Financial Advisory

How Insurance Works

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My financial advisory practice focuses on hard assets that create tax advantages. As part of my practice, I have an insurance license and occasionally use it to help clients buy life insurance products. I often walk my clients through a brief "How Insurance Works" talk because I think it helps them to better understand insurance products and, therefore, gives them the ability to make more confident decisions. I think that my readers, too, could benefit from such a discussion. After all - we all have insurance. Do we understand how it really works?

SHARING RISK – THE BASIC CONCEPT BEHIND INSURANCE

I will explain the basic concept of insurance by using an example that was taught to me back in the 1990's. Back in the early 20th century, let's say that there was a collective of 100 farmers in the Midwest. Farming was (and still is) a tough way to make a living: a family lived for an entire year on the crops that they harvested, brought to market and sold once per year. Through the years, these growers observed that 1 out of every 100 of them would experience a crop failure in a given year; that their odds of catastrophe were about 1%. If that year's harvest was a failure, the family would have no income for the year and would be ruined financially. These 100 families could form a group and agree to "take care of" any farmers who experienced a crop failure. Every year, each family could provide 1/100th of their income to a family (or families) that were in need, if necessary. The injured family would then receive 99% of their customary income and would be able to pay their bills.

This is really a simplified example of how modern insurance works. When I buy homeowner's insurance: I, along with thousands of other homeowners, will send in our premiums. The insurance company will gather all of this money into a "basket" for the benefit of all the insured. If someone in this group experiences a loss, (or a casualty, in insurance terms), the insurer will pay for that loss out of the basket of money that has been collected. If the insurer has calculated probabilities correctly, there will be enough money in "the basket" to pay all casualties and still leave a profit for the insurer.

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A WAY TO CHEAPLY INSURE AGAINST A LOW PROBABILITY, BUT CATASTROPHIC, RISKS

What is the chance that a given house will burn down this year? Very small. The effects of a house burning down, however, can be catastrophic – this may represent a financial loss that the home's owner could not recover from: a sizeable portion of their net worth has just "gone up in smoke." Additionally – the home probably has a loan on it, and that resident's lender is not likely to say "Oh, your house burned down? We forgive the hundreds of thousands of dollars that you owe us." Not likely, indeed! (This is why all lenders require borrowers to carry insurance.)

Let's say that the man in our example owns a property that is worth close to $600,000, and that it would cost about $500,000 to rebuild the home on it if a total loss was suffered. That man could see $500 per year as a fair price to pay in order to avoid a potential total loss.

The insurer in this example could be selling 1 million home owner insurance policies annually. How many homes in 1 million will suffer a loss in a given year? Not a huge number, and I think that the $500 million in premiums received is enough to cover it and provide a healthy profit for the insurer.

INSURANCE IS BOUGHT TO SOLVE A PROBLEM

What if I need to move to a nursing home? How will my heirs pay estate taxes? (if any?) How can I provide liquidity in my estate?

My tax-advantaged investment clients are usually looking at life insurance to solve a potential problem with their estate. What if I or my spouse need to move into a nursing home? A Long-Term Care Policy would pay expenses for a senior who needed such a facility, and some will even refund all the premiums if it is not used. Term life insurance policies can be used as part of estate planning to pay potential estate taxes, or to provide liquidity for heirs. (Your children would love to inherit your apartment properties, but perhaps some of them may need cash now, too – for things like your grandkids' college funds.)

Insurance is really just a way to pay someone else to take a risk for you. This somebody, the insurance company, will take enough payments from enough people that they will be able to pay for any casualties that result. Consumers can therefore rest easy without the fear of financial ruin if something terrible were to happen. If you have any questions, please call my office at (877) 313-1868.

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