

09-25 Class Session: Personal Finance-Insurance Guide

Personal Finance: Comprehensive Guide to Insurance

Core Concepts of Risk Management and Insurable Risk

Insurance is a tool for managing the *risk* of a future negative event, not for covering a loss that has already occurred. An individual cannot purchase insurance *after* an accident or disabling event to cover that specific incident. Individuals face daily risks that can lead to significant financial loss (e.g., a \$30,000 ER visit, major vet bills). There are two primary methods for managing this risk:

1. **Emergency Savings:** Maintaining a fund of at least six months of income for unexpected events.
2. **Insurance:** Transferring risk to an insurance company by paying a regular premium in exchange for a large payout in the event of a covered loss. The primary benefit is financial security and peace of mind. The ideal outcome is to have insurance and never need it, as this signifies no major negative events occurred.

Key Insurance Terminology

- **Policy:** The formal contract detailing rules, coverage, costs, and covered providers.
- **Coverage:** The specific financial protection provided by the policy (e.g., liability-only car insurance).
- **Premium:** The recurring fee (usually monthly) paid to keep the policy active.
- **Deductible:** The fixed amount the policyholder must pay out-of-pocket before insurance coverage begins. This can be per-incident (auto) or annual (health).
- **Copay:** A fixed fee paid upfront for a service (e.g., \$50 for a doctor's visit). It does not count toward the deductible.
- **Coinsurance:** A percentage of the bill the policyholder pays *after* the deductible is met. This helps keep premiums lower.
- **Payment:** The money paid by the insurance company to cover a loss after a claim is approved.

The Insurance Business Model and Claim Process

- ****Risk Pooling:****Companies profit by collecting premiums from a large pool of customers, calculating that the total premiums will exceed the claims paid out to the small percentage who experience a loss.
- ****Minimizing Payouts:****A common profit strategy is to offer a settlement less than the full value of a loss. It is the policyholder's responsibility to contest an insufficient offer.
- **The Claim Process:**
 1. A covered loss occurs.
 2. The policyholder files a claim.
 3. The company investigates the claim's legitimacy.
 4. The policyholder pays the copay (if applicable) and the deductible.
 5. The insurer pays the remaining costs (minus any coinsurance), up to the policy limits.
- 2. ****Role of Out-of-Pocket Costs:****Deductibles and copays exist to discourage claims for minor issues and prevent fraud. A Maryland case study showed that introducing a mere \$1 copay for state-funded health insurance dropped claims by over 70% by eliminating overuse for minor ailments.

Coinsurance Calculation Example

For a \$3,788 bill with a \$500 deductible and 10% coinsurance:

1. ****Pay Deductible:****Individual pays **\$500**.
2. **Calculate Remainder:** $\$3,788 - \$500 = \$3,288$.
3. ****Calculate Coinsurance:****10% of \$3,288 = **\$328.80**.
4. **Total Out-of-Pocket Cost:** $\$500$ (deductible) + $\$328.80$ (coinsurance) = **\$828.80**.
5. **Amount Paid by Insurer:** $\$3,288 - \$328.80 = \$2,959.20$.

Sources of Insurance

1. ****Out of Pocket (Personal Purchase):****Individuals pay for policies like homeowner's, renter's, car, and long-term care insurance.
2. ****Employer-Provided (Benefits):****Health, disability, and sometimes life insurance are offered as part of a compensation package. Employer-paid premiums are non-taxed "in-kind income," which can make a lower-salary job with benefits more valuable. Coverage for family members typically costs extra. Upon job loss, COBRA allows individuals to continue health coverage by paying the full premium themselves.
3. ****Government Programs:****Includes Social Security, Medicaid, Medicare, unemployment insurance, workman's compensation, and specific disaster coverage (e.g., flood insurance).

Underwriting, Fraud, and Policy Comparison

- ****Underwriting:**** Insurers assess risk before issuing a policy. This may involve a medical exam. Premiums are increased by factors like older age, high-risk occupations (oil fields vs. desk jobs), and high-risk hobbies (skydiving, rock climbing). Lying about risk factors (e.g., smoking) can lead to policy cancellation if a related illness occurs.
- ****Insurance Fraud:**** The act of intentionally causing a loss (e.g., faking car theft, arson) to collect insurance money. It is a crime with severe consequences, including prison time and being sued for the payout.
- ****Comparing Policies:**** The "better" policy depends on individual needs. A low-deductible, high-premium policy may be better for those expecting minor expenses, while a high-deductible, low-premium policy is better for protecting against catastrophic events.
- ****Insurance Networks:**** Insurers negotiate lower prices with a "network" of doctors and hospitals. Policyholders are heavily incentivized to use these "in-network" providers, as going "out-of-network" can result in no coverage.

Types of Insurance

- ****Health Insurance:**** A comprehensive plan should cover doctor/hospital visits, medical procedures, mental health, preventative care, and prescriptions. Vision and dental are often separate policies.
- ****Disability Insurance:**** Replaces a portion (e.g., 50-70%) of your income if you are injured and unable to work. It is especially critical for those in physically demanding jobs.
- ****Long-Term Care Insurance:**** Covers costs for a nursing home or in-home assistance for those with a long-term disability. It is cheap when young but cannot be purchased *after* a disabling event occurs.
- **Property and Liability Insurance:**
 - ****Homeowner's:**** Covers the physical structure and personal belongings from events like fire or tornadoes. It also includes liability coverage if someone is injured on your property and sues. Standard policies often exclude floods, requiring a separate government policy.
 - ****Renter's:**** Primarily covers the renter's personal belongings (typically \$25k-\$35k). The building is covered by the landlord's policy.
- ****Life Insurance:**** Provides a tax-free payment (death benefit) to a beneficiary upon the insured's death.
 - ****Purpose:**** For young people with no dependents, a small policy (\$20k-\$30k) can cover funeral expenses. For those with dependents, it replaces lost income to provide financial security. A common guideline is $\text{Annual Salary} \times \text{Years until youngest child is 18-22}$.

- ****Term Life:**** Affordable coverage for a fixed period (e.g., 20 years). It is pure insurance with no cash value, ideal for families with young children.
- ****Whole Life:**** Permanent, more expensive coverage that includes a cash value/investment component. Best for wealthy individuals for estate planning or for those with lifelong dependents.
- ****Strategy:**** The recommended approach is to use affordable term life for protection while actively building personal wealth through investing.

Next Arrangements

Insurance & Finance Assignments

- Complete the "Insurance Basic Challenge Questions" assignment. An extra credit opportunity is available for providing a unique example of a financial hazard loss.
- Complete the "Mr. Burkhardt's Insurance Issue" case study, due Monday.
- Use ChatGPT for the "Health Insurance Simulation" assignment, due Monday.
- Students must understand how to calculate total out-of-pocket costs (deductible + coinsurance) for a project question.
- The class will discuss life insurance and related topics in the next session.