Controlling the Cost of Insurance **by: Bob Williams, CPA**

Insurance can be a boring topic to discuss, but at the same time it is complex and the cost of premiums adds up quickly. Even though there is a bit of standardization among policies and insurance companies, typically policies are difficult to compare, and normally have many exclusions and complex terms. Another important consideration is the financial stability of the insurance company. Also it normally is not cost effective to switch a single policy to another insurance company, as insurance companies often offer discounts for bundled policies such as auto, property and life.

Here are a few principles to follow:

1. Keep insurance and investing separate. The purpose of investing is to grow your assets in order to meet your financial goals and to ultimately be financially independent. One of the purposes of insurance is to protect these assets. Building wealth with insurance may often lead to unnecessary costs being incurred.

2. Insure only for what you cannot afford to lose, and self-insure for the rest. A typical example of self-insuring would be to forgo collision insurance on an older vehicle.

3. Be sure to keep an eye on "premium creep" and shop around. As insurance is such a high ticket item, comparison shopping can often payoff with large premium savings. An individual with a high credit score or a business with a low risk profile may likely save big by finding an insurer hungry for the business.

To determine what insurance that is needed, breakdown the task into three categories of protection:

- Insure income through life and disability insurance.
- Insure assets through liability insurance (auto, home and umbrella policies).
- Insure against unmanageable expenses with health and/or long-term care insurance.

PROTECTING INCOME

Start with your total expected earnings over your career. For example, a 35-year-old earning an after-tax income of $100,000 with 3% annual increases, would expect earnings of around $4.75 million over the next 30years.

But that doesn't have to equate to needing that much life and disability insurance. Don't necessarily use a rule of thumb such as 10 years of income when determining the amount of insurance. The key is to protect your family's lifestyle. For example, if your family is thrifty and lives on an annual budget of about $50,000 and the other spouse works, only $500,000 in life and disability insurance may be needed. If the both spouses are financially independent, they may not need insurance at all. In addition, the need to insure income typically decreases over time because as people age, because they have fewer working years ahead. In most cases, it makes little sense to keep paying disability insurance when you are in your early 60s if the benefits are going to stop at age 65.

The issues can be more complex if both spouses have done sound financial planning, are financially secure and have retired, in this case, they may no longer have a need for such insurance. But, if they have an existing level term policy, they may want to keep it because the premium paid has a greater payout expectancy each year. A $1,000 premium has a much greater expected annual benefit at age 60 than at 25. The case to keep the policy is even stronger if one of the spouses has a life threatening health condition.

INSURING ASSETS

As you age, you should be converting your earnings to financial assets. You likely own larger homes and have investment portfolios that you want to protect against disasters and lawsuits. If your home burns down, or if you injure or kill a child in an automobile accident, a lifetime of wealth accumulation could easily be wiped out. Therefore having the right insurance can help to protect valuable assets. Fortunately, the likelihood is low that catastrophic events will occur, so the cost of insuring for them is normally reasonable.

Protecting assets from lawsuits is also critical, so consider getting a low-cost umbrella policy. How much umbrella liability coverage is needed is definitely a judgment call. A general rule of thumb is to have an umbrella liability policy equal to your net worth, but even that is debatable since you can always be sued for more than your net worth.

The principle of self-insuring is still important. Higher deductibles are a form of partial self-insurance. If you can save $500 annually by raising the deductible by $1,000, then the maximum loss you would incur is $500 - the $1,000 higher deductible less the $500 savings; and by the third year without a claim you have already come out ahead. In addition, if you have a low deductible, it may not pay to make a claim when the payout would be small and reporting the loss would increase future premiums.

CONTROLLING EXPENSES

Health insurance is a necessity as many health care costs are completely unaffordable. A heart transplant could cost over $1 million. Furthermore, beyond the expected payout, managed care policies such as PPOs and HMOs also offer lower contracted rates with health-care providers. Thus even a multi-millionaire could benefit by having health insurance since it is really a combination of insurance and discounted rates.

As a rule of thumb, a healthy family should pick a higher deductible plan since they can expect high savings with the partial self-insurance.

The most difficult decision lies in making a decision for long term care insurance. Long term care expenses are definitely high, and the premiums are not certain. When this was a new product, the majority of insurance companies underpriced policies for a variety of reasons, with the result that premiums are now increasing dramatically. To make matters worse, some companies are exiting the business altogether.

While coverage is a tough decision, a typical recommendation is either full or partial self-insurance, with partial self-insurance involving a lower daily benefit and a longer waiting period before the benefit begins meaning you may pay out of pocket for the first 90 days.

CONCLUSION:

Keeping some relatively simple principles in mind will help you choose the right amount of insurance at the best price. Remember that it is always a trade-off between the cost of insurance, the financial impact of a loss and the probability of such a loss.