11. Insurance 1: The Basics of Insurance Protection

Introduction

The purpose of insurance—and financial planning in general—is to make our lives more predictable from a financial standpoint. All people face the risk of certain types of loss every day: these risks pertain to our health, automobiles, homes, and many other aspects of our lives. Through the appropriate use of insurance products, you can make the risks of loss more manageable and predictable; managing your risks can bring you more peace of mind as you go about your daily activities and as you seek to achieve your personal and family goals.

Objectives

When you have completed this chapter, you should be able to do the following:

A. Recognize the importance of insurance.
B. Understand what leaders have said regarding insurance and the key principles of insurance.
C. Understand and create your Insurance Plan.

Recognize the Importance of Insurance

Insurance is a legal contract between you and an insurance firm. The insurance firm agrees that if you pay a specified amount, known as a premium, the firm will compensate you for certain kinds of losses or events, such as death, sickness, accident, loss of ability to work, and legal expenses.

There are many types of insurance, and because of the different natures of various types of risk, we have divided our discussion of insurance into sections about life insurance, health insurance, auto insurance, homeowner's/renter's insurance, and liability insurance.

The Importance of Insurance

The concept of insurance was sparked by the idea of pooling risk. People with families and valuable property have always faced the possibility of loss; the possibility of such loss has caused individuals so much concern that they have pursued options for the replacement of their loss. Thus, the practice of insuring property for its replacement value evolved. Life insurance, the practice of replacing the economic value of a human life, has also grown out of this same thought process.

Insurance allows you to transfer the financial risk of certain types of losses to another entity, usually an insurance company, which is organized according to stringent federal and state regulations specifically for the purpose of protecting you against losses. By transferring the financial risk to such an entity and paying the required premiums, you can receive compensation for loss in the form of either a lump sum or an annual amount of money. This compensation can maintain or replace your income stream. In this way, insurance helps you and/or your family maintain financial stability if you get sick or become unable to work because of disability, injury, or death.

If you have insurance but do not incur a loss for which you had coverage, you lose only the premium you paid, although some insurance policies do have a return-of-premium feature. Even though a particular loss may not occur, you still receive value from the premium paid in the form of peace of mind and the knowledge that you are taking care of your family. If you do not have insurance and you are sued, get sick, or die, you and your family may suffer serious consequences: your family may have to rely on only one income or a reduced income to get by, and your children may not be able to achieve important goals. Insurance allows you to transfer the financial responsibility for risks like illness, disability, and death to an institution capable of handling these risks.

Managing Risk

An important part of determining the right level of insurance you should have is understanding risk. Risk, in terms of insurance, is uncertainty concerning the occurrence of a specified loss.

There is risk in all areas of life, including your lifestyle, your career, your environment, and so on. You can manage risk in four ways: you can avoid it, reduce it, assume it, or transfer it.

> You can **avoid** some risks. For example, you can avoid some health risks by taking care of yourself, eating well, exercising, and avoiding high-risk activities where you might be hurt, such as skydiving. You can avoid some financial risks by diversifying your investments.
>
> You can **reduce** some risks by adding fire extinguishers and burglar alarms to your home, adding airbags to your car, using seat belts, and getting regular medical checkups. By taking these precautions, you can reduce the potential damage of some risks.
>
> You can **assume** some types of risk through self-insurance. For example, I used to own a 1973 Ford Pinto. Instead of carrying full-coverage insurance, which would have allowed me to get the car fixed if it were in an accident, I carried only liability insurance. If I had been in an accident, I would have had to pay to have the car fixed myself (in other words, I assumed the risk of repair and collision costs). If the costs are not too high, you can assume some risks by assuming the potential for additional costs, i.e., a higher deductible, and keeping a slightly larger emergency fund.
>
> You can **transfer** risk to others by purchasing insurance and thus transfer financial responsibility for a specific risk—death, disability, liability, and so on—from yourself to

an insurance company.

Once you understand how to manage risk, you can determine which risks you can avoid, reduce, or assume, and which risks you should transfer to an insurance company or other entity.

The Key to Insurance

The key to insurance is balancing the cost of reducing risk with the potential severity of a loss. Should you insure against all losses? While this may be possible for some people, it is not possible for most—the costs would be too high.

The key is to realize that some losses are not as critical as others. You should insure yourself against high-severity losses that rarely occur—those that would have a major impact on the financial condition of you and your family—such as death, illness, auto or home accidents, and accompanying liability issues. And you should avoid, reduce, or assume the other risks.

You can analyze and classify risk by looking at two important areas. The first area is the frequency of the potential loss: how often could the loss happen? Could it happen every month, every year, or just once in a lifetime? The second area is the severity of the loss: how severe would the implications be for you and your family if the loss occurred? These factors can be charted in Table 1.

Understand What Leaders Have Said Regarding Insurance and Key Principles

Acquiring insurance is an important step toward becoming financially self-reliant. We have been counseled by our leaders to live within our means, to put our lives in order, to provide for our future, and to obtain adequate insurance to meet our responsibilities as parents. We have also been commanded by the Lord to take care of our families.[1] Marvin J. Ashton offered the following counsel on insurance:

> It is most important to have sufficient medical, automobile, and homeowner's insurance and an adequate life insurance program. Costs associated with illness, accident, and death may be so large that uninsured families can be financially burdened for many years.[2]

N. Eldon Tanner also commented on this topic, saying "Every family should make provision for proper health and life insurance."[3]

Understand the Key Principles of Insurance Planning

Insurance should be an important part of your Personal Financial Plan. There are several different approaches to building an effective insurance plan. One approach is to focus on specific products; however, insurance products will and do change over time as new products are developed. A better method is a principles-based approach. While products may change over time, the principles regarding effective insurance planning do not change.

Table 1. Risk Matrix for Understanding Insurance

		Frequency of Loss	
		High	Low
Severity of Loss	High	Avoid Reduce	Transfer
	Low	Reduce Assume	Reduce Assume

The key to insurance is to balance the cost of reducing risk with the severity of the potential loss. Insure against high-severity losses that rarely occur—those events that could have a major impact on your financial situation. Reduce and avoid other risks to the extent that you can. Finally, self-insure against smaller risks that will have limited impact on your financial situation. Use insurance for what insurance does best. Be careful in using insurance products as an investment, or investment products as insurance.

So what are the key principles of insurance planning that we can apply to help us manage our various insurance products wisely? The following are a few ideas to help you understand the key principles of insurance planning:

1. Know Yourself, Your Vision, Goals, and Plans. Insurance is a tool that can help you plan for the future while living in the present. However, before you can develop an insurance plan, you must know what is important to you and what you want from life. Insurance is not an end in itself: it is a tool to help you achieve your vision and personal goals. What are your goals? One goal may include replacing your salary should you die.

Once you determine your goals, the challenge becomes figuring out which insurance products can help you reach your goals the fastest. You should understand each insurance product well. While it will take a significant amount of time to understand insurance products individually, your understanding of the main insurance products will increase with a general overview. Recognize that your insurance needs will change over time. Plan for the future, but live in the present.

2. Seek, receive and act on the Spirit's guidance. This includes seeking diligently through study and prayer, living worthy of the Spirit's guidance, and then acting on it once it is received.

3. Understand the key areas of insurance, and know your budget and how much you can afford. Before you can determine which insurance products you need, you must set a budget. How much can you afford to spend on insurance needs? It is important to be cost-effective in your insurance planning. Insurance is a long-term product, and certain insurance products have higher premiums than others; it makes no sense to begin an insurance program you cannot continue. As you think about your goals and insurance needs, recognize the potential for change in your income—or even loss of income—and the possible impact of such changes on your budget.

However, you need insurance to help you face risks that are beyond your control. You will face financial responsibility if certain adverse events occur. In making insurance decisions it is important to purchase all insurance that is necessary to allow you to survive the foreseeable adverse events of life. If your current consumption does not leave enough money in your budget to purchase necessary insurance, then you may need to reevaluate your priorities.

4. Understand in Detail the Costs and Benefits of Each Insurance Product. Knowledge is power. If you are to make wise decisions in your insurance planning, it is critical for you to understand in detail the costs, benefits, and risks of insurance products and their providers. Do your homework early and you will better understand what various insurance products can and cannot do. Weigh the costs and benefits carefully before you purchase a particular insurance product. Many insurance products have high beginning or up-front expenses and are very expensive to modify or change after the policy is in force.

Also, compare products across companies, and make sure you understand the differences between competing products. Ask for help from your insurance agent or potential insurance agent if you don't understand the differences.

5. Insure Against High-Cost, High-Severity Losses Only. Insure yourself against events that would have a major economic impact on you or your family. Self-insure against events that would have a smaller economic impact. Balance your need for insurance with the cost of the insurance. The goal is to use insurance to provide funds in those most adverse circumstances where your personal resources would not be sufficient.

6. Work Only with High-Quality Individuals and Institutions. Trust is a critical component of your insurance relationship. Since insurance is a long-term commitment, you want a relationship with an institution that will be willing and able to help you now and in the future. Work with individuals and institutions that make you comfortable. If you feel pressure in any way to purchase a product, find another insurance agent; you do not want an insurance agent who is there just for the sale. The key is to find an agent who will work in your best interests and help you achieve your goals, while at the same time finding an insurance agency that pays up when agreed so you don't have to dispute every charge.

Know how insurance agents are paid. Minimize the potential for conflicts of interest by understanding the costs of insurance products and how insurance agents are paid for selling these products. For example, the commission paid on cash-value life insurance policies to insurance agents can be *10 to 20 times higher* than commissions paid on term life insurance policies with the same face or policy amount. While the former are much more complex products and may have additional benefits over the alternatives, it is important to understand the potential for conflicts of interest.

Evaluate the insurance company carefully. You want to make sure that your insurance agent and the company will be around for a long time. Make sure the company is financially sound before you purchase their products. Getting your insurance products from the firm with the lowest prices will do you little good if the insurance company goes out of business. You can also evaluate the insurance company by checking the company's rating with various insurance-rating firms.

7. Review Your Insurance Needs Annually. Remember, your insurance needs may change over time as your family situation, investment portfolio, and work situation change. Use wisdom in planning your insurance coverage and in making changes to your policies. Be especially careful of the costs of making changes—many insurance products have higher up-front or beginning costs. Be an informed consumer of insurance products.

Finding Balance

As you work on managing consumer loans, finding balance among doctrines, principles and application is important in helping you become better at managing insurance. Below are a few ideas.

Principles	Doctrines
Know yourself, your vision, goals and plans	Identity
Seek, receive and act on the Spirit's guidance	Obedience
Know your budget and what you can afford	Accountability
Understand the tools of insurance and use carefully	Stewardship
Insure against high-cost high-severity events	Agency
Work with good people and institutions	Stewardship
Review your insurance needs annually	Stewardship

From Obedience to Consecration

As we work on understanding and managing our insurance needs, finding balance among doctrines, principles and application is important. We are not just insurance consumers,

> We are children of a King (identity), striving to live worthy of the Spirit (obedience), learning the critical areas of insurance (stewardship), so we can make wise choices in our use of insurance products (agency). Our goal is to maximize our protection and minimize

costs in each of the five key areas of insurance (stewardship), so we can get the protection we need at a cost that we can afford (stewardship), so that we can accomplish our individual missions and our individual and family vision and goals.

Understand and Create Your Insurance Plan

As you work on making insurance work, you can see the importance of following the principles. Becoming a wise insurance consumer is important to helping you achieve your personal and family vision and goals. Following are ideas as you put your Insurance Plan together. Being a knowledgeable and wise consumer of insurance products will allow you to get the coverage you need at the lowest possible costs.

Vision

- Likely from your Plan for Life. It may also include:
    - Insurance will be used for what it does best; providing security for myself and family.
    - We will not mix insurance and investments.
    - Insurance will help us with financial security.

Goals

- We will always have adequate auto, homeowners/renters, and health insurances.
- We will always have an Emergency Fund large enough to hold us over until government. disability is available. That way we can reduce the need for private disability insurance.
- We will not mix insurance and investments as each do their respective elements well.

Plans and Strategies

Life Insurance: Students and young marrieds

- If married, buy a small $250k - 20 year annual renewable term product with the convertibility option. Once children come, ladder on additional renewable convertible term products.

Married with families

- If term insurance rates have decreased, you can purchase a new product then cancel the old.

Empty nesters

- As your investment assets increase and children leave the home, you can allow some of the policies to terminate without renewing as the need for income replacement is diminished.

Health Strategies: Students and young marrieds

- If married without kids, compare your group plans to a Health Savings Account to see which plan has the best coverage for the costs

Married with families

- Once children come, switch to a traditional group plan to meet your family needs.
- Use a flexible spending plan if offered by your employer to reduce your medical expenses.

Empty nesters

- As children leave home, make adjustments to your health insurance to be cost effective with your coverage.

Disability

- Keep my Emergency Fund at 4 months so if I am disable, I will have sufficient to live on until Social Security or Workers Compensation is available.
- Live health and keep running.

Asset Protection: Students and young marrieds

- Have adequate renters insurance.—it is cheap.
- Have adequate auto insurance, with a minimum 100/300/100 split coverage initially.

Married with families

- Raise your split coverage to 250/500/100 to offer more protection when you have teenage drivers.
- Make sure teenage drivers take "safe-drivers courses" to reduce their insurance costs.

Empty nesters

- Consider an umbrella policy to reduce the risk of future litigation expense as assets increase.

Constraints

- Not living on a budget will make it difficult to save and to have adequate insurance.
- Getting caught up in the things of the world will make it difficult to save.

Accountability

- You will share your vision and goals with your spouse and children.
- You will remember these things in prayer with Heavenly Father each week.

Summary

The insurance industry is always changing, and it can be a challenge to understand the many insurance products available. Each of the many products the insurance industry offers has unique benefits and costs. Understanding what Church leaders have said regarding insurance will help you realize the importance of insurance as part of your Personal Financial Plan and your family's financial plan. If you understand how insurance can help you, you will be better prepared for the challenges you may encounter in your life. Finally, by understanding and applying the principles of insurance planning as they are outlined in this chapter to create your Insurance Plan, you can make sure the products you choose are the products that will most likely help you achieve your personal goals.

Assignments

Financial Plan Assignments

In this section you will complete your Insurance Plan. I recommend you use the PFP Insurance Template (LT01-09) as a starting point. As you learn about the different types of insurance in this course, think about the different ways to manage risk and the key principles and doctrines of insurance planning. These principles are important because they provide a structure to help you evaluate the different types of insurance and the uses of different insurance products.

Think about these principles as you read through the succeeding chapters on health insurance, life insurance, auto insurance, property insurance, and liability insurance and as you develop vision, goals, and plans and strategies for each of these types of insurance. Think about how you can apply the principles of risk management and insurance planning to the different types of insurance. You will incorporate these principles in the assignments for the succeeding chapters.

Review Materials

Terminology Review

Earnings Multiple Approach. This is one approach for determining the amount of life insurance required. The goal is earnings replacement. The earnings multiple approach seeks to replace the annual salary stream of a bread winner for X years, normally 10 – 15 times gross salary.

Insurance. Insurance is a tool help you achieve your personal and family goals. It is a product that transfers the risk of certain types of losses or events from an individual to another institution. By transferring risk, it can help the individuals achieve specific goals if they die, get sick or become unable to work. But it is a tool that needs to be understood and used wisely.

Investment Risk. This is the risk of who takes responsibility for the investment outcome, the insurance company or the insured.

Life Insurance. This is insurance that provides compensation to your beneficiaries should you die prematurely. It transfers the economic loss of death from an individual to an insurance company by way of a life insurance contract. It can help us take care of our own and extended families should we die.

Mortality Risk. This is the risk that the insured dies outside the contract period and is therefore not covered by insurance.

Needs Approach. This is an approach for determining the amount of life insurance that is required. It determines the total needs of the beneficiaries which includes immediate, debt elimination, transitional, dependency, spousal life income, education, and retirement needs. It is the most detailed of the approaches.

Permanent Insurance. Permanent insurance is an insurance contract that is purchased for the entire life of the policy holder with premiums divided between death protection and savings. Provides insurance that cannot be cancelled, may be used for estate retirement, and savings. It is complex, expensive, and not transparent, and unless premiums are paid, it can expire worthless. Please note that certain permanent products are not permanent, i.e. they can lose money.

Risk Pooling. It is the process where individuals transfer or share their risks with others to reduce catastrophic losses from health problems, accidents, lawsuits, etc.

Term Insurance. Term insurance is insurance protection for the insured over a specific term or time period. They may be renewable or non-renewable policies. It is the least expensive form of insurance and the death benefit coverage is only for a specific term.

Review Questions

1. What is insurance?
2. What is the purpose of insurance?
3. In regard to insurance, what is risk? What are the four ways to manage risk?
4. In Table 1, what are the two ways in which you can analyze risk?
5. What is the key to insurance?

Case Studies

<u>Case Study 1</u>

Data

Bill is 25, married with one child, and does not have any life or health insurance. He has a friend that sells insurance. His friend wants to talk to him about his insurance needs.

Application

What questions should Bill ask as he considers whether to work with this friend for his insurance needs?

Case Study Answers

The answers for these questions are based on information from Arthur J. Keown's *Personal Finance, Turning Money into Wealth Student Workbook.* [4]

1. Are you a full-time insurance agent?

    Work with agents who work full-time as insurance agents. This gives greater assurance that your agent is knowledgeable about the products you need and the products he or she represents.

2. How long have you been a full-time insurance agent?

    Work with someone who is experienced and has been established for a number of years. While a new agent may be competent, an experienced agent will be more likely to be competent.

3. Which life insurance companies do you represent?

   Generally, it is better to work with someone who represents at least one company with a top rating from A.M. Best for 10 consecutive years (see www.ambest.com/ratings for information. You can register for free and view the financial strength and issuer credit ratings on the different insurance companies you are considering). If the agent works with multiple companies, he or she may be able to offer more competitive products than captive agents (agents who only work for a single insurance company).

4. Are you a CLU (a Chartered Life Underwriter)?

   A CLU is preferred, especially if you are seeking advice or considering insurance other than term. Realize that an insurance agent is only able to sell things he or she is licensed to sell.

5. Will I be allowed to keep the insurance proposal you prepare for me?

   You should not consider an agent who won't allow you to keep the insurance proposal. You should be able to take the proposal home and review it on your time.

6. Would you be willing to inform me of the commission you'll receive on any policies you recommend?

   You want to make sure the agent is working on your behalf. Knowing the agent's commission on various policies may help you avoid policies that benefit the agent more than you. If the agent is not willing to share the amount of his or her commission on each product with you, go with another agent who will.

7. Do you have any clients who are willing to recommend you?

   Your agent should either supply you with names of satisfied clients or share testimonial letters from others. You should not consider an agent without recommendations.

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[1] 1 Timothy 5:8

[2] "Guide to Family Finance," *Liahona,* Apr. 2000, 42.

[3] "Constancy Amid Change," *Ensign,* Nov. 1979, 80.

[4] Prentice Hall, New Jersey, 2007, p. W47