The Basics of Insurance Planning

Covering the risks

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Insurance is something none of like to deal with, but it is critical to cover risks that all of us face. In this paper I will discuss the basic purpose, cost, elements, and considerations of the main types of insurance coverage. It's also my personal belief insurance should be purchased almost solely to hedge against risk of loss, but more on that later.

Since insurance is generally purchased to hedge against risk of loss we should begin by identifying these risks which include:

- Property
- Liability
- Health & Dental
- Loss of income

Property

Property insurance is something we all understand. We obtain property insurance to protect our tangible assets against risk of loss. I often find that clients are either over or underinsured, however. You should review your policies annually to gain comfort that limits of your various policies are within reasonable proximity to the actual value of your property.

Some tangible property is not fully covered by the "blanket" coverage quoted on your policies. These would include items such as:

- Artwork
- Jewelry
- Collectibles
- Firearms

If you own these sorts of items you should begin by itemizing them and estimating their value. For items of relatively high value it's also prudent to periodically obtain professional appraisals. The result of itemizing and valuing your tangible property should be fully discussed with both your advisor and insurance agent.

In the event a property loss does occur, documentation of the property beforehand is extremely useful. This documentation should include an itemized list of your items containing descriptions, identifying marks (e.g., serial numbers), and valuations. A video recording of your personal items wouldn't hurt either. Once you have documented your items you will want to be sure to keep copies of this documentation both at your home and at another secure location such as a safe deposit box. Some insurance companies also offer to maintain a copy of this documentation for their customers.

Liability

Liability insurance is purchased to cover events which our actions (or inaction) may cause us to be found liable for physical and/or monetary damage realized by others. This damage could result from an auto accident, injury on our property, libel or slander, negligence, errors or omissions, director or officer activity, etc.

When examining the need for liability protection, we should begin by asking ourselves a few basic questions including:

- Do my children or I drive an automobile?
- Do I rent or own a home?
- Do I own a watercraft?
- Do I own a business and/or serve as a Director or Officer of any Boards?
- What is my net worth?
- Do I engage in any activity which causes me to be exposed to greater risk of being sued?
- Do I or my family members have a high profile in the community?

Once you have answered these basic questions you can begin to assess what sorts of liability issue could potentially exist.

Auto & Home

Most everyone will have the need for home (including renters) and auto insurance. Not only will these policies cover your potential property losses, but they will serve as the primary lines of liability coverage as well. Given the fact of high medical fees and court awards, it is prudent to purchase at least $300k of *liability* insurance on each of these policies.

Umbrella

What if the policy holder is sued for more than $300k? Enter the umbrella policy (aka excess policy). Umbrella policies generally cover most all potential damages to others (unless associated an act related to activity as an owner, director, or officer of a business). Umbrella coverage is not only important for protecting your wealth you have, but also to cover the wealth you may create or receive in the future. Umbrella coverage is also relatively inexpensive, so it’s a no brainer for most of us.

The question then becomes: “How much umbrella coverage do I need?” This is a very difficult question to answer, but you should begin by asking yourself the following questions:

- What is my net worth?
- What is my income and income potential?
- Do I or my family members have a high profile in the community that would cause them to believe a large settlement is possible?

Standard advice is to secure at least enough liability coverage to equal your net worth, and then bump that amount up depending on the other three basic considerations. I know it's not very scientific, but planning for the unknown can be more art than science.

Some would argue that having umbrella coverage increases the likelihood you will be sued. This may be the case, but I gain more comfort knowing the insurance company will very likely help defend my case than pain caused by thinking the existence of a policy might increase the likelihood of being sued. More likely than not, if your actions caused damage to someone else you will be sued one way or the other.

Recall that Auto & Home policies provide the *primary* line of defense. For example, if you are sued because of acts related to your auto, then that policy would likely be the first line of protection. If liability arises from acts not related to your auto, then your home policy would likely be the first line of defense.

Why not just purchase umbrella coverage and be done with it? The answer lies in the fact that umbrella coverage does not cover the first portion of liability (generally $300k). This is why it is important to have adequate liability coverage on your home and auto so there are no gaps in coverage between the underlying policies and the umbrella. Otherwise, you could be on the hook for the "gap" amount.

Special consideration should be made for watercraft and other vehicles which can create unique liability issues. These should be fully discussed with your advisor and the insurance agent. It's important to confirm that liability potentially caused by any these vehicles would be covered by your policies.

Liability caused through activity as an owner, director, or officer of a for-profit or nonprofit business entity is not covered by auto, home, or umbrella policies. If you are an owner of a company, you should discuss this thoroughly with the insurance agent. Similarly, these policies also do not cover liability arising from activity as a Director or Officer (D&O). If you are a Director or Officer you should request the business entity provide you with a copy of their D&O policy. If the business entity does not have a policy, you should encourage them to purchase one. If that fails you will either need to purchase your own policy, bear the risk of loss (which is not prudent!), or resign your post.

Health & Dental

WARNING: I'm about to say some things the reader may find disturbing.

Insurance is generally purchased to cover risks that we cannot afford to bear if they actually transpire. Health & dental coverage is interesting since they generally cover two types of expenses: expenses that *will* occur and those that *might* occur.

If a service provider knows their customers will incur certain costs every year, their premiums will reflect those certainties. This is the part of coverage I consider to be “prepaid expense”. Prepaid expenses include such things as prescriptions, check-ups, and dental cleaning. You’re going to incur these costs with or without coverage and the insurance companies know this.

Granted, you may receive a discount on these prepaid items by having coverage, but these discounts need to be weighed against the cost of the prepaid expense assuming you were to pay for them on your own. This is accomplished by getting quotes for various levels of deductibles, and then comparing these quotes to what is anticipated to be your actual cost of these expenses should you pay them on your own. Simply put, a higher deductible may be economically more advantageous than a lower one.

If you have medical and/or dental coverage through your employer, this will probably not be as much of an issue. If you don’t have employer provided coverage, you should develop a process to properly weigh the pros and cons of each alternative. The ending result should be to obtain economically efficient coverage that provides assurance an unpredictable event will not cause financial ruin. If coverage comes with a “prepaid expense” benefit that makes economic sense, great. Just be sure to properly analyze what you are paying for.

(Note: taking care of our physical and mental selves is also a form of insurance which I highly recommend!)

Loss of income

Injury and death are also risks that can potentially cause extreme financial hardship. In order to properly hedge against these risks, the main policies are:

- Disability
- Life

Disability

Loss due to disability is far more likely than loss due to death, but it’s seldom considered. This loss occurs when a worker is no longer able to earn the same level of income due to an injury.

When seeking alternatives for disability coverage, the following issues are the main ones to consider:

- Waiting period before benefits are paid
- Level of benefits (usually a percentage of earnings)
- Amount of time benefits will be paid
- Whether coverage is for your *own* occupation or *any* occupation

Each of these characteristics is extremely important to understand before obtaining coverage.

Life
Life insurance is sometimes obtained to provide estate liquidity, but generally the main goal is to insure against the risk of losing a person's household contribution.

You will notice that I used the word "contribution" and not "income". Though we certainly should insure against losing income, also important is the nonmonetary contribution someone bring to the household. The perfect example is a stay at home parent whose work and diligence would need to be replaced should something happen to them.

Once we have quantified a person's annual contribution to the household we can assess the level of coverage we require. Adequate coverage generally lasts until children have grown and/or the survivor believes they will be able to fully support the household without the deceased person's contribution.

Unless a policy is purchased for the purpose of providing estate liquidity, it generally does not make sense to purchase anything other than a term life policy. I will cover this next.

Life Coverage: Insurance or investment?

When purchasing life insurance it's critical to know there may be two separate components to the policy: insurance and investment.

The two main categories of life insurance are:

- Whole life
- Term life

Whole life policies generally provide coverage throughout a person's life, and then pay out upon their eventually demise. Since insurance companies *know* they will eventually have to pay, they will set the premiums accordingly. That is, they will set the premiums as though they are prepaid expenses. This causes whole life policies to be quite expensive since the insured is buying insurance against an untimely death and a prepaid expense that will eventually be paid.

To make whole life policies more attractive, insurance companies will add an investment component. Though this investment component varies greatly from policy to policy, they all tend to be quite expensive compared to investments that could be made outside a life policy. Insurance agents are not deterred by this since they know most investors will have a difficult time evaluating their alternatives given the complex nature of these products, but it is critical you thoroughly review the alternatives.

I prefer "term" policies. Term policies generally provide a constant level of premiums, coverage amount, and duration. These policies are pure insurance; easy to compare and evaluate; premiums tend to be relatively inexpensive; and policies can be dropped if they are no longer needed.

In my experience I have yet to discover one instance where an investor was better off by purchasing a whole life policy versus a term policy plus an outright investment. I suggest you do your homework.

Summary

The main purpose of insurance is to hedge against risk of loss that would cause financial devastation. We should evaluate our risk and insurable property to understand what needs to be insured and what does not. With that understanding we can then evaluate alternative solutions while realizing some may contain components of prepaid expenses and/or investment qualities. If alternatives do have these additional qualities, those qualities should be thoroughly evaluated against the additional costs and benefits they provide.

None of us likes to think about insurance, but if an unlikely event does occur it can be financially devastating. The purpose of purchasing insurance is to hedge against these risks while not paying for products we do not need.