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Choices and Risks

All choices involve risk—some more than others, of course. Let's consider driving a car. Everyone knows that when you drive a car you risk having an accident. You could cause an accident yourself or another driver could cause an accident that involves you. How can you reduce the risk associated with having an automobile accident? You have three choices.

First, you could choose to stop driving—ride the bus, ride a bike, or walk. But the no-driving alternative may seem extreme. Let's examine the other choices. Second, you could become a safer driver. You could take a course in defensive driving; study the state's road-safety manual; pay attention in driver's education class; avoid driving during rush hours, on dangerous roads, and late at night. And, third, you could purchase auto insurance. You could purchase insurance to protect you from financial loss for money spent on car repairs, medical care, or lawsuits that result from an accident. With insurance, you might still have a wreck, but the consequences would not be as bad as they would have been if you did not have insurance.

Your choices about driving are similar to many other situations involving choice. Usually your best way to reduce risk is to take certain actions yourself. For example, to reduce health problems, you could resolve to eat right, get plenty of exercise, get enough sleep, avoid drugs, and so forth. Buying health insurance provides another way to reduce the risk of financial loss from health-care costs. To reduce the chances of loss from theft, you could install good locks on your doors, stop mail and newspaper deliveries when you are away, and keep areas around your house or apartment well lit. Buying homeowner's or renter's insurance provides another way to reduce the risk of financial loss from theft.

The purpose of insurance is to spread risks out over many people. Let's consider an example. Imagine that the student council in a high school of 1,000 students wants to offer all students insurance against the theft of personal possessions from school lockers. The student council has decided to establish a locker insurance company. Suppose that students in this school have an average of $50 worth of personal stuff in each locker. Suppose further that, on average, 10 in every 1,000 lockers are broken into each year. In a typical year, students in the school lose a total of $500 ($50 of stuff x 10 locker break-ins) to locker theft. If all 1,000 students wish to buy insurance, it would cost:

$$\frac{\textbf{\$500 loss}}{\textbf{1000 students}} = \textbf{\$.50 charge for each student for locker insurance}$$

If every student bought $.50 worth of locker insurance, all of them would be covered against losses they might incur from locker break-ins. This is fundamentally how insurance companies work. Insurance companies charge a fee (a premium) paid by customers to provide protection against certain types of loss. The fee or premium covers the losses and also the costs of operating the business and earning a profit.

The table on the following page shows types of insurance you can buy to manage different types of risk. Study the table and answer the questions that follow.

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Types of Insurance

Type of Insurance	Purpose	Examples of Coverage
AUTO	Provides financial protection against losses caused by an auto accident or other damage to a car	**Collision:** Provides for the repair or replacement of the policy owner's car damaged in an accident. **Liability:** Covers the cost of property damage or injuries to others caused by the policy owner. **Comprehensive:** Covers the cost of damage to an automobile as a result of fire, theft, or storms. **Uninsured and underinsured motorist:** Covers the cost of property damage or injuries to the policy holder when the driver at fault is uninsured or doesn't have sufficient coverage to pay for all the expenses related to the accident.
HEALTH	Provides payment for certain health-care costs including coverage for dental and vision care	**Traditional health insurance:** Provides reimbursement for hospital, surgical, medical, and other expenses; plans can include deductible and co-payments of 20 percent or more. **HMOs:** Cover hospital, surgical, and medical services through a group of physicians; fees based on a monthly charge whether or not services are used. **High deductible health care:** Covers hospital, surgical, and medical services through either an HMO or traditional health care plan; consumers pay much higher deductibles in exchange for lower premiums; these policies are often used to insure against catastrophic health events. **Health savings accounts (HSAs):** Provide a tax-sheltered account where consumers can save for their medical expenses.
RENTER'S	Provides financial protection in case of loss of personal possessions in a rental unit, as well as injury to others on the property	Reimburses the policy owner for loss of possessions in a rental unit caused by fire, theft, water damage, etc. Also provides liability protection for bodily injuries occurring in the rental unit.

Type of Insurance	Purpose	Examples of Coverage
HOMEOWNER'S	Protects against financial loss from damage to your home or its contents, as well as injury to others on the property	**Physical damage:** Reimburses for fire or water damage to the house, its contents, or other structures on the property. **Loss or theft:** Reimburses for personal property damaged or stolen. **Liability:** Protects against loss from a lawsuit for injuries to invited or uninvited guests.
LIFE	Provides financial protection to dependents of policy owner when policy owner dies (to cover such expenses as income replacement, debt repayment, funeral expenses, and education expenses)	**Term life:** Offers protection for a specified period of time; the policy must be renewed if coverage is desired for another period of time. **Cash value life:** Combines protection and savings or investment. Cash value life insurance can cost many times more than term life insurance because of the investment feature. However, there are usually many better investment opportunities than cash value insurance. Common types of cash value insurance policies include: • **Whole life:** Provides cash value and protection during the lifetime of the policy holder. • **Universal life:** Provides term policy protection with an investment feature of a whole life policy; the face value of the policy can change during the time of the policy. • **Variable life:** Similar to universal life, but allows the policyholder some choice in the investments for the cash-value portion of the policy.
DISABILITY	Provides income over a specified period when a person is ill and unable to work; most disability policies end at retirement age of 65-70	Policy owner selects a replacement income for lost wages if an illness or accident prevents the person from working. Disability is paid for a specified time after a waiting period. Disability insurance is more important for a young, single person than life insurance. The likelihood that a person in his or her 20s will become disabled is seven times greater than his or her chance of dying.

Questions:

a. All choices involve at least some measure of risk. Name two ways to reduce risks.

b. How does insurance work?

c. What is a premium?

d. What does each type of insurance typically provide?

i. Auto:

ii. Health:

iii. Renter's:

iv. Homeowner's:

v. Life:

vi. Disability:

e. In the case of auto insurance, what is the difference between collision and liability coverage?

f. You are taking a new job and have two choices of health insurance (see below). Which one would you choose and why?

- Traditional health insurance with coverage for office visits, laboratory, hospital costs, and routine care as well as protection for larger bills from illness or injury. The annual deductible is $500, and there is an 80/20 percent co-insurance clause with an out-of-pocket annual limit of $2,000 (this means you are responsible for the first $500 of health expenditures each year and after that, you pay 20% of all medical bills up to a total of $2,000 per year). The monthly premium for this coverage is $180 per month. This plan allows the consumer to use the provider (doctor) of their choice.

- HMO with coverage for all medical expenses. There are no deductibles, but there is a $25 co-pay for each time you visit the doctor. The premium for this coverage is $150 per month. Consumers must use providers within the HMO network to receive services covered by the plan.

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The Big Risk

You have just graduated from high school or college, and you are single. You own a number of assets that you are thinking of insuring, including an automobile, inherited jewelry, a rare coin set, and the contents of your rented apartment.

Your employer provides a health insurance plan you can purchase. Examine the cost and the risk of each of the things you would like to insure below, and circle them. Do not spend more than $2,900; you may spend less. Indicate your choices below.

Renter's Insurance *(theft, fire, acts of nature, liability)*	**Jewelry Insurance**	**Automobile Insurance** *(collision, comprehensive, liability, uninsured motorist)*
Premium: $240/year Loss: $2,800 Risk: 1 in 12 Card: 9 Deductible: $250	Premium: $60/year Loss: $3,400 Risk: 1 in 12 Card: 7 Deductible: None	Premium: $1,200/year Loss: $5,000 Risk: 8 in 12 Card: 5-12 Deductible: $250
Health Insurance *(doctor visits, surgery, lab work)*	**Life Insurance** *(death, debt repayment, school)*	**Rare Coin Insurance** *(loss due to theft)*
Premium: $750/year Loss: $1,200 Risk: 11 in 12 Card: 2-12 Co-pay $25 *(Assumes 2 visits per year)*	Premium: $300/year Loss: $300,000 Risk: 1 in 144 Card: Must draw two 12s in a row Deductible: None	Premium: $200/year Loss: $1,000 Risk: 1 in 12 Card: 4 Deductible: None
Disability Insurance *(long-term injury, illness)*	**Choices** *(types of insurance chosen)*	**Premiums**
Premium: $700/year Loss: $14,400 Risk: 7 in 12 Card: 6-12 Deductible: None		

Adding Up Insurance

1 Card Chosen	2 Year	3 Annual Premium of Insurance Coverages You Chose	4 Losses Caused by Unexpected Events When Insured (Deductibles, Co-Pay)	5 Losses Caused by Unexpected Events When Uninsured	6 Total Dollar Costs
6	0 (uninsured)	0		$20,600	$20,600
6	0	$1,900 ($1,200 car insurance + $700 disability insurance)	$250 (automobile deductible) $0 (disability)	$1,200 (health)	$3,350
	1 (uninsured)				
	2 (uninsured)				
	3 (uninsured)				
	4 (uninsured)				
	5 (uninsured)				
	1				
	2				
	3				
	4				
	5				

TOTAL (uninsured): ____________________ TOTAL (insured): ____________________

Questions:

a. For insured people: What were your losses over the period of the simulation?

b. For uninsured people: What were your losses over the period of the simulation?

c. Which students had fewer losses?

d. Were the costs of purchasing insurance worth the benefits?