

10.5.1: Insurance- What do you need?

Life's Problems Will Happen to You

Sorry to tell you, but life is hard. You will have difficulties, and there will be accidents and events that affect your property or your health. To put it another way, life inherently contains risk. You and your family are at risk that you may be in an automobile accident. You and your family are at risk that one or several of you may become ill and require a hospital stay. You and your family are at risk that a tree may fall on your house. Of course, not all these risks have the same probability of occurring, and not all of these risks will incur the same amount of financial loss.

The Concept of Insuring Against Risk

Insurance companies take on your risk for a fee, known as a premium. By buying insurance, you are protecting your wealth and income against unexpected events that can take away your wealth or income. There are many types of insurance you can buy to protect yourself, your family, and your property:

- Automobile insurance
- Homeowner's insurance
- Health insurance
- Disability insurance
- Life insurance

There are also specialty insurance companies for special risks, such as insuring professional football or basketball players against a career-ending injury. Then there are also a few insurance programs administered by federal and state governments that people often forget:

- Social Security insurance
- Medicare insurance
- Unemployment insurance (federal and state)

Insurance companies have experience with the costs of fire, accidents, and casualties, so they price their premiums on anticipated claims against the insurance policies they sell. As a consumer, you should do a cost/benefit analysis. Always get at least three quotes for your insurance, and if you have been with a company for a few years, you should get quotes to make sure you are being charged a competitive premium.

However, there is one rule that you should always follow. If a potential casualty loss is so large that it will really hurt you financially, you must insure against it. For example, if your house burns down, even though this is an unlikely event, you should insure against the loss because of its financial consequences.

The Business Model of Insurance Companies

Commercial insurance companies are in the business of making a profit. They sell policies to customers and charge an annual premium for the protection. An insurance policy is a legally binding contract, and it obligates the company to pay for any of the claims that are covered in the policy. For example, when you buy automobile insurance, you agree to pay the annual premium, and the insurance company agrees to pay for damages from an accident.

Insurance companies have teams of actuaries who estimate the probable amount of claims in each category of things they insure, based on historical averages. The insurance company charges enough premiums to pay for the claims, while still having a profit left over to pay dividends to their shareholders. In most years, if fate behaves, claims replicate their historical averages. However, when unexpected events happen, such as Hurricane Katrina or the West Coast Wildfires, insurance companies lose money.

Since claims occur over the course of a year, insurance companies invest the premiums they collect in short term investments (e.g., in the case of auto or homeowners' policies) or in long term investments (e.g., in the case of whole life insurance). This gives them another source of profit for their shareholders.

There are insurance companies that are mutual insurance companies. These are analogous to credit unions in the banking sector. In mutual companies, the policyholders are the owners of the company. That means that while a mutual company must cover all their claims, they do not have to generate a profit for their shareholders. If they have extra cash left over at the end of the year, they can

send refund checks to their policyholders or reduce premiums the next year. Mutual insurance companies are very competitive in their rates.

When you are new to the insurance market, it is a good idea to use an insurance broker who can advise you on the ins and outs of the market. The broker is paid a commission by the insurance company (normally in the range of 8% of the premium) to place your insurance with them. Once you become confident, try companies that sell by phone or over the internet. This usually saves money because they do not pay commissions to brokers. Make sure you get at least three quotes. Here are some legitimate companies that sell by phone or internet:

- GEICO
- Liberty Mutual
- Progressive
- USAA (for veterans of families of veterans)

I personally switched a number of years ago from a commercial insurance company to Liberty Mutual for both auto and homeowners' insurance and my premium went down by about 25%.

Health Insurance

Health insurance can be expensive compared to auto or homeowners' insurance. In 2020, the average national cost for health insurance was \$5,500 annually for an individual and \$13,800 for a family per year. However, costs vary among plans. There is a wide selection of plans and programs for health insurance, such as opting for a Health Maintenance Organization or agreeing to only use the doctors approved by the insurance company. In addition, most companies offer health insurance to their employees, and by joining a group insurance plan of mostly healthy people, premiums are reduced. Further, companies that provide health insurance for their employees usually pay for a good portion of the premium.

As an historical note, the United States is the only developed country (other than China) that does not have a national insurance program. The expansion of private health insurance in the U.S. goes back to World War II. Six million men and women were sent to fight in Europe and the Pacific. Thus, the military-industrial complex on the home front had a shortage of workers just as it was producing war material at full speed. One consequence, of course, was the recruitment of women to staff the manufacturing lines. Another consequence was the competition for employees. Companies were not allowed to give raises during the war in order to avoid inflation; in order to compete for employees, companies started giving benefits, like health insurance. From after the war until today, pharmaceutical companies, hospitals, doctors, and insurance companies have lobbied against the U.S. having a national health insurance plan. They are afraid (and rightly so) that a government insurance program will use its buying power to control their fees.

The most common types of health insurance programs are fee for service and managed care plans. Both cover doctors' visits, hospital outpatient services, medical procedures, and hospitalization. Fee for service (sometimes called Personal Choice) allows you to choose your own doctors and specialists. Your doctor submits a bill to the insurance company and is paid all or part of their fee. If the insurance company thinks the fee from your doctor is higher than the prevailing rate in that area, the insurance company will only pay the prevailing rate, and you must pay the rest, a drawback of the fee for service policy.

Managed care plans require the policyholder to go to a specific group of doctors and hospitals identified by the insurance company. They are called in network doctors and hospitals. The value of this program is that the doctors recommended will not charge you above the fees agreed with your insurer, and you will not be billed for any difference. Health maintenance organizations (HMO) are insurers that usually establish a set annual fee per patient with doctors. You must go first to the primary care doctor, which you choose from their list. Any referral for further treatment by a specialist must first be approved by your primary care physician. The HMO is paying the primary care physician to keep you well and is controlling any unnecessary trips to specialists. The premiums for fee for service are higher than the managed care policies, which are higher than the HMO policies. Your choice of plan affects your premium payment.

Being part of a health insurance group (such as your employer-sponsored health insurance program) significantly reduces the total premiums. Of course, your employer decides how much of the health insurance premiums they are willing to subsidize. If you are self-employed or between jobs without health insurance, there are often ad hoc groups in your area that sponsor group programs. For example, you can join the local Chamber of Commerce that sponsors a plan that is cheaper than buying as an individual.

Finally, federal law states that an insurance company cannot refuse you coverage due to a pre-existing condition, as part of the Affordable Care Act (ACA) legislation. If you lose your healthcare because you lose your job, you should at least buy a low

premium policy in case of an unexpected hospitalization. Hospital stays are expensive, and you should at least protect yourself against those expenses. If you are out of work, you should be able to enroll in a very reasonably priced ACA policy. There are also government subsidies for those with low income. You would likely qualify for this if you are single, and your only source of income is unemployment compensation.

The Main Reason People Go Bankrupt

A 2019 Harvard study found that 66.5% of all bankruptcies were tied to medical issues, due to high costs of care and time out of work. This includes an estimated 530,000 families. This study also shows that 78% of bankruptcy filers had some form of health insurance but not enough to cover their medical costs (CNBC). Even if you are young and healthy, you should at least have health insurance for what are called catastrophic illnesses. This includes things like accidents that put you in the hospital, cancer, and COVID-19. Because you are young and healthy, the probability of these events is low, so the premium is low.

Recent support for Medicare for all stems not just from the plight of uninsured people but also from middle class people who have catastrophic illnesses that are not covered by insurance. With this model, the government can achieve substantial savings by negotiating fees and costs.

Affordable Care Act

The Affordable Care Act (ACA) was passed in 2010, in the second year of President Obama's first term. The Republicans immediately took to calling it Obamacare and have been trying to repeal it as unconstitutional ever since it was passed. A Republican court case even made it to the U.S. Supreme Court, which upheld the constitutionality of the ACA by a five to four vote. Republicans continue to challenge the ACA, so expect it to continue to be in the news. The ACA has three main goals:

1. Reduce the price of health insurance in order to make it available to the millions of people. The government subsidizes the cost of health insurance for households whose incomes are 100% to 400% of the federal poverty level.
2. Expand Medicaid. Medicaid is free health insurance for households whose incomes are substantially below the federal poverty level. States are responsible for administering Medicaid, and many states with Republican governors or legislatures refused to accept this expanded federal aid.
3. Find and support medical care delivery systems that lower the cost of providing healthcare.

The ACA has been successful by any measure. In 2020, 23 million people are covered by the ACA. In addition, 31 states accepted the expanded Medicaid program. In 2020, a total of 73 million people are now insured under Medicaid or under the Children's Health Insurance Program (CHIP). In addition, children are now able to remain on their parents' healthcare policy until they turn 26, and no insurance company can refuse healthcare coverage because of a pre-existing condition.

Another benefit of the ACA is that it modernized the health insurance search, establishing an online marketplace for health insurance. When you access the marketplace, you will be asked some relevant questions and receive an estimate of the subsidy you may qualify for. After this, you will have access to the private insurance companies offered through the marketplace. All participating companies must offer at least these ten essential benefits in their plans:

1. Ambulatory patient services (outpatient care)
2. Emergency services
3. Hospitalization (like surgery and overnight stays)
4. Pregnancy, maternity, and newborn care (both before and after birth)
5. Mental health and substance use disorder services, including behavioral health treatment (this includes counseling and psychotherapy)
6. Prescription drugs
7. Rehabilitative and habilitative services and devices (services and devices to help people with injuries, disabilities, or chronic conditions gain or recover mental and physical skills)
8. Laboratory services
9. Preventive and wellness services and chronic disease management
10. Pediatric services, including oral and vision care (but adult dental and vision coverage are not essential health benefits)

In addition to these, birth control coverage and breastfeeding coverage must also be offered.

Finally, health insurance plans on the marketplace can offer additional coverage for services like dental and vision care, but these plans will cost you more. As I said before, if you lose your healthcare coverage due to any reason, you should at least buy a

minimum policy that will cover an unexpected illness. Look at the ACA Marketplace for these options.

Disability Insurance

Disability insurance provides income if you cannot work due to an illness or accident. Short-term disability typically covers you for 13 to 26 weeks and will pay 40% to 70% of your salary during that period. It costs about 1% to 3% of your salary and may be paid for by your employer as a benefit. The premium depends on your age and occupation. Long-term disability insurance also costs about 1% to 3% of your salary, and these policies will begin payment after the period of short-term disability payments. Depending on the policy you select, the long-term disability payments can cover 20 years, 30 years or until retirement.

The Social Security system also pays disability payments under the SSDI program, and, if you qualify, you can collect this in addition to your private insurance. These SSDI payments range from \$800 to \$1,800 per month, depending on your earnings history, providing only a minimal safety net; it will not replace your income. Buy long-term disability insurance; it is not that expensive if you are part of an employer sponsored plan, and it protects you and your family.

Auto Insurance

All fifty states require auto insurance if you own a car. This is mostly to protect other drivers if you are at fault. However, you should also get a provision against uninsured drivers. This will protect you if someone without insurance hits you, causing damage to your car or injuring you. This is a common provision in auto policies. The national average of car insurance in the U.S. is \$1,400. This will vary if you have an expensive car, have just gotten your license, or have a bad driving record. Below are some potential types of coverage you can have.

Coverage A: Liability Coverage

If an accident is your fault, by law you must pay for the damages. This includes both property damage and bodily injury to another. Some states have no-fault property damage laws, eliminating the need for lawyers, thereby reducing costs. In this scenario, your insurance company fixes your car, and my insurance company fixes my car. However, no-fault does not apply to bodily injury.

Coverage B: Medical Payments Coverage

If you are at fault, your insurance company pays any medical bills for the other person. This is the law.

Coverage C: Uninsured or Underinsured Motorist Coverage

If the other driver is at fault and has no insurance, you are covered by your policy. This is a good provision to have.

Coverage D: Collision and Comprehensive Coverage

Collision covers damages to your car if you are at fault in an accident. Comprehensive covers all other damages or loss to your car, such as theft, vandalism, floods, hail damage and other unhappy events.

The deductible is the amount you pay out of the total of each claim. You can choose the deductible, but it normally ranges from \$250 to \$1,000. The higher the deductible, the lower the premium, because you will not bother your insurance company every time your car gets a dent or scratch. Many insurance companies also offer a discount for safe drivers. Note that each state has a different minimum insurance coverage required.

Renter's Insurance

If you are a renter, almost every lease has a provision that says if an event happens that damages your property, the landlord will not pay for it. If someone breaks into your apartment and steals your laptop, the landlord has nothing to do with that and will not reimburse you. This is why you should buy renter's insurance. Renter's insurance is inexpensive, with an average price at about \$15 per month in 2020. It covers fire, damage and theft.

You should also ask for liability to be included in the policy. This will protect you if a visitor gets injured in your apartment or if your dog bites the neighbor. Also, it is helpful to keep photos of your important property. Take pictures of your new laptop, your television, and expensive jewelry (include receipts if possible). This will help you establish your claim to the insurance company if you have a loss.

Homeowner's Insurance

For many, their most valuable asset is their home, thus it is important to protect it with homeowner's insurance. Homeowner's insurance should protect your home against fire and wind damage, theft, falling trees, and personal liability. Standard forms of

homeowners insurance policies are numbered from HO-1 to HO-8. These are structured with different degrees of coverage and the premiums are different for each package.

- HO-1: The most basic and limited type of policy for single-family homes, HO-1s are all but nonexistent nowadays.
- HO-2: A more commonly used policy and a slight upgrade from the HO-1.
- HO-3: The most common type of homeowners insurance policy with broader coverage than the HO-2.
- HO-4: A policy type that is specifically for renters.
- HO-5: The most comprehensive form of homeowners insurance and the second most common policy type for single-family dwellings.
- HO-6: A type of coverage designed for condo owners.
- HO-7: The type of policy you get if you own a mobile or manufactured home.
- HO-8: A special type of homeowners insurance for homes that do not meet insurer standards for other policy forms.

The insurance policy will generally be a cash value policy; if the house is destroyed, you will be paid the current value of the house. Since ground does not burn, what the company is insuring is the structures on the property. You should try to get a replacement value policy which will increase the value of the house according to inflation and pay the cost to replace it. Your policy will also specify the replacement of other structures on the property such as a detached garage or swimming pool. In addition, the policy will cover personal property in the house such as furniture, computers, televisions, jewelry and clothing if there is fire, theft, or vandalism. There is usually a set limit on the cash amount covered under this. If you have especially valuable items in the house, such as jewelry, paintings, or antique rugs, you should catalog them specifically in the policy or buy a separate valuable items policy. The insurance company may ask you to present an appraisal to establish their value.

Liability is also an important part of the homeowners policy. If someone is hurt on your property, you are covered up to a certain amount. However, you are not covered if you are breaking the law. For example, if you allow your teenager to have a party at your house with underage drinking and someone gets hurt, you will be in deep trouble, and your insurance company will not cover your liability.

The national average annual premium for homeowners' insurance is \$2,300. However, this is for the average home price of \$300,000 and with a \$1,000 deductible. Your premium will vary according to several factors, including:

- The value of your house
- The deductible you choose
- Whether your area is subject to earthquakes or wildfires
- Whether there is a fire hydrant nearby

Ask your real estate agent for a recommendation for an insurance broker. After you are comfortable with homeowner's policies, you can get quotes from the direct to customer insurance companies. The Insurance Institute recommends these ways to lower the cost of your insurance premiums:

1. Shop around.
2. Before you buy a car, compare insurance costs.
3. Ask for higher deductibles.
4. Reduce coverage on older cars.
5. Buy your homeowners and auto coverage from the same insurer.
6. Maintain a good credit record.
7. Take advantage of low mileage discounts.
8. Ask about group insurance.
9. Ask about other discounts, such as for safe drivers or if you install smoke alarms in your house.

Flood Insurance

If your home is in a location prone to flooding, you will need to buy flood insurance. Your homeowner's policy does not cover flood damage. The Federal Emergency Management Administration (FEMA) offers flood insurance, with an average annual cost of \$700. This is a good investment, since one inch of water in your house can cause about \$25,000 in damage. FEMA has detailed maps online of frequent and moderate flood zones to help you determine if your property is at risk. Your mortgage lender may insist you buy flood insurance if you are in a flood zone, but you should whether they insist or not.

Life Insurance

Whole life insurance is like having a savings account that you are forced to put money in each year. Its main function is to protect your family with a lump sum payment if you die prematurely. However, as long as you pay the premiums, the whole life also accumulates savings (building up a cash value) that you can withdraw at the end of the term. If you purchase a 20- or 30-year whole life policy for \$400,000 face value, at the end of 30 years, even if you have not died, you can withdraw the \$400,000. However, a whole life policy is not a good investment from an economic point of view. The insurance company takes your premiums and invests them, at 7% or 8% annual return. They offer you a guaranteed return on the policy of anywhere between 1.5% to 3% annual return and keep the difference. This is simply not a good deal for you.

Instead, you should purchase a term life policy. This does not build up cash value; rather, it is similar to auto and homeowner's insurance in that you are paying for coverage only against the event of your premature death. Because you are not building up cash value, term life insurance is inexpensive. The premium, of course, depends on your age and health, but the average national cost of a term life policy for a healthy 30-year-old male is \$26 per month for a \$500,000 policy. The policy premiums will likely increase every year, so be sure to shop around.

A 2020 report by McKinsey and Company showed that life insurance companies have suffered from a decade of declining profitability and growth. One major reason is that customers (and financial advisors) question the value of whole life insurance. McKinsey recommends several changes to revive insurance companies, including a more personal connection to customers and invention of new products, such as whole life policies that can be converted to long term nursing home care policies. We will have to wait and see.

Umbrella Personal Liability Policy

As your wealth increases, you have an economic incentive to protect it. The least expensive way to do this is by purchasing an umbrella personal liability policy. You likely will be carrying personal liability coverage of about \$250,000 total on your auto policy and on your homeowner's policy, but it is expensive to increase the limits on these policies. Instead, you can buy a \$1,000,000 umbrella policy for about \$200 per year. It will pay any excess claims above the limit of \$250,000 paid by your auto or homeowner's policy.

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