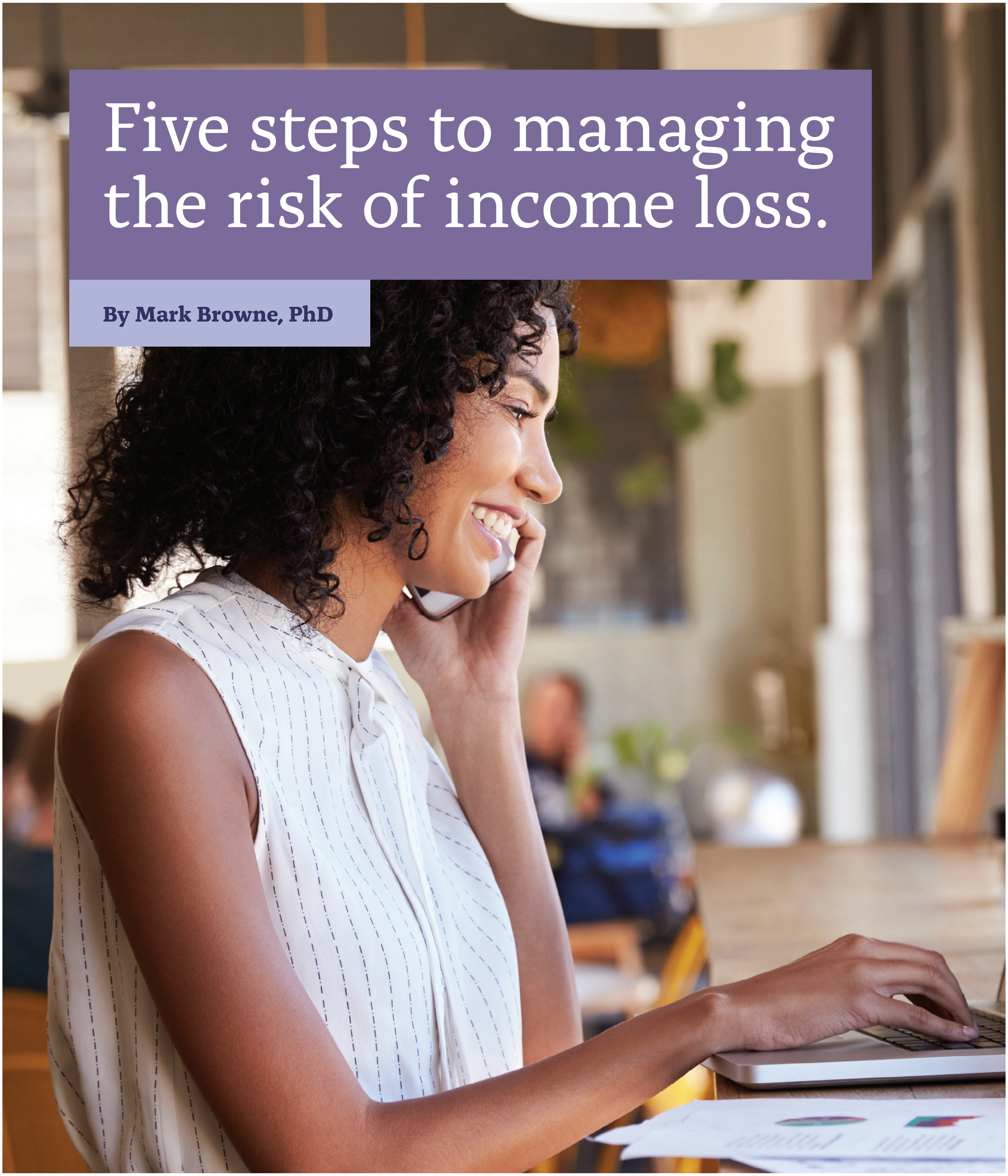
Five steps to managing the risk of income loss.

By Mark Browne, PhD



Long-term financial goals, such as accumulating savings to fund a child's educational expenses and building wealth for retirement, typically take years to achieve. Realizing long-term financial security and overall financial wellness takes discipline and sacrifice, but it also depends upon access to income sources that allow you to save and invest over time. Safeguarding your income sources is a bedrock of managing personal financial risk.

Most people's primary income source is derived from their human capital—their current and future employment earning capacity. Protecting one's human capital should be part of any long-term financial strategy. Two major risks to human capital are premature death and disability. In this paper, we'll discuss five important steps to take to manage your income risks.

A well-executed risk management solution includes (1) identification of one's goals, (2) determination of the risks to the income needed to achieve those goals, (3) analysis of those risks to better understand them, (4) recognition of different strategies to address the risks identified, and (5) implementation of those strategies best suited to address the risks.

Step 1: Identify Long-Term Financial Goals

The first step in the risk management process is to identify the goals you wish to achieve. Family financial goals frequently include a time limit for reaching the goal—for instance, accumulating savings for a child's college costs by the time the child reaches college age and accruing sufficient wealth for retirement by the age one wishes to retire. Financial goals vary across households, but income is fundamental to their achievement. Insuring against risks that can impair one's income allows financial goals to be pursued even under difficult circumstances.

The most common long-term financial goals include:

- **Economic security in retirement.** Determining the amount one needs to save for a comfortable and secure retirement requires evaluating one's desired age of retirement; understanding the different sources of retirement income that will be available (such as retirement-related employment benefits, Social Security, and investment income); and setting a retirement budget for expenses such as housing, transportation, taxes, food, clothing, entertainment, and healthcare. Currently, the average annual household expenditures for adults 65 years and older is over $50,000.[1]

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- **Paying for a child's college education.** To pre-fund a college education, one needs to estimate what the total cost of a college education will be; consider the timetable for saving; and assess the different savings vehicles that are available. The 2023 average cost of one year of college in the United States is $36,436 per student, including books, supplies, and daily living expenses.[2] Over the past 10 years, the average annual growth rate in college costs has been 2%.[3]

- **Saving for a down payment on a house.** Considerations in saving for a down payment include housing costs, borrowing costs, and the amount of time until one wishes to purchase a home. To avoid the cost of mortgage insurance, many home buyers aim to make a down payment of at least 20%. Others strive for a higher down payment to minimize the size of their mortgage. Although costs vary by location, the median and average home sales prices in 2023 were $436,800 and $516,500, respectively.[4] A down payment of 20% based on the average sales price would be over $100,000.

Step 2: Identify the Risks to Income Required to Meet Financial Goals

While individuals' long-term financial goals differ from person to person, to be attainable they must be tied to decisions and actions that are under one's control, such as setting a savings rate and sticking to a plan. They also require income. Two devastating risks to human capital that individuals do not choose, but rather must confront, are premature death and disability.

Life and disability insurance are among the most important tools available to protect oneself against these two major risks to income.

[1] Bureau of Labor Statistics, "Consumer Expenditures in 2021," Table 14. https://www.bls.gov/opub/reports/consumer-expenditures/2021/home.htm#:~:text=Consumer%20Expenditure%20Surveys%2C-,2021%C2%A0,-%5B%2B%5DTable%2015
[2] https://educationdata.org/average-cost-of-college (updated June 25, 2023)
[3] https://educationdata.org/average-cost-of-college (updated June 25, 2023)
[4] https://fred.stlouisfed.org/release/tables?rid=97&eid=206085#snid=206087 (Quarter 1, 2023)

Step 3: Analyze Risks

After identifying the risks to your future income, it is important to analyze each risk for the likelihood that it will occur, the impact it will have, and the exposure that it creates to your financial well-being. Your exposure depends not only on the likelihood of the impact, but also on the magnitude of the impact given the composition of your family over the relevant time horizon—whether you are a single person or a single-parent household, whether your family consists of a working couple with young children or not, whether one or both partners work outside the home, and whether your family includes dependent parents.

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The Risk of Death

Likelihood. Although many people would prefer to avoid planning for death—and particularly a premature death—the risk of an early death is more likely than many people realize. An average 20-year-old faces a roughly one-in-five chance of dying before retirement.[5] Even if you do all you can to minimize the risk of premature death, its possibility and its potentially detrimental fiscal impact on your family remains.

Your risk exposure depends on both the likelihood and the magnitude of the impact of potential income loss.

Impact. In addition to the tremendous emotional toll of a loved one's death, the financial toll can also be devastating. The premature death of a working-age individual results in an irretrievable loss of current wages as well as the loss of all future earning potential. The negative impact on household income is considerable. Even after adjusting for the reduced household size with the death of a family's breadwinner, there is an average decline in household income of 11%.[6] Death may also terminate the availability of employer-sponsored benefits such as medical insurance, paid leave, and retirement benefits—which typically account for 30% or more of total compensation.[7]

Exposure. While every household will be impacted financially by the death of a family member, some are at greater risk than others. After paying death-related expenses, the lower household consumption associated with a smaller family size may mitigate the loss of the deceased person's income. The income of other family members, however, may also be impacted depending upon the family structure. A surviving spouse who did not

[5] https://www.govinfo.gov/content/pkg/CHRG-108hhrg99667/html/CHRG-108hhrg99667.htm
[6] https://www.chicagofed.org/publications/chicago-fed-letter/2020/438
[7] https://www.bls.gov/opub/ted/2023/compensation-costs-for-civilian-workers-averaged-42-48-per-hour-worked-in-december-2022.htm (based on data for private industry workers)

work outside the home may need to find a job to replace lost wages and benefits. Alternatively, a surviving spouse may need to reduce working hours to care for dependent children. Families with young children are at greater risk as the financial costs of caring for children will last for years into the future. Families in the early years of paying off a mortgage also face significant risk as they will need to make payments for years into the future to avoid foreclosure.

Life insurance can be designed to protect specific goals, limit overall exposure, or both. For example, one can purchase a term policy to pay off a mortgage and thereby protect and stabilize the household's living situation. A permanent policy can help the household maintain its standard of living and keep financial goals, such as paying for college, on track.

The Risk of Disability

Likelihood. A disability can limit a person's physical and mental abilities and their capacity for work—directly lowering an individual's earning potential. The odds of becoming disabled at some point during one's working life are substantial, and the risk increases with age.[8] More than 25% of 20-year-olds will become disabled before reaching retirement age.[9] Most disabilities are not caused by an accident, but rather an illness.[10]

Impact. Disability reduces one's capacity to work and earn money—partially or completely—resulting in a loss of household income. Becoming disabled may limit working-age individuals' ability, both in terms of the type of work they can undertake as well as the amount of time they can work. Without disability insurance, households often access savings, credit cards, or retirement savings to supplement lost income.

Exposure. The more a family unit is dependent on any one individual's income to meet its financial needs, the greater the risk to the family's financial well-being should that individual become disabled. One family member's disability may also impact the earning potential of other family members. For example, the able-bodied spouse may work more to increase household income or may need to reduce hours of employment to become a caregiver for the disabled spouse or minor children.

The loss of income can make achieving long-term financial goals difficult without a risk management strategy like disability insurance in place. The adverse consequences of disability on a family's finances vary depending on the family composition. Single-parent households are at greater risk without the labor earnings of a spouse to make up for the loss in income. In addition, families with young children and families carrying mortgage debt have financial obligations extending years into the future.

[8] https://www.bls.gov/news.release/pdf/disabl.pdf (Half of all people with a disability are over the age of sixty-five.)
[9] https://www.ssa.gov/disabilityfacts/facts.html
[10] https://disabilitycanhappen.org/overview/

Step 4: Identify Strategies and Plan a Course of Action

Implementing lifestyle changes to lower the risks of death and disability is one strategy to mitigate these risks. Another essential strategy is to plan for the event that they do occur: How would your family safeguard your income in the event of death or disability? There are social insurance programs that may be available as an income source that should be considered when developing a risk-mitigation strategy. However, these sources meet critical, basic needs and do not build wealth or finance long-term financial goals. Thus, a strategy that includes safeguarding your household income sources is optimal. Some available insurance tools are better suited to manage long-term risks of death or disability; others can provide shorter-term stopgap or defined-term protections.

Life insurance policies, for example, pay a death benefit to insure against death of the policyholder. However, the riders available to augment your coverage as well as the cash value component of certain life policies can help abate other risks besides death. The cash value component of certain policies may be accessed to help fund long-term financial goals as protection needs change.

Premature Death

Social Security provides some income replacement benefits to dependents based on the deceased worker's earnings.[11] Social Security survivor benefits are designed to be a financial safety net, and while they can be a much-needed lifeline, they are not likely to be sufficient to keep long-term goals on track.[12] For example, benefits for surviving children cease when the child is no longer a minor—Social Security is not designed to support a child's college education.

Another source of income replacement is an employer-based life insurance policy. This insurance is typically term coverage payable as a lump sum to the designated beneficiary and offered by employers as part of a benefits package. Average policy limits, when available, are often insufficient to replace the lost household income needed to support a surviving spouse and dependents. Employer-based coverage may be based on a multiple of a worker's salary, but it is often a fixed, basic benefit amount (commonly $10,000 to $25,000).[13] This insurance is generally not portable if you change jobs.

Death benefits that might be available from Social Security even in combination with employer-provided life insurance are typically insufficient to maintain a household's financial health upon the death of an adult family member. Thus, without proper life insurance protection, long-term financial goals are at risk. Therefore, owning personal life insurance is a proactive and effective way to mitigate financial risks associated with a premature death.

[11] There are rules regarding dependent eligibility for spouses (current and former), minor children, and parents. https://www.ssa.gov/pubs/EN-05-10084.pdf
[12] The Social Security Administration has online tools to estimate individualized survivor benefits for planning purposes
[13] https://www.bls.gov/ebs/publications/national-compensation-survey-glossary-of-employee-benefit-terms-2021.htm#benefit_formulas

Life insurance protects your human capital by paying a specified amount to your beneficiaries in the event of death. Two basic categories of life insurance policies—permanent and term life insurance—can be customized to address diverse needs, economic circumstances, and other preferences.

Permanent life insurance. Permanent life insurance protects your human capital with a benefit payable upon death, but it also has a cash value. A policy's cash value component is a critical difference between permanent and term life insurance. Permanent policies can vary in terms of premium flexibility, death benefits, and the opportunity for dividends, but all have a cash value component that can accumulate funds—while at the same time protecting you against unexpected death. The variety of permanent life insurance policies that are available allows households to optimize their coverage to address their financial needs. Cash value built into permanent life insurance coverage can be accessed to address financial goals such as financing college or supplementing other forms of retirement income. The cash value element can also be used to manage risks other than death. For example, in the event of a financial shock, such as a job loss or a divorce, a policy's cash value can be accessed to provide financial support at a critical time. In addition, adding riders to your permanent life insurance policy allows you to mitigate the risks of becoming disabled or chronically ill.[14]

Term life insurance. Term life insurance is temporary life insurance coverage for a limited, specified period—such as a specific number of years or to a specified age. There is no cash value element associated with this type of policy. Term life insurance can be invaluable in providing gap coverage to mitigate the risk of death during a specified period of time. For example, one can use a term insurance policy to ensure that large household debts—such as a home mortgage—can be paid off in the event of a death. In the case of a divorce, a term life insurance policy on an ex-spouse can help ensure that the spouse's support obligations for minor or college-aged children are met in the case of their death. Adding additional riders can be purchased to customize your term life insurance premium and can help reduce your household's exposure to the risk of disability as well as death.

Disability

Government programs to protect the disabled provide for only the most basic of needs.[15] Social Security pays disability benefits through two federal government programs: the Social Security Disability Insurance (SSDI) program and the Supplemental Security Income (SSI) program.[16] The SSDI program covers people with a sufficient work history who have recently worked in jobs covered by Social Security. The definition of disability under this program is extremely strict. To qualify for SSDI, a person must have a medical condition that is expected to

[14] These types of riders are made available for an additional charge and accessing cash value will reduce the available cash surrender value and death benefit.
[15] The average monthly Social Security disability benefit is an amount barely above the poverty level. https://www.ssa.gov/disabilityfacts/facts.html
[16] Currently, there are five states that offer short-term disability benefits: California, Hawaii, New Jersey, New York, and Rhode Island. Puerto Rico also has a program. https://oui.doleta.gov/unemploy/pdf/uilawcompar/2021/disability.pdf

keep them from being able to work for at least one year or result in death. To receive benefits under the means-tested SSI program, one must be sixty-five or older; partially or totally blind; or have a medical condition that is expected to keep them from being able to work for at least one year or result in death.

Workers injured in an accident on the job may be eligible for workers' compensation benefits for medical care and income replacement. Benefits vary by state. However, the most common causes of disability are not work related and are not covered under workers' compensation.[17]

Disability insurance. Disability insurance helps protects against loss of income due to injury or sickness. Disability insurance can be designed to protect against partial, total, temporary, or permanent disability. When available, government-provided disability assistance and employer-provided disability benefits alone may be insufficient to maintain most households' pre-disability financial condition, let alone keep a family's financial goals on track. Employer-sponsored disability insurance is available to fewer than half of U.S. employees.[18]

Therefore, individual disability insurance is beneficial in protecting against financial hardship by keeping financial goals alive through helping to replace lost wages. Individual disability insurance can supplement other forms of disability coverage, thereby insuring more of your lost income is replaced during times of hardship. Unlike disability insurance through your employer, this is personal coverage that stays with you if you change jobs.

[17] https://disabilitycanhappen.org/common-causes/
[18] https://www.bls.gov/opub/ted/2020/short-term-and-long-term-disability-insurance-for-civilian-workers-in-2020.htm (March 2022); https://www.bls.gov/news.release/pdf/ebs2.pdf (Disability insurance was available more often to higher-wage earners than lower-wage earners.)

Step 5: Implement and Monitor Your Risk-Mitigation Goals

Armed with an understanding of one's financial goals, the risks to achieving those goals, and the tools to manage those risks—financial success can be achieved. Life insurance and disability insurance play an important role in personal financial risk management. Regularly monitoring and updating a family's financial risk management strategy is a prudent practice. As financial circumstances and household composition change, a sound risk management program needs to as well. Tolerance for risk may also change over time—for example, when minor children become adults. Monitoring and updating one's goals to keep pace with these changes are an essential part of managing risk and making sure one stays on track to achieve long-range financial goals.

Conclusion.

Achieving long-term financial goals requires discipline, commitment, and continued access to income sources. Protecting your human capital from the major risks of premature death and disability is the foundation of managing personal financial risk. Life and disability insurance are among the most important tools available to help protect your family against income loss. These insurance policies can be optimized to protect your household's financial wellness—given your family circumstances now and into the future.

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Mark J. Browne is the chair of the faculty of the School of Risk Management in the Tobin College of Business at St. John's University. Dr. Browne has served as president of the American Risk and Insurance Association, the Risk Theory Society, and the European Group of Risk and Insurance Economists. He has been awarded lifetime membership at the Risk Theory Society. An expert on risk management, insurance, and employee benefits, he teaches courses on these topics and has consulted with businesses on issues related to them. Mr. Browne's research has appeared in many publications, including the *Journal of Risk and Insurance*, the *Journal of Insurance Regulation*, the *Journal of Risk and Uncertainty*, the *Journal of Legal Studies*, and the *CPCU Journal*. He is regularly consulted by media and has been quoted in the *Milwaukee Journal Sentinel*, the *Wall Street Journal*, and *Bloomberg Businessweek*, among other publications.

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