help make ends meet in the event of disability. In addition to personal savings, family and friends, credit and insurance, many look to the government for support. Unfortunately, support from the government is limited and comes with very specific qualifying conditions. For example, to be approved for Social Security disability benefits, income cannot be more than \$1040 per month, and there is a six-month waiting period after the disability occurs before any benefits can even be paid. Government support at best would only provide for a small proportion of the income needed in the event of a derailing life event.

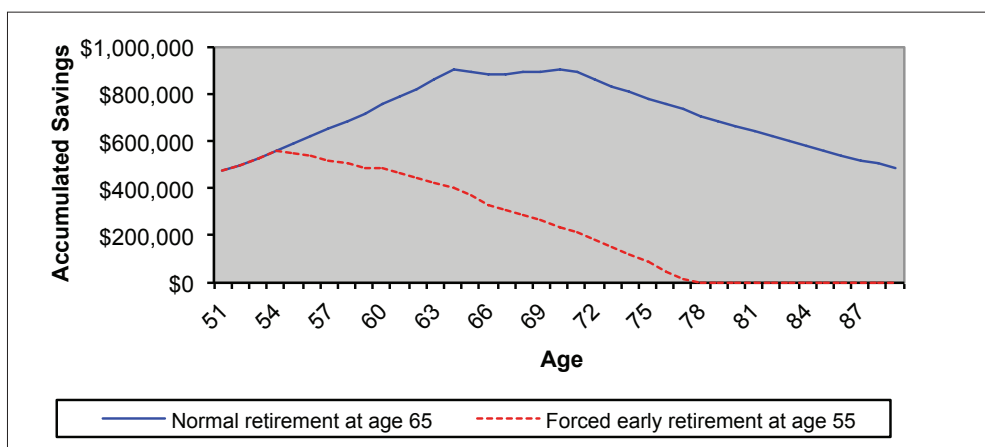
Between the age of 45 and 64 the chance of becoming disabled and unable to work is more than 1 in 5. The Centers for Disease Control and Prevention notes that 21.8% of males and even a higher proportion of females, 25.9%, in this age group consider themselves to be disabled.³ However, few Americans appear to be prepared to withstand the impact of a critical illness or disability. For example, less than half of US workers have disability coverage according to a recent insurance survey. Only 49% have short-term disability and 44% have long-term disability, which is lower than previous years' data, so the trend in coverage is downward.⁴

The financial impact of disability or major illness

Consider again the couple whose financial plan gets derailed 10 years before their age of retirement, at the age of 55. The dual impact on their financial plan of less income and potentially more spending on health

care costs can turn a financial plan from one that projected accumulated savings to last until at least age 90 to one where all of the family's savings are exhausted at a much earlier age.

The impact of a disability/major illness before retirement



Source: Wealth Institute / Assumptions: Accumulated savings in qualified and non-qualified accounts; 3% Inflation Rate; 3% Rate of Return (Interest); \$48,000 indexed withdrawal per year. A couple, both age 51 and working, on track with their financial plan for retirement when they reach age 65. Their financial plan becomes derailed when one suffers a life changing disability at age 55 and is no longer able to earn an income.

Proactively planning for Disability and Illness

In order to be prepared for the financial impact of a disability or illness, families can build an emergency fund and buy insurance. An emergency fund could be a source of income to help cover costs during a short-term disability. Consolidating funds held in smaller accounts across multiple financial institutions can simplify building and managing such an emergency fund.

When setting up an emergency fund, one of the most important factors to consider is the security and safety of the fund. Consider alternatives that provide FDIC insurance coverage, even though the yields available may not keep up with inflation. In addition, as a last resort pulling funds from a Roth IRA is an option as contributed amounts can be taken out

tax-free without penalties even before 59 ½ as disability is one of the allowed reasons for early distributions (although the earnings from the Roth IRA are subject to a 5-year rule to avoid being subject to tax). Insurance should also be considered to help reduce the potential impact of a disability on the family's financial plan. Insurance products that should be considered include income replacement insurance, critical illness insurance and long term care insurance.

Some individuals are fortunate to have disability insurance coverage through their employer's group benefit programs. A typical group plan covers short and long term disability. For example, Short Term Disability (STD) usually pays 100% of base salary for 3 – 6 months. The Long Term Disability (LTD) plan covers between 60 and 70% of pre-disability earnings and begins after 90 or 180 days of being disabled. Typically, there is a maximum monthly benefit payable (\$6,000-\$10,000 per month) and many group plans cover base salary only. Disability or income replacement insurance can be purchased on an individual basis and used to replace lost earned income or fill the gap of a partial replacement from the group plan by providing a monthly benefit to the disabled party.

It is important to understand the income tax consequences of contributory versus non-contributory plans. Upon disability, if the company has been paying the premium then the benefit will be taxed as ordinary income. If the employee is paying the premium any benefits will be received income tax free. The definition of disability is also an important factor. An example is a plan that defines disability as the inability to do your own job for the first two years (known as "own occupation") and then switches the definition to the inability to do any job (known as "any occupation"). Supplemental individual disability income policies can be designed for "Own Occupation Benefits" payable to age 65 or 70 and are very important for high income professionals with expertise in a chosen career. As many disabilities can last for years, depending on only group disability coverage leaves a financial plan more at risk, especially for higher wage earners.

Another form of insurance to consider is Critical Illness, which is typically a rider available on most life insurance policies. This can provide accelerated death benefits in the case of a terminal diagnosis which will help the family deal with unexpected costs, or help meet current cash flow needs.

Long-term care insurance is an option that can be used to pay for the costs of home health care and nursing home costs for end of life planning. By shifting the risk to a third party (insurance company) this should result in more wealth transferred to heirs, if that is an objective.

By planning for the long term, and considering the needs of the whole family, it is possible to put in place plans to reduce the stress that a catastrophic injury or illness can have on the family's financial plan.

Death – lack of planning can lead to significant consequences

Of the three life events referenced in this report, the premature death of a spouse or partner is the one most likely to have a catastrophic financial impact.

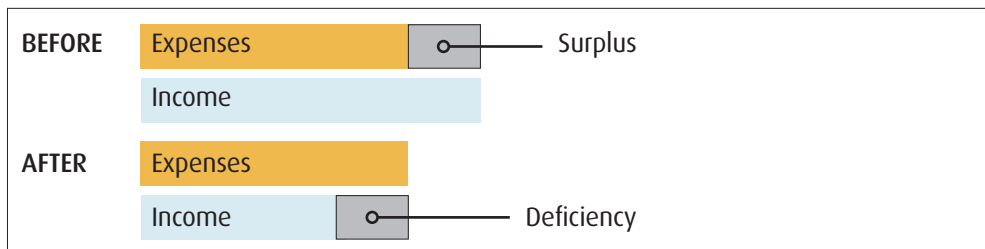
Surprisingly, the incidence of death during the pre-retirement years is quite common. According to a U.S. Census Bureau report 14% of American women between the ages of 20 to 64 have lost their spouse.⁵

The financial impact of widowhood

The financial impact of suddenly becoming single due to the death of a spouse can be substantial. For instance, consider a couple with no life insurance. If one spouse were to pass away prematurely there could be a double shock; income stops but the bills and expenses continue to come in.

Depending on the deceased spouse's responsibilities within the home, the loss will require significant adjustments. Continuing income will be required, the household will have to be maintained and any minor children cared for. This often results in additional costs that the surviving spouse has to cover, such as nanny or child care expenses.

Potential Shock of Widowhood



Planning to Reduce the Financial Risks

Now unexpectedly single, this life changing event requires a review of beneficiary designations, wills and power of attorneys, and a re-examination of the financial plan.

There are many insurance options available that are worthy of consideration. There are two general categories of life insurance, Term and Permanent. Both have a specific role to play in the protection of the surviving family members. Term insurance is very inexpensive and used to cover a period of time, usually the “critical years” for a family just starting out. They have mortgage and debts to cover, income to replace, college costs looming in the future and retirement funds to accumulate. “DIME” is a helpful acronym to estimate the amount of coverage, which stands for debt, income, mortgage, education. Term can be purchased for those critical years by purchasing 10, 15 or 20 year term plans, or by purchasing a ladder term portfolio by combining various term periods.

Permanent insurance is often considered for risks that are more long term in nature, such as providing for a surviving spouse should death occur later in life. Some Permanent life insurance policy designs provide the opportunity to build up cash value on a tax deferred basis. This accumulation of a cash value inside of a permanent insurance policy can be used as an emergency fund reserve. Permanent policies can be designed for single life coverage or joint life coverage. Single life coverage protects a primary wage earner, business owner and/or a key employee. For clients who are in a taxable estate situation, joint life coverage (also known as second to die) is generally purchased in

a trust so the death proceeds are not includible in the taxable estate and are used to minimize estate taxes and maximize wealth transferred to family and charity. With permanent insurance it is possible to accelerate the payment of the premiums (also known as short pay) associated with a policy prior to retirement so that no premium payments are required during retirement.

As there are many insurance options available, it is very important to consult a qualified professional regarding different types of policies and their uses. Speak with your BMO financial professional who can help make the appropriate referral.

Divorced – now what?

Becoming unexpectedly single can also occur when a relationship ends due to divorce. Unfortunately, the incidence of divorce continues to be relatively high. It is now expected that nearly 5 in 10 marriages in America will end in divorce. In addition, the incidence of 'gray divorce' has doubled in the past two decades for those ages 50 and older.⁶ The impacts extend well beyond family issues and custody of children. The financial impacts must also be considered as it could result in each of the ex-spouses and the children having a lower standard of living than was previously enjoyed. By dividing what was once a single nest egg into two, less will be available to help meet future needs as many expenses, such as housing and utilities, increase as the result of having two separate residences.

The key to financial survival through the often difficult process of obtaining a divorce is to have your financial house in order. As a starting point – recalibrate, that is review and update the financial plan as it will be under significant stress as a result of divorce. A financial plan can help highlight any necessary adjustments to your current financial situation to meet your future goals based on your new level of income, expenses, assets and liabilities.

Beneficiary designations on life insurance policies, group insurance through employee benefit programs, pensions, Individual Retirement Accounts (IRAs) and 401(k)s should all be reviewed to determine if changes are required. You should also work with your qualified legal advisor to review your will and power of attorney and either adjust or rewrite these to make sure that the heirs, executors, attorneys, trustees, and guardians (for minor children) named meet your updated wishes.

Determine if additional insurance coverage is required as spousal coverage on employee group plans typically ends as a result of divorce. Life insurance, protection against disability, and health benefits insurance should all be re-examined as a result of divorce.

You should work with your financial professional to update your credit profile and work to eliminate any joint responsibilities or guarantees that may be in place for your ex-spouse. Ensuring your credit is on a firm foundation will provide greater access to a personal line of credit or a credit card in your name to help with the transition forward. This is especially important as credit is often an essential source of funds in the event of becoming suddenly single.

Conclusion

There are many other potential events that can have a significant financial impact on the family. An unexpected career change as a result of a downsizing or employer bankruptcy can cause financial distress similar to any of the more testing events described earlier. On the positive side, a family might be the recipients of a sizeable inheritance.

We believe proactive planning and professional advice go hand in hand. By working with a BMO financial professional who understands the impact of these derailments on a financial plan and who can also make the appropriate referral or introduction to other key professionals, Americans can develop a thoughtful plan and enjoy greater peace of mind.

¹ Retirement and Health Care Costs Weighing Heavy on Americans' Minds, HarrisInteractive.com, November 5, 2012

² "Two Thirds Don't Have a Financial Plan", Financialplanning.com, September 24, 2009.

³ Centers for Disease Control and Prevention, Prevalence and Most Common Causes of Disability Among Adults, 2005

⁴ "Percentage of US Workers with Disability Coverage Declines", InsuranceJournal.com, June 8, 2011

⁵ US Census Bureau, Marital Status of the Population by Age and Sex 2010

⁶ Susan L. Brown and I-Fen Lin, "The Gray Divorce Revolution: Rising Divorce among Middle-aged and Older Adults, 1990-2009", National Center for Family & Marriage Research, Bowling Green State University, March 2012

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