Risk Management

What is it?

Introduction to risk

Before you can participate in the complex risk-management process, you need to have a general understanding of the concept of risk itself. In very broad terms, risk is the possibility of harm, injury, loss, danger, or destruction. Risk can be further subdivided into two basic types: speculative risk and pure risk. Speculative risk has the potential for either gain or loss, much like the financial risks you assume when you put your money into certain investments. Pure risk, on the other hand, has no potential for gain; it can only result in loss or no loss. Most of the risks to which you are exposed in your life are pure risks. An example would be the risk of an accident each time you drive your car. The worst possible outcome is that you will be involved in an accident, while the best-case scenario is simply that you will have an uneventful, accident-free trip.

All pure risks exist because of various dangers known as perils. Perils are the actual, direct causes of loss and include death, disability, illness, fire, theft, and accident, among other things. In contrast, hazards are acts or conditions that could increase either the severity of a loss or the chances of a loss happening in the first place. A simple example will illustrate the distinction between a risk and a hazard:

> **Example(s):** Say you leave a cigarette burning in your living room. It falls to the floor, the rug catches fire, and your house (along with all the property in it) goes up in flames. Fire was the peril that directly caused the loss in this case, while the unattended cigarette was the hazard that increased the likelihood of a fire occurring.

Why should you manage your risks?

The combination of perils and hazards creates risks to which you are vulnerable every day of your life. These range in severity from your risk of dying to something as minor as your risk of coming down with a common flu bug. They also vary in likelihood from high-frequency to low-frequency risks. Your chances of getting the flu at some point in your life are obviously much greater than your chances of perishing in an airplane tragedy. But whatever its likelihood or possible severity, every risk carries the potential for some type and degree of loss. If you don't have medical insurance, even the risk of the flu can produce financial losses in the form of such expenses as doctors' visits and prescription drugs.

In effect, if you want to minimize the losses associated with different kinds of risks, you need to develop a plan for dealing with risk. This plan should treat each specific risk you face on an individual basis while simultaneously addressing them all together as a total package of risks. This is where risk management comes into play.

> **Tip:** You should pursue a plan of risk management with the help of additional resources. These may include qualified professionals such as a financial planner, an insurance specialist, a CPA, and/or a property casualty expert.

Objective of risk management

Given the number and variety of risks that exist in the everyday world, the basic objective of risk management should be fairly obvious. Risk management is simply intended to combat the risks you face in your life and, in so doing, to minimize the financial and other losses potentially associated with those risks.

Risk-management process

Basic mechanics

In general terms, the risk-management process involves taking steps to cope with risk and thereby to minimize losses. If you want to undertake a comprehensive plan of risk management, here are the basic steps you should follow:

- Identify and evaluate the various risks to which you are exposed in your life
- Identify and evaluate the potential losses associated with each particular risk
- Formulate and map out a strategy or set of strategies for dealing with the risks/losses you've identified, both individually and collectively
- Put the strategy(ies) into action
- Periodically review the plan you've set up and, where appropriate, make changes to it as your circumstances change

Not surprisingly, these steps toward personal risk management are very similar to the steps that risk experts take in an effort to manage risk for major corporations. If you follow them properly, you are well on your way to achieving the basic objective of risk management.

Use additional resources to help you with the process

Unlike a large corporation, you probably won't have a personal risk manager. Instead, you may hire qualified professionals, such as a financial planner and an insurance agent, to assist you with the overall risk-management process. These professionals will examine your age, occupation, financial situation, and lifestyle to determine what types of risks and losses you face in your life.

They will also take into account the probability that a given risk will materialize, the severity of the risk, and the size of the potential losses. Based on these findings, they will help you develop and implement the particular method or set of methods that seems most appropriate for managing your risks. Specific risk-management strategies they may suggest include risk avoidance, risk retention, and risk transfer, among others. For more information on each of these strategies, see the discussion below on selecting techniques for treating potential losses. They will also help you monitor your risk-management plan and decide when changes seem necessary.

> **Tip:** No matter how you look at it, risk management is a lengthy and involved process. As you go through the process, remember that your life and the risks that come with it are unique. With this in mind, one of the most important rules of risk management is to make sure that your plan is specifically tailored to your individual circumstances.

Identifying potential risks and losses

The first step of the risk-management process is to identify the various risks you face and the potential losses that may result from them. Unfortunately, this is not as easy as it sounds. With the help of your additional resources, you must collect and analyze information on your assets (your investments and real estate, for example), your liabilities (your outstanding debts), your salary and other sources of income, and your age and health, among many other things. This kind of data-gathering allows you to zero in on some of the major areas that need to be addressed. You can start by identifying obvious risks (such as death, illness, fire, theft, and loss of a job) and determine what financial losses you and/or your loved ones would suffer in each case.

Some important considerations for identifying risks and potential losses include your lifestyle, your existing insurance, and your relationship with your advisor(s).

Lifestyle

In terms of lifestyle, if you participate in dangerous activities such as hang gliding or mountain climbing, you are exposing yourself to risks that most of us don't have. Since these activities put you at increased risk for injury and premature death, you need to be especially concerned about the financial losses for your dependents if something happened to you. Other lifestyle issues that may raise similar concerns include smoking, alcohol consumption, and occupational hazards.

Existing insurance

Your existing insurance may make it easy to pinpoint the areas where you're vulnerable to loss and other areas where you're not. Insurance is specifically designed to safeguard you against the risk of loss. Assuming you have carefully chosen the type(s), coverage and amount(s) of insurance you need, you may already have enough protection against certain kinds of losses. If so, your chance of loss in those areas is minimal, so you can forget about them and move on to other areas, if any, where your protection is not as adequate. Let's say you have $500,000 of life insurance coverage but no health insurance. While you may not need to worry about how your family will get by if you prematurely die, you should consider how you'll pay the medical bills if you're suddenly stricken with a serious illness that's expected to drag on for years.

Advisor relationship(s)

Equally important in identifying potential risks and losses is your relationship with your financial planner and any other advisors whose aid you have enlisted. The reason is simply that the better you and your advisor know each other, the more familiar he or she will be with your finances, lifestyle, and other circumstances. This greater familiarity will make it easier for your advisor to identify the risks and potential losses that apply to your situation. It should also make for a more comfortable relationship that will allow the two of you to candidly discuss particularly sensitive matters (e.g., your spouse's aversion to handling money) that might come into play at this stage of the risk-management process.

Evaluating risks and potential losses

When you've identified all the risks and potential losses that apply to you, you should evaluate them. That is, you need to assess each risk/loss in terms of its potential severity as well as its potential frequency or likelihood of occurrence. For example, even though the potential losses resulting from an earthquake would probably be far more severe than the losses associated with a shattered car windshield, you may opt to have glass coverage on your auto insurance but no earthquake coverage on your homeowners insurance. Particularly if you live in an area where earthquakes rarely occur, you might base these decisions on the fact that the probability of damage to your car windshield is much higher than the probability of earthquake damage to your home. Of course, other types of risks with the potential for high-severity losses may be evaluated very differently than earthquakes based on the greater likelihood that they will occur.

If you want a more sophisticated method, your advisor may be able to suggest a system you can use to quantitatively evaluate your exposure in different areas. Such a system may allow you to classify your potential losses into specific categories (e.g., very critical, critical, moderately critical). In any case, however you do it, you need to somehow evaluate your potential losses before you can forge ahead with the risk-management process. Only when you've understood, assessed, and prioritized each of your risks can you develop a comprehensive set of strategies for managing all of them.

Selecting techniques for treating potential losses

Now you're ready to decide exactly how you're going to deal with your risks and minimize your potential losses. There are a variety of strategies available for this purpose, some or all of which may be appropriate in your case. While some people rely on just one strategy to the exclusion of all others, most use a combination of risk-management techniques. The particular formula that works best for you will depend on your individual circumstances.

Avoidance

Some people choose to avoid certain types of risks altogether. That is, they remove the possibility of losses associated with a given risk by not exposing themselves to that risk. In general, this strategy is appropriate for certain risks that are both high frequency and high severity. With hang gliding, for instance, both the frequency of accidents and the severity of the accidents that occur are high. Thus, the best course of action if you want to ensure that you don't die or suffer injury while hang gliding is nonaction. In other words, don't hang glide and thereby avoid all the attendant risks. The tradeoff of risk avoidance is that it usually requires that you give up something. In the case of hang gliding, avoidance means that you sacrifice the thrill of the sport for the physical safety of your life.

Because it's not an appropriate strategy for dealing with most of the risks that we face, risk avoidance is rarely a big part of any risk-management program. For example, if you want to ensure that you will never suffer financial loss from a car accident, you could avoid the risk by never driving a car. While this certainly would eliminate the possibility of loss, it's clearly not a viable option for those of us who must drive in order to function on a daily basis. That's why most of us take out auto insurance to combat the financial risks associated with driving.

Retention

With certain types of risks, some people opt to retain or just live with the risk rather than take steps to deal with it. This strategy is generally appropriate for risks that occur frequently but are of low severity. Such risks are usually difficult to protect against through insurance because of the high cost of handling frequent claims. Beyond that, even if you could obtain insurance coverage for these high-frequency, low-severity losses, it would probably be unwise to do so because the cost of paying for the insurance would likely exceed the cost of paying out-of-pocket for the losses yourself.

> **Example(s):** Consider your risk of getting a flat tire while driving. This is something that happens to everyone, but it usually does not produce devastating financial losses when it occurs. Most insurance companies will not cover you for this event as part of your auto insurance policy because they would be inundated with claims from countless policyholders who had flat tires.
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> **Example(s):** Moreover, they would probably charge you so much for this additional coverage that it would end up being cheaper for you to just pay as you go for each flat tire. In other words, live with the risk. Risks such as these can't be avoided or transferred to an insurance company. Other risks that can't be transferred or shared must be retained if you choose not to avoid them (even though you could avoid them if you wanted to). If you go hang gliding in spite of the dangers involved, you have made a conscious decision to live with the risks associated with that particular activity.

Other types of risks simply cannot be reasonably retained. These are the ones that should probably be transferred to an insurance company. For instance, the risk of premature death, though not likely, is something that you would probably be foolish to try and live with, especially if you have dependents whose long-term financial security is important to you. As a result, this risk generally calls for life insurance or other risk-management measures.

Noninsurance transfers

Risk transfer is one of the fundamental principles underlying insurance (see Transfer Risk to Insurance Company). There are also ways to transfer your risk that have nothing to do with insurance. Examples may include a rental agreement between you (the tenant) and a landlord, a service contract beyond the warranty period on a car or other item, and various other contractual arrangements.

In reality, it's impossible to completely remove a risk by transferring it to someone or something else. Risk transfer can actually be thought of as risk pooling, since what you're really doing is shifting some of the risk by sharing it with an entity or other individuals. Depending on your willingness to assume certain kinds of risks, this may be the best available strategy in some cases. Take the rental agreement, for example. If you're uncomfortable with the financial risks that come with owning your own home, such as the potential for property damage expenses, renting enables you to transfer most of that risk to the landlord who owns the property you are leasing. The risk itself still exists, but most of it has been shifted to someone else. You are clearly not totally free of risk, since you would be financially liable for any property damage you caused, but everything else would generally be the responsibility of the landlord.

Loss control

Loss control, as opposed to loss prevention, refers to measures aimed at minimizing the severity of losses if they should occur. This could mean simply relocating your valuables from your home to a safety deposit box at a bank to minimize any losses that could result in your home from fire or theft. You may still suffer some financial loss if your home burns down or if thieves burglarize it, particularly if you don't have homeowners insurance, but those losses will be less severe than if you hadn't moved some of your belongings. With your investment portfolio, one loss-control measure you can implement is to shift some of your assets from volatile, aggressive stock funds to less risky Treasury securities. If the stock market takes a huge plunge, you will have reduced the size of your financial loss. From an insurance company's standpoint, one noteworthy example of loss control is the stop-loss provision that governs many health insurance policies. If included in your policy, this provision allows the insurance company to refuse to cover your total medical bills beyond a specified maximum dollar amount.

Besides minimizing the size of losses, another way you can control them is by minimizing the chances that a given peril will occur. For instance, if you want to reduce the possibility of a fire destroying your home, one loss-control measure you can implement is to quit smoking or install smoke alarms in your home. Unfortunately, because the direct benefits of loss-control methods are often difficult to measure, they are not as widely used as insurance and other risk-management techniques. However, loss control can be very effective when used in combination with other strategies. Beyond that, the law in some situations mandates loss-control measures that might not otherwise be justified on a pure cost-benefit basis. This is true, for example, in the case of federal legislation that requires employers to incur expenses for certain loss-control measures pertaining to job safety.

Insurance

Insurance is by far the most common and generally the best strategy for managing your risks and losses. It's no coincidence that so many people have life, health, auto, and homeowners insurance. By weighing the price of protection against the potential benefits--not to mention peace of mind--most people conclude that insurance offers the most effective, cost-efficient way to cope with risk and guard against financial loss. No one likes to pay insurance premiums, but the cost will be well worth it if the covered loss actually occurs and the company comes through with a large amount of money when you need it.

When you buy insurance from an insurance company, you are essentially entering into a contract with that company. You pay premiums and, in return, the company agrees to indemnify or cover you for specified losses. If you take out auto insurance, for example, your company may provide financial coverage (according to the terms of the policy) for any medical expenses and property damage resulting from a car accident that involves you. In general, you are free to cancel the contract any time you choose. You simply stop paying the premiums, and your company will not cover you anymore if something happens. However, the company will generally be obligated to cover you for the term of the contract as long as you keep paying your premiums on time. The basis of the insurance contract is the principle of risk transfer (see Transfer Risk to Insurance Company).

You reduce your individual risk of loss by shifting part of it to your company and sharing it with numerous other policyholders covered by the same company. This way, you receive protection against risks that you would probably not be able to cope with by yourself. Your company also benefits in that it takes advantage of risk pooling and the law of averages to generate more money than it pays out in claims. Insurance is not, however, the solution to every problem that involves risk. In fact, strange as it may sound, insurance is generally not the appropriate strategy for many kinds of high-frequency, low-severity risks or losses. The greater the probability of loss, the higher the average loss per insured and the higher each policyholder's premium will be. Thus, if the risk in question produces minimal losses each time it occurs, it may be cheaper and smarter to pay out-of-pocket for these losses yourself on an occurrence basis rather than to shell out a lot of money for an expensive insurance policy. In contrast, insurance is perfect for most low-frequency, high-severity risks or losses such as death and terminal illness. Because the likelihood of the covered event occurring is so low, the cost of the insurance is correspondingly lower. At the same time, the potential benefit is great, and generally exceeds the protection that any other risk-management strategy could provide for these kinds of losses.

> **Tip:** If you are considering insurance, there are specific considerations you should understand for each different kind of insurance. For more information, see our discussions of Life Insurance, Health Insurance, Disability Insurance, and various types of Property and Casualty and Liability Insurance.

Risk management and insurance

If you're reading this, you've probably already decided that you need one or more types of insurance. If so, there are some basic steps you should follow to properly design and monitor your insurance portfolio.

Selection of insurance coverages

Your first step is to decide what type(s) of insurance you want based on the kinds of risks or losses you want to guard against. This is relatively easy for the average person because most of us have the same basic protection needs. You will probably conclude that you should have life, disability, health, homeowners, and automobile insurance. There will be exceptions to this general rule, of course. You probably don't need auto insurance if you don't drive, just as you won't need homeowners insurance if you don't own your own home (although you may need renter's insurance if you rent). You may even be in a position to forgo life insurance if you have sufficient resources to self-insure. On the other hand, you may determine that you need other forms of insurance above and beyond the four basic types. This may include, among others, personal liability insurance (also called an umbrella policy).

Whatever types of insurance you choose to have, the process of building an insurance program becomes more involved when you've made those decisions. Now you must select the right type and amount of coverage within each category of insurance. With homeowners insurance, for example, you must decide what property items (e.g., jewelry and antiques) you want covered besides your home itself and what particular perils (e.g., fire and floods) you want to guard against. In addition, based on the value of the covered property, you'll need to determine an appropriate coverage level or maximum dollar amount up to which your insurance company will cover you for financial losses. Keep in mind that there may be separate coverage limits for specific types of property and perils. You can follow the same general guidelines with auto insurance. Here it's particularly important to select appropriate coverage levels for medical expenses and property damage resulting from collisions. Beyond that, determine what else you want covered (e.g., theft, vandalism, glass, towing and rental) and up to what amount(s).

With life insurance, the process can be considerably more involved than with other kinds of insurance because there are so many factors to consider when choosing the best policy with the right type and level of coverage. Among other things, you need to take into account your age and health, your occupation, your current income, the value of your assets, your family make-up, and anticipated future expenses. You may even need to employ complex mathematical formulas to help you arrive at an appropriate coverage level figure. For more information to help you with life insurance, see Evaluation and Comparison Methods, Policy Types, and Determining the Need for Life Insurance: How Much Is Enough?.

> **Tip:** With all types of insurance, particularly life insurance, you should consult additional resources to help you select the appropriate type(s) and amount(s) of coverage.

Selection of an insurer

One of the most important parts of building and managing your insurance program is selecting the right insurer. While you can obtain insurance from other sources, including private associations and the federal government, the vast majority of people get their insurance by purchasing it from one or more insurance companies. Whatever type of insurance we're talking about, choosing a good company takes time and effort. You will have to do some research and consult outside resources, such as your financial planner, to help you make the right choice. While many companies offer multi-policy discounts if you have more than one policy with them, don't be surprised if you find that you need different companies for different types of insurance. A company that specializes primarily in life insurance may not be your best choice for auto or homeowners insurance.

The criteria that you use to select an insurer can be both qualitative and quantitative. Qualitative information may include word-of-mouth references as well as articles and other written resources that evaluate the company. These reports may be based on the company's reputation for quality products and strong customer service. If you want more concrete information, you can obtain quantitative data, such as figures on sales and earnings, from the company's annual report and other published documents. You can also obtain a rating of the company from a respected ratings service organization. These ratings are based on such factors as the company's record of meeting its projected dividends and the number of policies terminated or retained in a given year (this is called a "lapse ratio"). A low lapse rate reflects a higher consumer retention of the company's products.

> **Tip:** Much of this information is free at your local library. Finally, and most obviously, base your choice largely on whether a company can offer you the best policy for your money and your needs.

Negotiation of terms

An insurance policy is a contract between you and your insurer. You pay premiums, and your company agrees to cover you for certain types of financial losses. The insurance contract differs from most contracts, however, in that you can just terminate it (cancel the policy) at will. You can simply stop paying the premiums without having to worry about any legal ramifications or other adverse consequences (except, of course, the loss of coverage).

Another important difference is that, unlike a typical contract, the purchase of an insurance policy generally does not involve any negotiations over the terms of the contract. If you are about to enter into a verbal or written contract with a carpenter to perform a certain job, there will likely be flexibility as far as the price of the work to be done. You and the carpenter negotiate back and forth until you settle on a price that's agreeable to both of you; only then will the price be included in the contract and written in stone. With an insurance policy, there is no negotiating. An insurance company typically writes and then offers to the public different kinds of policies, each of which provides for a specified type and amount of coverage. Moreover, each policy will be available to you at a specified preset price. Both the price and the terms of the policy are generally non-negotiable. You either accept the policy as offered by the company and purchase it, or you reject it and continue shopping around. With most policies, however, you do have the option of modifying the policy to tailor it to your needs. For example, you can usually add life insurance coverage (through riders and endorsements) and raise your coverage level for an extra cost. For more information, see Life Insurance Provisions, Options, and Riders.

> **Caution:** Keep in mind that while your annual premium will probably be fixed when you initially purchase your policy, it may fluctuate from one year to the next.

Periodic review of insurance program

Building an insurance program that fits your needs and circumstances can be difficult enough. But even after you've completed that stage of the process, there's still more work to do. Specifically, you'll need to periodically review your insurance program to make sure it's still right for you. You can do this as often as you like, although once a year is a good guideline, with the help of your financial planner, insurance agent, and other resources.

Review both your insurance companies and the specific policies with each company. Ask yourself whether the factors that induced you to choose the company are still in place. Does the company still enjoy a solid reputation as a leader and innovator in the insurance industry? What has happened to its quality rating since you first obtained a rating? A dip in its rating could indicate that the company is experiencing financial troubles or, in the case of life insurance companies, that their mortality assumptions proved to be wrong.

A more subjective measure will be the extent to which you have been satisfied with the company's level of customer service. With policies, you need to look at more specific factors. You should take into account any changes in the policy itself as well as any changes in your own circumstances. The most common policy consideration will be the premium that may fluctuate widely from one year to another for a variety of reasons. If a jump in the premium puts a policy beyond your budget, you may have a problem. Consider whether certain financial changes, such as a drop in income, affect your ability to afford a given policy.

Beyond that, examine any changes in your coverage needs for each type of insurance you have. With life insurance, for example, a substantial increase in the value of your assets may warrant a reevaluation in that area, particularly your coverage level (see Replacement and Conservation Considerations).

For other types of insurance, relevant changes may include trading in your old car for a new one, adding a garage or other structure to your house, and being diagnosed with a chronic illness. These are just a few of the things to consider when you conduct a thorough review of all the different parts of your insurance portfolio.

> **Tip:** Based on the results of your review, you may decide to make changes to your insurance program in one or more areas. These may include replacing a policy, changing the coverage level on an existing policy, or modifying an existing policy in other ways. Or you may decide to just leave all or most of the program as is. For more information, consult additional resources and see our separate discussions of each type of insurance.

Insurable interest

What is it?

The doctrine of insurable interest is an important legal concept underlying all insurance policies. Basically, this doctrine states that an insurance contract is legally binding only if the insured has an interest in the subject matter of the insurance and this interest is in fact insurable. The subject matter in question may be a home, a car, or a person's life, among other things.

Generally, an insurable interest exists only if the insured would suffer a financial loss in the event of damage to or destruction of the subject matter of the insurance. More precisely, an insurable interest involves a specific kind of relationship between you--the person taking out the insurance--and the "thing" being insured. There must be a reasonable expectation that under normal circumstances you would somehow benefit from the subject matter of the insurance and that you would incur a loss of some sort without that subject matter.

Why do we need it?

The doctrine of insurable interest was developed largely to safeguard against people trying to take advantage of insurance policies. It ensures that people can't profit from insurance or use insurance for morally questionable purposes. For example, you can't take out a homeowners policy on your neighbor's house because, from an insurance standpoint, you don't have an insurable interest in that property. Without the doctrine of insurable interest, you would be able to purchase insurance on your neighbor's home, vandalize the property when no one was home, and then collect money from the insurance company for damages that you caused. You would, in effect, be profiting from the arrangement. For similar reasons, you can't take out a life insurance policy on your neighbor or someone else in whose life you have no insurable interest.

How do you determine insurable interest?

The first requirement is that the subject matter be insurable. While your home and car will be insurable in most cases, your life may not be, depending on your age, health, and other factors.

After you've determined insurability, exactly what constitutes insurable interest depends on the particular kind of insurance. To illustrate this point, consider one major type of insurance: property/casualty/liability insurance.

Here, insurable interest is based on a financial relationship between you--the insured--and the property in question. Ownership obviously fits this description. If you own a house or a car, you have an insurable interest in that possession because damage to or loss of it would result in a financial setback to you. Someone can also have an insurable interest in property of this type without actually owning it. For example, if you use your home as collateral for a bank loan, your lender may have an insurable interest in the home.

With life insurance, insurable interest may be based on other factors as well. Here, a relationship based on love and affection may be sufficient to establish insurable interest even if the possibility of financial loss does not exist. Thus, you have an insurable interest in your spouse's life and can take out life insurance on that person even if he or she doesn't work and you would suffer no financial loss if your spouse died. On the other hand, if your spouse is the sole breadwinner in your house, the death of that person could be financially devastating to you. In this case, your insurable interest in your spouse is both economic and emotional. In general, the relationships that can qualify for insurable interest without the possibility of financial loss are limited to close relationships, such as husband-wife and parent-child. For further information, see Determining Insurable Interest.

Understanding the underwriting process

Underwriting in general

Underwriting is the process of selecting and classifying exposures. More specifically, it's the process by which an insurance company gathers and analyzes data to evaluate an application for insurance. Based on its findings, the company may reject the application or decide to offer the applicant the desired insurance at a specified price. In effect, the purpose of the process is to weed out applicants the company is unwilling to insure because of certain risk factors. However, it doesn't always come down to the two extremes of coverage versus no coverage. While insurance companies will generally not cover risks they view as severe based on their own claims experiences, they may agree to provide high-risk coverage at correspondingly higher rates. These higher rates are calculated based on actuarial data.

While you will usually qualify for automobile and homeowners insurance, you may not under certain conditions. For example, in some states, a company may be able to deny you auto insurance if you have a history of drunk driving or moving violations. More often, the results of the underwriting process will prove to be a deciding factor in the areas of health insurance and particularly life insurance. In many cases, these results can be an obstacle that prevents you from obtaining the insurance you desire.

Take life insurance. If you have a serious medical condition, work in a hazardous field like law enforcement, and participate in dangerous recreational activities like hang gliding, a company may refuse to sell you life insurance when they discover these important facts about you. The best-case scenario is that if they do agree to sell you life insurance, it would be at an above-standard rate.

On the other hand, if you are a young, healthy individual whose exposure to risk is relatively low, the outcome of the underwriting process may have no affect on your chances of getting life insurance. It all comes down to the fact that insurance companies want to avoid high-risk situations or at least charge more to cover those situations. This is simply because they want to minimize their financial losses and maximize their profits.

After all, they are a business like any other. However, the point is not to avoid all applications viewed as risky. That would be impossible anyway. The point is not to have a disproportionate number of high-risk insureds who will collectively increase the likelihood of substantial claims payments on the part of the company. Clearly, the underwriting process requires considerable time and effort on the part of an insurance company. After all, it has to perform extensive research in order to collect and analyze information on the health, lifestyle, occupational hazards, and other risk factors of each insurance applicant. The sources that an insurance company uses to conduct the underwriting process may include one or more of the following:

- Information from the person's application for insurance
- Information from the person's insurance agent and/or financial planner
- Investigations into the person's background, lifestyle, etc.
- Information bureaus (see Medical Information Bureau below)
- Physical examinations of the person

Financial underwriting requirements

Financial underwriting is one part of the overall underwriting process. It involves determining whether the amount of coverage provided by an insurance policy bears a reasonable relationship to the financial setback the insured would suffer if the subject matter of the insurance was lost or damaged. In other words, financial underwriting attempts to answer this question: Is coverage in the form of potential claims payments appropriate in light of potential losses? This prevents the insured from profiting from the insurance contract beyond financial losses actually incurred.

> **Example(s):** Say you own a home with a value (including the value of your other belongings inside the house) around $300,000 and you want a homeowners policy with coverage of $1.5 million. Through financial underwriting, the company would determine that $1.5 million is not an appropriate coverage amount because if your home and all its contents burned to the ground, you would receive $1.2 million in profit over your actual losses ($300,000). In effect, the company would probably require you to settle for a policy with a lower coverage level that is more proportionate to the size of your potential losses.

Similarly, with life insurance, you will generally not be able to obtain a policy with a coverage level that vastly exceeds the financial losses your dependents would suffer in the event of your premature death.

> **Example(s):** Say you earn $25,000 a year and want to purchase a life insurance policy with a coverage level of $1 million so as to provide ample resources for your spouse if you meet with an untimely end. In all likelihood, you will have to settle for a lower coverage amount. This is because $1 million would probably be far beyond the amount of money your spouse would need to carry on if he or she no longer had your salary as a source of income. You may be able to (and indeed probably should) obtain coverage in excess of your $25,000 salary, but $1 million would almost certainly be out of the question. There must be at least some relationship between coverage and projected losses. Financial underwriting ensures that such a relationship exists.

The MIB Group

What is it?

The MIB Group (formerly, the Medical Information Bureau) is a nonprofit information agency that is supported by the insurance industry. Many insurance companies rely on the MIB to provide data they can use to determine whether or not an applicant is insurable for life and/or health insurance.

How does the MIB operate?

The main purpose of the MIB is to assist insurance companies in uncovering the misrepresentations and fraudulent actions of people who apply for insurance. Once an MIB member insurance company finds a health problem or impairment in an applicant, it is required to report its findings to the MIB in the form of a code number. The MIB then includes the information it receives about the applicant in its centralized files along with similar types of information on the medical conditions of other people who have applied for insurance with member companies. Working together in this systematic fashion, the MIB and its member companies can more easily investigate those applicants who try to obtain insurance for which they would not qualify under normal circumstances. This arrangement benefits you, the consumer, as well as the member companies, enabling both sides to save money in the long run.

The MIB does not, however, keep records of legal and other actions taken by member insurance companies against fraudulent applicants. Moreover, the MIB is required to respect the privacy of each insurance applicant at all times. The MIB requires each member insurance company to take the following steps when dealing with an applicant for insurance:

- Provide written notice to the applicant that the company may report its health findings to the MIB
- Provide notice that an application for coverage with another MIB company or a claim for benefits may be cause for the MIB to release any relevant information it has on file
- Obtain authorization from the applicant for the MIB to disclose any relevant information to other member companies
- On the applicant's written request, provide the applicant with any relevant information the company has on file about him or her. Such information would be released to the applicant's physician rather than directly to the applicant. The applicant can then contact his or her physician to obtain the information.

Implementing the risk-management program

So you've done your homework, weighed and evaluated all your options, and developed a comprehensive plan of attack for risk management. Now it's time to act. Implementing the risk-management program involves putting into practice the risk-management strategies and techniques you have determined are appropriate for you.

If you have decided you need certain kinds of insurance, enacting that part of your program simply means purchasing policies that meet the criteria you have established for each type of insurance. If you want to implement the risk avoidance part of your program, you may have to refrain altogether from the dangerous activities (such as hang gliding) that you decided were exposing you to excessive risk of bodily harm or death. If you want to implement a property rental agreement, which is one form of noninsurance risk transfer, you just find an apartment or other dwelling you want to rent, sign the lease, and move in. You get the idea. It's just a matter of translating the different parts of the plan you've mapped out from paper into action.

> **Tip:** Make sure that you enlist the aid of qualified professionals to help you implement your risk-management program.

Periodic review and evaluation

Every so often, perhaps once a year, you should review and evaluate all aspects of your risk-management program to make sure it still suits your personal situation. If all the factors that led to the creation of your plan are still in place, it may be best to just leave the program as is. However, if any of your various circumstances have changed dramatically since you first implemented your program, it may be necessary to overhaul the program or at least modify it. Some of the many changes that might warrant a reevaluation of your program are increases/decreases in your income or the value of your assets, large future expenses that you previously failed to take into account, a new job with greater risk exposure, lifestyle changes, and new children.

> **Example(s):** Take the following scenario: You put together a great risk-management program back in January, but now it's December and a lot has changed for the better in eleven months. During that time, you've won $2 million in the lottery, bought a new car, and inherited a collection of valuable jewels from your grandmother. The following changes to your risk-management program might be in

order:

- You purchase auto insurance that you didn't have before because you didn't have a car then.
- You cancel your existing life insurance policy or at least lower the coverage level (see Changing Levels of Coverage) because your lottery winnings have put you in a financial position to self-insure.
- Even though your homeowners insurance would probably cover you financially for the jewels if they were lost, they're all one-of-a-kind items that can't be replaced. So, to ensure their safekeeping, you move them from your home to a bank safe deposit box and, in so doing, add a loss-control measure to your program.

Since your life and the risks to which you are exposed are constantly in flux, think of your risk-management program as fluid rather than static. It must be adapted to meet your changing needs.

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