Insurance Markets and Your Insurance Strategy
By William C. Wood

Comparison shopping and insurance market competition are your friends as you put together an insurance strategy. A high degree of competition means that you will be able to choose from a number of companies. Strong competition tends to keep the companies' premiums close together. In itself, this competition will do you some good—but you will do even better if you comparison shop among the competing providers.

When risks go up or down, premiums change. For a greater risk, insurers charge more. For a lesser risk, insurers charge less. The lower premiums occur because buyers seek, and insurers offer, lower premiums to cover the lesser degree of risk. In a competitive market with well-informed buyers, the increased profits from lower risk do not last long. They instead get passed on to customers in the form of lower premiums.

A good example of insurance competition has occurred in the market for basic life insurance coverage. These rates have gone down as life expectancy—the average age at death—has increased. With higher life expectancy, there is less chance the insured person will die during the covered period. In this situation, the insurance company gets the premiums but does not have to pay out until much later. Competition for this profitable business lowers the premiums.

Competition does not always work well, however. If buyers are not alert and do not comparison shop, high premiums may continue, especially in small markets. A major reason for competition not working, however, is protection from competition by governments. Some important forms of insurance (health insurance, for example) are not sold across state lines. Insurance is regulated by state governments and the regulations can vary sharply across states. This makes competition less intense in any one state and prevents consumers from getting the full benefits of rivalry among insurers.

Insurance Strategy

The goal of a sensible insurance strategy is to prevent large losses. When individuals or governments do more with insurance, it's usually a bad deal. Here's an example: Car insurance is excellent for dealing with the consequences of large accidents. If you unfortunately cause a lot of damage in a car accident, the insurance protects you from financial ruin. But what if auto insurance covered something as commonplace as replacing windshield wiper blades—would that be a good deal? Probably not. Since windshield wiper blades routinely wear out and are replaced, premiums would have to build in that cost up front. That's not a good way to pay for wiper blades, because of all of the expense of collecting the money up front, handling claims, and writing checks.

Here's another example of using insurance to prevent large losses, and nothing more: As we will see, life insurance is the most cost-effective when it simply pays a death benefit in return for premiums—and nothing else. It is less cost-effective when it comes bundled with investment products. Although bundled financial offerings have their benefits, they do not offer the best deal on life coverage.

People keenly feel the cost as they pay insurance premiums. Naturally, they want to get something back from their insurance. However, under the best individual insurance strategies you rarely get anything back. To put it simply: You do not want to collect. Why? There are several reasons:

- Something bad has to happen in order for you to collect, such as an accident or fire.
- Insurance generally does not cover everything if something bad happens to you. Because of the hassle and inconvenience, you generally will not be equally well off.
- If you buy insurance to cover predictable losses, you're really just engaging in costly prepayment.

Think about it in terms of another form of protection against risk. Suppose you buy a fire extinguisher for your kitchen, but a fire never occurs and you do not get to use it. Would you be upset that the money you spent on the fire extinguisher was wasted? Of course not. You would be happy that your kitchen did not catch fire. Insurance is like the fire extinguisher: it is good to have, but you are happier when you do not have to use it.

The issue of insurance payouts not covering all the harm from an accident comes up when you are considering the deductible on your insurance coverage. The deductible is the amount you pay before your insurance kicks in. Many insurance consumers would like to have a low or even zero deductible—that is, "first-dollar coverage." However, first-dollar coverage is expensive to provide. Most insurance consumers are better off taking a higher deductible and saving up an emergency fund ("Real World Savings Account") to pay for what insurance does not cover. (See *Common Sense Economics*, Part 4: Element 6 for additional details on the importance of a Real World Savings Account.) Higher-deductible insurance is so much less expensive that you can usually save up more than enough to cover future losses—if you have the discipline to do it.

Many insurance consumers like the idea of everyone paying the same rate for insurance. However, when you understand how insurance works, you can see how difficult that would be. People have different risks, like a 25-year-old hot-rodder as opposed to a

40-year-old minivan-driver when both are seeking car insurance. There are also very different risks for home insurance for a three-bedroom suburban house as opposed to a lakefront mansion. If insurers were forced to offer uniform rates for very different risks, then some customers would end up paying for others' risky behavior. Taken to an extreme, a requirement of uniform rates would make insurance very difficult to offer.

This is worth keeping in mind when you buy insurance. When you think about the level of coverage and the deductible, think about the magnitude of the risk you face. Are you at greater risk than an average person? If so, you may end up paying more for insurance. Are you buying insurance against a risk that few people face? If so, insurers will likely know that the people who buy coverage against that risk are the ones who are more likely to need it, so coverage will be expensive.

Your Insurance Plan

To come up with your own insurance plan, figure out what your major risks are. Then decide on a combination of:

- assuming the risk
- reducing the risk
- sharing the risk through insurance

Remember that you're required by law to have certain insurance, such as minimum coverage if you drive a car. Plan on meeting the requirements, and then consider whether you want more. Keep in mind that like any other purchase, insurance has opportunity costs—you could be doing something else with that money. Sometimes it makes more sense to assume the risk and forego insurance.

Auto insurance

Remember that our objective is avoiding big losses. What might bring about a big loss when you have a car?

1. A collision—and in response you might carry collision coverage to replace your damaged or "totaled" car.
2. Liability—and you will ordinarily be required to have coverage to pay for damage you caused.
3. Non-collision damage—and so you may carry "comprehensive" coverage to cover such things as fire, theft, or storms.

Applying a smart strategy, here's how a consumer will deal with auto-related risk:

- Assume small risks, such as the total loss of your 20-year-old "beater" car. If it's only worth a couple of thousand dollars, then it's better not to keep paying for collision coverage on it.
- Assume small risks by having a high deductible. This means the consumer pays smaller premiums but must pay more when an accident occurs. That's fine if the customer takes advantage of the lower premiums to save up an emergency fund (or "Real World Savings Account," as was discussed in *Common Sense Economics*, Part 4: Element 6).
- Reduce all car-related risks, with such actions as driving carefully and locking up when leaving the car.
- Share liability risk by having liability coverage. This is required by state law, with some provisions for those who cannot afford coverage. Do not underestimate the damage you might do in a car. What if your accident destroyed a truckload of iPhones?

Now more than ever, auto insurance companies are likely to use your credit score in making decisions about insuring you. The companies may charge high premiums to those with poor scores (or even decline to cover them). Why should your payment record on credit cards affect your car insurance? It turns out that poor credit scores are statistically linked to more and bigger claims. That linkage is imperfect, because there are always people who have poor credit but drive very carefully. Car insurance can now be added to the long list of reasons people should maintain good credit.

Insurance at home

Your home insurance strategy will depend on whether you are a homeowner or a renter. If you are a homeowner, homeowner's insurance is a great idea. It's also required, if you have a mortgage. Your mortgage lender has rights to your house as security for the loan, and is out of luck if an uninsured house burns down. In addition to covering fire damage, homeowner's insurance also covers many other risks such as storms and liability claims. If you rent, on the other hand, you are generally not required to have renter's insurance.

Applying the general strategy to home risks, here are some smart moves:

- Assume small risks, such as the risk of losing all of your belongings if you rent and you do not have very much.
- Reduce other risks, by doing such things as locking doors when you leave and maintaining smoke detectors.
- Share big risks such as fire and theft by using renter's and homeowner's insurance.
- Share the big risk of liability—courts are inclined to find you responsible if someone is injured at your home; (liability is included in homeowners insurance).

Life insurance

Life insurance pays a beneficiary when the policy owner dies. It does not actually insure your "life;" instead, it insures your earning ability. Sound strategy for life insurance involves elements like these:

- Assume small risks, such as loss of life by a single person at age 21 with no dependents. This person has little to insure and therefore very little need for life insurance.
- Reduce the risk of your own premature death, by paying attention to your health and safety. The methods of doing this are widely known, including not smoking and always wearing a seat belt in a car.
- Share the big risk of loss of earning power from premature death—by buying life insurance. This would be especially important for the primary earner in a family with young children. That family would keenly miss the income if an uninsured death occurred.

Term life insurance is the kind of insurance that most efficiently provides a death benefit. You pay regular premiums and in the event of your death, the policy pays the dependents you specify. Term life insurance, as the name implies, lasts for a fixed term such as five or ten years. It may be renewable up to a certain age. Personal finance experts overwhelmingly recommend term life insurance for people with a need to insure income.

In addition to term life insurance, there are many other kinds. They are all mixed products, providing payment in the event of death just like term insurance, plus something else. A leading example is whole life insurance, which provides a death benefit plus a saving or investment vehicle. You pay a lot more for whole life insurance than for term insurance and—unlike term insurance—the policy builds investment value over time.

Why is whole life insurance so often criticized by personal finance columnists and writers? It is much more expensive for a given level of death benefit, and therefore not the best choice for someone who simply wants to protect an income against premature death. With whole life insurance, typically a large part of your payment goes to commission for the sales representative rather than the protection or the saving-investment element. And the saving-investment products built into whole life insurance are often not as good as what you can buy separately.

There are other variations on life insurance. Universal life insurance combines term insurance with a cash account. Variable universal life insurance combines term insurance with an investment account. In each case, there are some advantages but there is also a smaller amount of life insurance protection for the money than what term life insurance offers.

It is easy to get caught up in the terminology of various forms of insurance. The key thing to remember is to use insurance as part of an overall plan to assume some risks, reduce other risks, and share the remainder.

William C. Wood is Professor of Economics and Director of the Center for Economic Education at James Madison University. He is widely recognized for his achievements in both teaching and economic education. In 2002, he was an inaugural winner of the Southern Economic Association's Kenneth G. Elzinga Distinguished Teaching Award. He has authored five books, more than 40 scholarly articles, and national economic education materials for school and adult audiences. His doctoral degree is from the University of Virginia.