MODULE L: SMART CHOICES FOR INSURANCE

Common Sense Economics ~ What Everyone Should Know About Wealth and Prosperity

http://CommonSenseEconomics.com/
RISK AND INSURANCE

- Read: What is Risk and How Can We Manage it? by William C. Wood
- Watch: Choice, Chance, and Control by Media Options

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RISK AND INSURANCE

Is there risk in these events?
- You drive to work in the morning.
- You get coffee at a convenience store.
- You send a text to your friend during a dull meeting.
- You go for a run in your neighborhood.
Risk and Insurance

Answers To the Questions From Previous Slide

- Yes, all these options involve risk – just look at the definition:

  Risk is *the possibility that an injury or loss will occur.*

  (Driving can lead to accidents, coffee can spill, texting at the wrong time can get you reprimanded, and you may be injured in your own neighborhood.)
What is Insurance?

Insurance involves *making regular payments in order to receive compensation if an injury or loss occurs.*

There are two parts to an insurance transaction

- First, the regular amounts you pay in, called *premiums*.
- And second, the payments you receive if a covered loss occurs.

Question: If you paid your car insurance for a year and did not have an accident, was the money wasted?

- *No, you had the protection for a year, and that is valuable.*
RISK AND INSURANCE

The Briefcase Experiment

- I have a briefcase with a gift for you in it: $50,000, legally yours. Will you accept it?
  - Most people say “yes.”
  - Even a saint who did not want to keep the money might accept it for a favorite charity.
The Coin Flip

- You have the briefcase and $50,000.
- But wait – I have a deal for you, at your option:
  - I flip a coin. Heads, you get $100,000. Tails, you get nothing (not even the $50,000 you had).
  - Would you take this deal? Most people say “no.”
- Why? Because with $50,000 in hand the additional (marginal) benefit of another $50,000 is low compared with the pain of losing the $50,000 altogether.
RISK AND INSURANCE

One More Coin Flip

- You have the briefcase and $50,000.
- But wait – final deal, *at your option*:
  - I flip a coin. Heads, you get $75,000. Tails, you get $25,000 instead of the $50,000 you had.
  - Would you take this deal? Most people still say “no.”
- Yet more people take this deal than the $0-vs.-$100,000 gamble.
- Why do most still take the sure $50,000? Because people are generally *risk averse*. (They avoid risk unless they get something in return for assuming it.)
RISK AND INSURANCE

- The three deals, illustrated.

- Which would you take?
RISK AND INSURANCE

An Example of Risk and Diversification

- People in Leiper’s Fork have 100 barns.
- Sadly, one may burn down – but we don’t know which one.
- Leiper’s Fork has a town meeting to decide what to do. All of the options come down to three:
  1. Assume the risk – if your barn burns, tough
  2. Reduce the risk – take extra caution
  3. Share the risk – through some form of pooling
RISK AND INSURANCE

A Way of Sharing

- If all 100 barn owners pitch in 1/100 of the cost of rebuilding a barn, Leiper’s Fork now has the ability to rebuild one barn.

- If a barn burns down, Leiper’s Fork has a “barn-raising.”
RISK AND INSURANCE

Barn Raising and Insurance

- Leiper’s Fork residents engaged in diversification – they replaced a single risk (losing a barn) with a number of smaller risks (possibility of having to participate in barn raisings).

- People love the image of a barn raising – neighbors helping neighbors.

- But the idea of a barn raising, implemented through markets, is insurance.
RISK AND INSURANCE

Insurance, Company Size, and Competition

- Why are big insurance companies needed?
  - A big company can spread risk over thousands of barns, not just 100.

- Why is competition needed?
  - It’s competition rather than size that really matters for insurance companies doing a good job for customers.
  - Many freely competing insurers will keep premiums in line – but government restrictions on competition usually will not.
Risk and Insurance

Example of Insurance Competition

- Life insurance rates have gone down as life expectancy increased.
- Why? Increased chance that the insured person won’t die during covered period.
- More often than before, insurance company gets the premiums but does not have to pay out.
- Competition over this profitable business lowers the premiums.

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Types of Insurance

- Read: Insurance Markets and Your Insurance Strategy by William C. Wood
- Read: The Special Case of Health Insurance by William C. Wood
- Watch: Car Insurance Coverage with Jay Windland
- Watch: Life Insurance Needs by Primerica
- Watch: Moral Hazard by Learn Liberty

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 TYPES OF INSURANCE

Insurance in Personal Finance

- The goal is to reduce the risk of large losses.
- Insurance does not work well for coverage of low-cost items or tie-in savings plans
  - Example: Use of insurance to prevent large and small losses.
    - What if auto insurance covered replacement of wiper blades? Premiums would have to be higher, and it would become more complicated to get new blades.
  - Example: Combined insurance-investment products.
    - They prevent large losses, but also have built-in savings plans that often are not a good deal.

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What is a Deductible?

- In the event of a loss, it is the amount you must pay before your insurance reimbursement begins.
- People like low or even zero deductibles ("first-dollar coverage").
- But that’s very expensive to provide.
- Most people are better off saving up in an emergency fund ("Real World Savings Account") to cover things like deductibles.
- General principle: Most people will be better off saving to cover deductibles and choosing relatively high deductible insurance policies.
TYPES OF INSURANCE

Uniform Rates?

- People like the idea of everyone paying the same rate for insurance.
- But, this is difficult in practice, because risks vary.
  - Who is more likely to have a car accident?
    - 25-year-old hot-rodder or 40-year-old minivan driver?
  - Following a severe storm which will be more costly to rebuild?
    - 3-bedroom suburban house or lakefront mansion?
- Uniform rates make some pay for others’ risks.
TYPES OF INSURANCE

Insurance Strategy
- Figure out your major risks.
- 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 types and levels of insurance. Consider whether you want more.

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Types of Insurance

Auto Insurance Strategy

- Theme: avoiding big losses
- What might bring about a big loss?
  1. A collision – so you might carry collision coverage to replace your damaged or “totaled” car.
  2. Liability – having to pay for damage you caused.
  3. Non-collision damage – as from fire, theft or storms (typically included in “comprehensive” coverage).
 TYPES OF INSURANCE

Sound Thinking about Auto Insurance

- *Assume* small risks, such as total loss of your 20-year-old “beater” car (don’t carry collision coverage).

- *Assume* small risks by having a high deductible and saving up an emergency fund (“Real World Savings Account”).

- *Reduce* other risks, by driving carefully. Note: Some insurance companies reward safe drivers.

- *Share* liability risk by having liability coverage (you can cause a lot of damage – what if your accident destroyed a truckload of iPhones?).
TYPES OF INSURANCE

Sound Thinking About Home insurance

- *Assume* small risks, such as losing all your stuff if you rent and you don’t have much.

- *Reduce* other risks, by locking doors when you leave and maintaining smoke detectors.

- *Share* big risks using renters or homeowners insurance.

- *Share* the big risk of liability – courts are inclined to find you responsible if someone is injured at your home (included in homeowners insurance).

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Types of Insurance

Life Insurance Basics

- Life insurance provides payments to beneficiary when the policy owner dies.
- It is important if others (e.g. children or spouse) are depending upon your earnings.

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TYPES OF INSURANCE

Sound Thinking About Life Insurance

- Assume small risks, such as loss of life at age 21 with no dependents (little to insure).
- Reduce the risk of your own premature death, with attention to health and safety.
- Share the big risk of loss of earning power from premature death by buying life insurance.

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Types of Insurance

Understanding Term Life Insurance

- *Term life insurance* does
  - In the event of your death, pays the dependents you specify.
  - Lasts for a fixed term, such as five years (typically with annual premiums you pay).
  - May be renewable.
- Personal finance experts overwhelmingly recommend *term life insurance* for people with a need to insure against loss of income.
- If no one else is dependent on your income, little or no life insurance is needed.
Types of Insurance

Understanding Whole Life Insurance

- Whole life insurance combines life insurance with a saving-investment plan.
- Separate saving-investment products are often better than the ones built into whole life insurance.
- More expensive than term-life for a given level of death benefit.
- Large amount of your payment goes to commission for the sales representative rather than the protection or the saving-investment element.
TYPES OF INSURANCE

Health Insurance

- Health insurance provides coverage or reimbursement for healthcare costs.
- Coverage of healthcare cost is only partial.
  - Most will face an annual “deductible” – the part they have to pay before coverage kicks in.
  - An additional fee per doctor visit or prescription is known as a “copayment.”
  - Most policies do not pay 100 percent even after copayment and deductible are met.
  - The percentage you pay is called “co-insurance.”
TYPES OF INSURANCE

Sound Thinking About Health Insurance

- Assume small risks, such as the risk that you’ll need to pay for an Ace bandage.
- Assume the small risks represented by your copay per doctor visit.
- Reduce other risks, by good health habits.
- Share the risk of big medical expenses by carrying appropriate coverage.
TYPES OF INSURANCE

Are higher medical deductibles a good idea?

- Tradeoff: You pay more out-of-pocket but also have lower premiums.
- Try to anticipate upcoming medical expenses and decide accordingly.
Types of Insurance

The Moral Hazard Problem

- Moral hazard occurs when someone takes additional risk *because of insurance*.
  - Example: Someone with full coverage leaves a car unlocked and the premium sound system is stolen.
  - Example: Someone installs a new fireplace but is not careful with it, knowing that homeowner’s insurance covers fire losses.
Types of Insurance

The Adverse Selection Problem

- Adverse selection occurs when someone avoids buying insurance unless it is sure to be needed.
  - Example: A homeowner sees a flood coming, and therefore quickly buys flood insurance.
  - Example: Someone learns from the dentist that orthodontic work will be necessary, and so adds expanded dental coverage to a health insurance policy.
**Types of Insurance**

Response to Insurance Challenges

- Moral hazard and adverse selection can make coverage unprofitable to offer, so it vanishes in the long run.
- Both can be reduced through information and changes in insurance terms.
- Examples:
  - Charging more to insure custom sound systems in cars.
  - Requiring additional on-site inspections of homes with wood-burning fireplaces or stoves.
  - Requiring 30-day wait for flood insurance coverage.
What is a Death Spiral?

- Suppose insurers respond to moral hazard or adverse selection by raising rates.
- Now, the moral hazard may become worse, because people pay more, and feel justified in taking more risk.
- Now, adverse selection may become worse, because only people who are truly sure they’ll need the coverage will buy it.
- So losses are again higher than expected, and rates are raised again until the market disappears – a death spiral.
Types of Insurance

Ways to Save on Insurance Costs

- Shop around: Check the rates of alternative insurers.
- Concentrate on guarding against large losses.
- Chose high deductibles and set aside additional savings to cover the deductibility cost.
- Reduce risks, especially those noticed by insurers, such as driving a fast car, smoking, and excessive consumption of alcoholic beverages.

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