Insurance: What's Your Risk?

Consumer Alert!

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By Edward Tonini, Director of Education.

"More than nine in ten Americans purchase and carry the wrong types and amounts of insurance."

Eric Tyson (author of *Personal Finances For Dummies*)

How would you handle a major unexpected expense? Would an accident or job loss be devastating? Do you have a plan for protecting your assets and your future earnings? If your answer to any of these questions has you feeling a little shaky, this publication will reveal how using insurance in a plan to manage risk will help you get on solid ground.

What Is Insurance?

Insurance is a way of reducing your individual financial losses through group participation. It's part of a plan for managing risk. An *insurance policy* is the legal contract between the person buying the insurance (you - the *insured*) and the insurance company (the *insurer*). The policy includes all of the conditions, rights and responsibilities of both parties. The insurance company charges you a fee - called a premium - which you typically pay monthly, quarterly, semi-annually, or annually. In exchange for your premium, the insurance company agrees to pay you or your loved one (the *beneficiary*) in the event of a financial loss that meets the conditions in the policy.

Types Of Insurance

There are many different kinds of insurance but they can be divided into two groups: insurance on you and insurance on your stuff. This publication will address the former, which includes life insurance, disability insurance, and health insurance.

Life

The purpose of life insurance is to provide income to your dependents, in the event of your death, to cover lost income, funeral expenses, debt repayment and other re-adjustment needs. There are two main questions: how much and what type.

How much?

The answer to this question depends on your situation; for example, someone who is young, single and has no dependents doesn't really need life insurance. There are different ways to calculate the dollar value you need. One method is to add your estimated costs and subtract the value of government benefits and certain assets you are willing to have sold. For example*:

+ Income-replacement (sub-calculations required: current after-tax annual income x Y {Y is a factor that represents the number of years you want to replace given a certain interest rate, for example: for 10 years with an interest rate of 4%, the factor is 8.11})
+ Final expenses (ex. Funeral, burial)
+ Re-adjustment costs (ex. Related to job re-entry or employment training/upgrading)
+ Debt repayments (ex. Paying off a mortgage or auto loan)
+ College expenses (ex. Contributions to a college fund)
– Special needs (ex. Care for a disabled family member)
– Government benefits (ex. Social Security survivor benefits; to estimate visit www.ssa.gov)
– Other insurance or assets (ex. A death benefit that is part of another policy, or a luxury asset you are willing to have sold)
= Face value (dollar amount) of policy

Term or cash-value?

Term life insurance is sometimes referred to as pure or straight insurance. You select an amount and a time period for the coverage, then you pay the regular premium. If you expire before the policy does, the beneficiary is paid the amount stated in the policy. Term life comes with different features. Better policies are *Guaranteed Renewable*, meaning they can't be cancelled if your health degrades.

Cash-value life insurance comes in various flavors including: whole, universal, and variable. A savings/investment component is included in these policies. Some of the money from your premium goes into an account that grows in value over time and after several years you can stop paying the premium. It may sound like a good deal, but it's not actually because the premiums are about 8 times more than the equivalent cost for term insurance.

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Financial experts typically advise to buy term insurance and invest the rest.

Disability

The purpose of disability insurance is to replace your income if you become disabled and unable to work. Social Security disability is very limited and in order to receive it you must be completely unable to work for over a year. Worker's compensation only pays benefits if you're injured at work.

You'll need to select the amount of coverage you want (typically equal to your after-tax income) and the duration (typically until age 65). Other features you'll want are guaranteed renewable and *cost-of-living-adjustment* (meaning your benefit will increase with inflation).

The best way to purchase disability insurance is through your employer or your professional organization. To save some money on the premium, take the longest *waiting period* (the time period between the start of the disability and the first day you collect benefits) you can afford.

Health

Health care protection provides or pays for your care if you become ill or injured. There are basically two types of health care protection: Fee-for-Service plans and Managed Care plans.

Fee-For-Service plans, also called indemnity insurance plans, provide reimbursement for medical costs after they occur. You have complete control over choice of physician and type/source of care, however, dollar limits are placed on your coverage and you are required to pay for common office visits and routine preventative care.

Managed Care plans provide health care to members for a fixed, prepaid monthly fee (premium). They are a more cost-effective form of care but carry more restrictions.

- A **Health Maintenance Organization (HMO)** has a low cost for *deductibles* (the annual amount you agree to pay before the insurance company begins paying) and *co-insurance* (the share of medical fees you agree to pay), but assigns you a primary-care physician. This physician must approve referrals to a specialist and your choice of facilities is also limited.
- A **Point-of-Service plan (POS)** is an HMO variation. With this plan, you can choose a primary-care physician from an approved list. You can choose a provider not in their network, but you will pay a much higher deductible and *co-payment* (the amount you agree to pay for office visits or prescriptions).
- A **Preferred Provider Organization (PPO)** is a group of health care providers who have contracted with an insurance company to provide discounted services. Policy holders pay a small percentage of fees (typically 20%) for medical services from an in-network provider. If you go out-of-network for services, you will pay a much greater part of the fee.

Reducing Your Health Care Costs

- ✓ Use your employer-sponsored plan to cover your major medical expenses: hospitalization, physician, and ancillary charges (X-rays, lab work). Understand how your particular plan works: How much of the premium will you have to pay? What services or medicines are covered and what will be out-of-pocket? What is the co-pay and the deductible?
- ✓ To reduce your premiums, choose the highest deductible and co-payment you can afford.
- ✓ Contribute to a *Health Savings Account* (HSA) or a *Flexible Spending Account* (FSA). These programs let you pay for out-of-pocket medical expenses with pre-tax dollars (in effect, a discount equal to your tax rate). An HSA allows you to roll over the unused money you put into the account to the next year, but you must have a high-deductible policy. With an FSA, any unused money is kept by your employer.

Saving On Insurance

Some people take huge risks by foregoing insurance because of the cost. By utilizing the following principles, you can lower your costs.

1. Just insure for the big stuff. Buy insurance to cover only financial catastrophes; losses so large that they would financially ruin you. At least every three years, or whenever your health or family situation changes, re-evaluate your particular risks and only buy coverage for what you need.

2. Choose the highest deductible you can afford. If you're wondering how you could afford a larger deductible, consider this example. If you raised a deductible from $150 to $1000, which lowered the premium on a six month policy by $100, you could put the money you saved into an interest-bearing account. In about four years, you would have enough to cover the deductible in the event of a claim.

3. Buy broad coverage. Choose insurance that will protect you in the widest range of circumstances.

4. Reduce potential losses. Drive a vehicle with an excellent safety rating. Keep your home properly outfitted with working smoke detectors, fire extinguishers, and dead-bolt locks. Ask your insurance company about other safety or loss control measures they will reward with lower premiums.

5. Minimize risky behaviors. Most insurance companies charge lower premiums to non-smokers. This is because studies show that smoking reduces a person's lifespan by seven years on average. Many more personal habits are within our control such as eating a healthy diet, getting regular exercise, avoiding excessive use of alcohol, and getting adequate rest. These behaviors improve your quality of life and can significantly reduce the risk of heart disease and cancer.

6. Shop for the lowest cost. Be sure to include quotes from direct sellers because commissions tend to bias what insurance agents recommend and policies that pay the biggest commissions tend to be more expensive. Most companies offer multiple policy discounts (for insuring more than one vehicle, or a vehicle and a home, etc.). When shopping for insurance, you'll want to choose a stable company that will be around for the life of your policy. You can check the ratings for companies online at sites such as www.ambest.com. Some places to get quotes online are: www.insure.com, www.quotescout.com, or www.insurance.com. USAA is one organization that sells direct (www.usaa.com or call 800-531-8000).

Maximize Your Safety Net

In addition to insurance, use several strategies for managing risk.

- ✓ Keep an emergency fund equal to three to six months of income.
- ✓ Maintain a balanced investment plan and make full use of tax-sheltered retirement plans.
- ✓ Don't neglect your professional development.

To Find Out More

- *Be A Saver* (Alliance): www.knowdebt.org/education.php.
- *Personal Finance For Dummies* (E. Tyson, Wiley Publishing Inc.).
- *Personal Finance* (Garman & Forgue, Houghton Mifflin Company)

*An example Needs-Approach life insurance worksheet is available at: http://lifehappens.org/life-insurance/life-calculator.