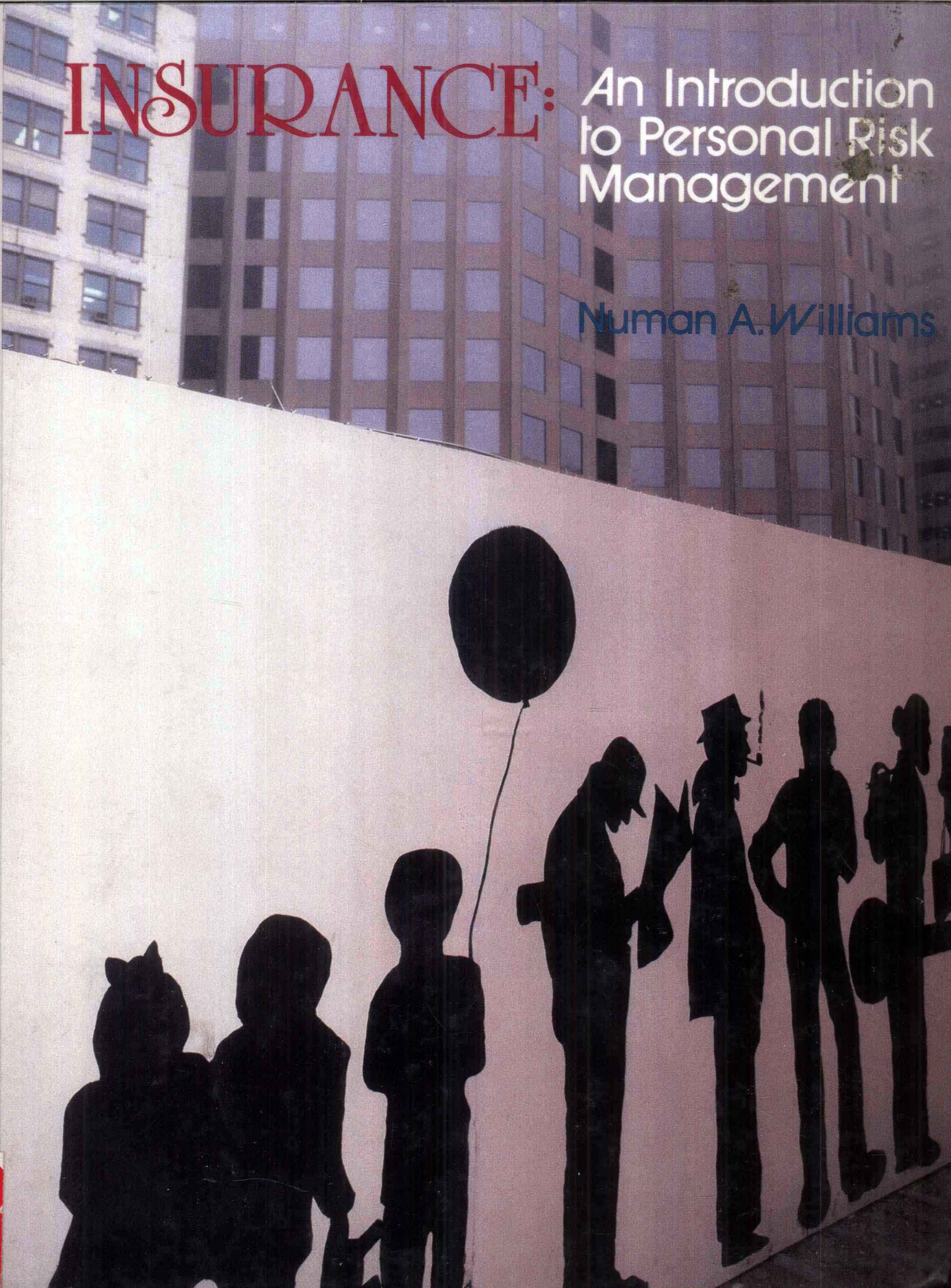
INSURANCE: An Introduction to Personal Risk Management

Numan A. Williams



INSURANCE: An Introduction to Personal Risk Management

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PREFACE

Author's Intent

Fifteen years of teaching undergraduate insurance courses has brought me to the conviction that the average student simply will not read most assigned insurance texts—they are too long, too detailed, and are thought of as being too dry and uninteresting. A need exists for a concise, readable, and reasonably interesting insurance text. *Insurance: An Introduction to Personal Risk Management* was written to fill that need. It is designed to provide the basics of insurance in a form that undergraduates will read and can easily understand.

The text's emphasis is on what insurance professionals call "personal lines"—the insurance needs of the typical American family. It provides the insurance information necessary to make an intelligent purchase of insurance by and for the average American family. The text deliberately avoids discussion of commercial insurance and also avoids technical aspects of insurance that are primarily of interest to the insurance professional.

Readability was a major concern of mine while developing this text. Most Americans have a mental block about insurance—they seem to think the subject is too complex for mere mortals to understand. My intent has been to present the basics of insurance in a clear, understandable way.

Organization

Organization of the material follows a fairly standard format. Part 1 covers the risk management process, and its major purposes are:

- ▲ to relate insurance to the larger area called risk management.
- ▲ to start students thinking about loss control.

- ▲ to lay the foundation of general insurance knowledge requisite to an understanding of specific policies or specific types of coverage.

Part 2 introduces liability coverage, and its major purposes are:

- ▲ to explain the basic fire policy.
- ▲ to discuss the homeowners' series of policies.
- ▲ to lay the foundation of tort law that is necessary for students to understand liability insurance.
- ▲ to discuss the need for liability insurance.
- ▲ to explain the coverages, terms, and exclusions found on most auto policies.
- ▲ to explain in general terms the concept of no-fault automobile insurance.

Part 3 concerns life and health contracts, and its major purposes are:

- ▲ to discuss the need for life insurance.
- ▲ to explain the three basic types of life insurance.
- ▲ to explain the more important provisions contained in life insurance policies.
- ▲ to explain the types of annuities currently available and why it is important to start saving for retirement at an early age.
- ▲ to explain the basics of health insurance and to discuss some of the serious problems facing the health insurance industry today.
- ▲ to explain the benefits provided by Social Security and to point out that not all such benefits go to the elderly.

Part 4 examines the insurance environment, and its major purposes are:

- ▲ to explain why and how the insurance industry is regulated.
- ▲ to help students make intelligent insurance purchases.
- ▲ to outline some of the job opportunities that exist in insurance.
- ▲ to present some of the current issues being discussed relevant to the insurance industry.

Special Features

Photographs: Photos are used throughout the text to emphasize important concepts.

Learning objectives: Each chapter begins with a list of key concepts that the student will master by studying the chapter.

Key terms: Insurance terminology is reinforced by highlighting key terms in the margin, by presenting a list of new terms at the end of each chapter, and through the glossary at the end of the text.

Questions for discussion: These were prepared with the chapter objectives in mind. They are meant to reinforce the key concepts studied in the chapter.

Cases: Short case problems, many of which are adaptations of situations that I have encountered in my profession, are included at the end of each chapter to make the student apply the knowledge gained through studying the chapter.

Instructional Aids

I have designed the instructor's manual to help you prepare for class with minimal time invested in the text. I intend to make it possible for you to review the text material within the manual and get a good feel for what the student has read without continual reference to the text. Each chapter in the manual follows the same pattern, presenting eight different sets of information.

1. I begin with a paragraph which describes the *purpose* and motivation of the chapter.
2. A chapter *outline* is presented.
3. The *learning objectives* from the text are repeated.
4. The chapter *summary* is reprinted.
5. The *list of terms* as defined in the chapter are presented.
6. *Teaching suggestions* that I have used in preparing the material for class are included. These vary in length from chapter to chapter and are included for those instructors who may want to use them to expand on some ideas in class.
7. *Suggested answers* to all end-of-chapter questions and cases are presented.
8. *Multiple-choice questions* for examination purposes are included.

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Prologue

An insurance agent called me this morning. This particular agent wanted to discuss my automobile coverage, but the next agent to call might be interested in my life insurance program, my health insurance, or fire protection for my home and furniture. The American consumer often feels beseiged by insurance agents. Many agents selling many different policies call us by phone and sometimes even come to our door. These insurance agents are always friendly, well dressed, and eager to be of help.

Yet few Americans really enjoy visiting with these eager, helpful men and women. We are not happy when they call us; we are on guard when they visit our homes. They are never really our friends; at best, they are a necessary evil.

Three reasons for our reluctance to discuss insurance can be suggested. First of all, insurance is expensive. A young father who purchases a fairly small life insurance policy agrees to pay a premium of $200 per year for 40 years—a total of $8,000.[1] Many college students pay $800 to $1,000 per year for auto insurance. In effect, they pay as much for the insurance as they do for the car itself. Health insurance that pays for modern medical miracles often costs American wage earners and their employers as much as $2,000 per year. Adequate insurance is expensive; it is a major item in most family budgets.

Insurance also reminds us that we live in an unsafe world. We are human and we must face the possibilities of sickness, injury, death, and financial loss. Our rational minds recognize the many unfortunate events that can occur, but in our hearts we hope that we might be spared. Serious injury or death is not a pleasant subject to discuss or even consider. We are afraid; we would rather talk about baseball or the weather or what we had for lunch.

Finally, insurance is a difficult, complex subject. No one understands it completely and only a few insurance professionals really feel

[1]Based on the rate of a leading company for a $10,000 policy purchased at age 25 with payments made annually until age 65.

comfortable in a discussion of automobile, homeowners', life, and major medical coverages. We feel inadequate and try to hide our ignorance by avoiding discussions of insurance.

Yet these three reasons for not discussing insurance provide three excellent reasons why we should learn more about it. Insurance is expensive. In a lifetime, many of us spend as much on insurance as we do on the purchase of a home. If we are to spend our money intelligently, we need information about the products and services available. We don't depend entirely on salespeople when we buy a car, a house, or a suit of clothes. Neither should we depend entirely on the agent when we buy insurance. We need a basic knowledge of insurance coverages if we are to be intelligent consumers.

The intelligent consumer faces problems squarely. Although accident, illness, and death are not pleasant subjects, each of us knows we face these possibilities. It is better that we plan for these situations by finding means to deal with them than to just hope that they somehow go away.

Although insurance can be complex, its basic concepts are neither difficult nor impossible to learn. Quite the opposite. Insurance fundamentals can be understood by those willing to study them. Serious study provides knowledge. The study of insurance is an effective, proven method of dealing with the insurance ignorance faced by many American families.

This book is about insurance—but it is also about risk management. Risk management is a broad term that includes insurance and several other significant concepts. This book, more specifically, is about personal risk management rather than business risk management. It is concerned with the insurance purchased by the family, the household, and the wage earner. The text does not mention the insurance needs of a large steel mill, of a manufacturing plant, or even the needs of the corner grocery store. Business insurance is the subject of many textbooks, but it is not the subject of this one.

You will not become an insurance expert or a professional risk manager by reading this book. That is not its purpose. It is designed to introduce the basic concepts of risk management and insurance, to provide some insight into the insurance policies owned by most Americans, and to make you, the reader, a more intelligent insurance consumer.

CONTENTS

Part 1

THE RISK MANAGEMENT PROCESS

Chapter

1

RISK AND ITS MANAGEMENT

Risk or the chance of loss is a continual part of human existence. Although we seek security, it seems always just beyond our reach. We want to be safe and to avoid loss, so we learn to face the facts of life. Risk cannot be avoided completely, and since it is a part of life we must develop means to deal with it.

No book can list all the risks we will face during our lives. Such a list would be infinite in length and would include possible losses from the catastrophic to the trivial. Experience indicates that we live in a world that can be both hard and cruel. Serious injury or death, for example, faces us each time we venture onto crowded highways. Our homes could burn or our valuables could be stolen.

Over the years, people have developed many different methods of meeting risk. Prehistoric peoples moved their homes into caves to reduce the risk of attack by wild animals. Primitive religions developed partly as a method of meeting risk; a rain dance, for example, is an attempt to avoid the risk of crop failure through drought. The

In studying this chapter you will learn:

- The difference between speculative risk and pure risk.
- The various methods used to identify risk.
- The difference between frequency and severity as they relate to measuring risk.
- How risk avoidance, risk retention, risk prevention and reduction, combinations, and the transfer of risk through insurance are used to control risk.

development of walled cities during the Middle Ages was an attempt to lessen the risk of enemy attack. The entire field of medicine represents a major effort to reduce the risk of early death.

Risk management is a rational attempt to reduce or avoid the consequences of loss or injury. It seems a highly worthwhile endeavor. Given the natural catastrophes and the human failings that are a part of our world, it is necessary to meet dangers and attempt to alleviate the hardships they can cause. Mature individuals do not avoid these matters. They recognize that serious loss can strike at almost any time, and they try to do something to protect themselves.

SPECULATIVE RISK VERSUS PURE RISK

A poker player faces risk when attempting to draw to an inside straight. If the player is familiar with the game, the probabilities of filling the straight will be known. If successful, a great deal of money can be won; more frequently, the cards are wrong and money is lost. The poker player, naturally, can either win or lose. The same is true of the stock market investor. If the investor buys 100 shares of stock, the stock can go up or down. The investor can either gain or lose money.

Primitive religions developed partly as a method of meeting risk.

Speculative risk

These individuals are speculating. They face a real and significant risk which is called **speculative risk** and is characterized by the potential for *either* gain or loss. However, speculative risk is not the subject of risk management or the subject of this book.

Pure risk

Another type of risk is called **pure risk**. Pure risk cannot produce a gain; it can result only in a loss. The risks of an auto accident, of fire, or of a heart attack are pure risks because the only possibility is loss. The individuals involved usually cannot profit from an auto accident, a fire, or a heart attack. It is this type of risk that is called pure risk, and it is this type of risk that is the subject of risk management.

The first step in risk management is the separation of those risks that are speculative (capable of producing gain or loss) from those that are pure (capable of producing only loss). These are the first risk classifications. They are relatively easy to understand and essential to further discussion of risk management.

MANAGING RISKS

If we are to be risk managers we need a rational approach. We face an infinite variety of risks; a hit-or-miss attempt at risk management will naturally be incomplete. We must consider all the possibilities. In short, we need a system. Risk management provides such a system. It provides a method of risk classification that is essential if we are to consider each of the risks we face.

Risk management

Risk management involves the identification, measurement, and control of pure risk. Each of these three activities (identification, measurement, and control) is examined in this chapter.

Risk Identification

The effective risk manager seeks to identify every potential risk. It is this aspect of risk management that is perhaps the most difficult. Most homeowners realize, for example, that they face the risk of property destruction by fire. But they should also recognize other events that could destroy their property. Lightning, earthquake, and windstorm must be considered; the possibilities of theft and vandalism should not be ignored. Neither can the homeowner concentrate risk management efforts only on the home and the furniture it contains. There might be property elsewhere, such as a summer cottage. A son or daughter might have valuable property in a dormitory room at college. Each risk, involving each item of property, must be identified.

Furthermore, the possible loss of property is not the only risk facing the homeowner. Other, more serious risks are present. A guest might slip, fall, and fracture a limb. The resulting damage suit could cost thousands of dollars. A young wage earner might die and leave a spouse and small children to face life without an adequate income. To effectively manage the many different risks facing us each risk must be identified. How is this identification accomplished? How can we be certain that each risk is recognized and considered?

Agent identification

Agent identification. The most usual risk identification method might be described as **agent identification**. We might contact an insurance agent or, more frequently, the agent will contact us. The agent identifies risks and suggests insurance to cover possible losses. This approach is easy; it involves little investment in time or knowledge by the homeowner. The entire problem is turned over to a professional who assumes control of the situation.

The agent's control of the situation, however, is not always beneficial to the consumer. First there is the question of the agent's ability, experience, and knowledge. The insurance profession, like any other, contains knowledgeable experts of the highest ability and skill. It also contains beginners and others who still have a great deal to learn. Each of us wants our own insurance agent to be experienced and able. But how do we tell a good agent from a poor one? Although later pages discuss this question in detail, a first step in the recognition of a qualified agent is to obtain a basic knowledge of the risk management subject matter yourself.

Another significant problem in relation to agent identification involves conflict of interest which is a difference in basic purpose between the insurance agent and the consumer. The agent wants to sell insurance; the consumer is interested (or should be) in effective risk management. This is an important difference. Some risks are not insurable, and for other risks the best risk management method might not be insurance. The objectivity of the insurance agent needs to be considered. Risk management should be an area in which the informed, intelligent buyer works with the insurance agent without relying completely on the agent. Ideally, risk management should be a partnership between the individual and the professional advisor.

Policy checklists

Policy checklists. There are other methods of risk identification. One involves what are called **policy checklists**. Reference books are available that list each type of available insurance coverage. Such alphabetical lists could provide some risk identification help to persons extremely well versed in insurance. But the fact that you are taking a course in personal risk management indicates that you probably do not know the coverages provided on such policies as the Tenant's Package, Family Auto, or Jumping Juvenile policies. A list mentioning these policies probably would not help you to identify the specific risks that you face.

Risk classification. A third method of risk identification can offer significant assistance. This method involves the classification of pure risks into three major areas and the careful examination of risks in each area. The three major areas of risk are (1) risks to property, (2) risks arising from liability, and (3) personal risks.

The process by which pure risks are classified is demonstrated in Figure 1-1 on page 7. Under these major headings come those items or activities that expose the family to financial loss.

The effectiveness of the process demonstrated in Figure 1-1 depends on the care with which the risk classification process is undertaken. This method provides no guarantee that all risks will be identified, but it does provide a framework that has been shown to assist those who will carefully undertake the risk identification process. Now let's take a look at the three major risk areas.

Risks to property. Each of us owns property. Obviously, the amount and kind of property we own depends on financial circumstances and on our individual interests. College students sometimes own little other than clothing, a few books, and personal items such as a watch or stereo. After graduation they may buy a car, furniture, a house, and many other types of property. But whether we own only a little property or a great deal, that property is subject to loss. It is exposed to risk. Property can be damaged or destroyed by many things such as fire, lightning, wind, or theft. The list of possible causes of loss is nearly endless. The important point is that property should be identified (inventoried) and that the potential for loss to that property should be recognized.

Liability

Risks arising from liability. **Liability** may be defined as one's legal obligation or responsibility. The word "legal" is a key to the concept. Liability involves either a damage suit in the courts or the possibility of such a suit. Suits of the kind with which risk management is concerned result from injury to another person (bodily injury) or from damage to the property of another (property damage).

FIGURE 1-1

Risk Classification: Family of Robert N. and Sarah J. Johnson

Property	Liability	Personal
Home at 205 Garfield Street	Home and premises	Life of Mr. Johnson, Mrs. Johnson, and their two children
Garage at same address	Summer cottage and premises	Medical expenses for family of four
Contents of home (furniture, clothing, personal effects)	Automobiles	Loss of earnings for Mr. Johnson and Mrs. Johnson
Summer cottage in Maine and contents of cottage	Sports activities	
Automobiles: 1980 Chevrolet, 1973 Volkswagen	Pet: German shepherd dog	
Coin collection	Other activities	
Golf clubs and other sports equipment		
Stereo equipment, records and tapes		

We are continually faced with liability risks. The ownership or rental of real estate can produce liability. A broken step or an icy sidewalk can cause someone to slip, fall, and be injured. A damage suit against the property owner is often the result of such an injury.

Automobiles are a major liability risk. Approximately 50,000 persons are killed in auto accidents each year and another 5 million persons are injured. Based on these figures, an individual has about 1 chance in 4,000 of being killed in an auto accident and 2 chances in 100 of being injured. The economic loss from auto accidents now exceeds \$58 billion annually.[1] Your share of the cost of auto accidents is now about \$263 per year. The death, injury, and damage statistics clearly indicate that the automobile has become a lethal weapon.

Liability can also arise from other activities. Some recreational

[1] *Insurance Facts: 1982–83 Edition* (New York: Insurance Information Institute, 1982), p. 58.