

Insurance:

NECESSITY OR NUISANCE?

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If you need a particular type of insurance, it is better to have it even if you never use it. The hard part is knowing the difference between insurance you *need* and insurance you are better off *without*. Many people purchase insurance without knowing whether they need it or not. Unless you fully understand insurance, you may be wasting money on insurance products you don't need.

In some cases insurance is a necessity. Paying premiums for insurance you don't need is a nuisance. When insurance is a necessity, getting the right amount of coverage is important. How much insurance to buy depends on your situation and needs. Spending money for a larger amount of coverage than necessary is also a nuisance.

Purpose of Insurance

Insurance protects you against financial losses from various types of risk. *Risk* is the uncertainty that you will incur a financial loss and uncertainty about the size of the financial loss. Insurance may not be necessary to cover all risks. In addition, insurance is available for risks you may never encounter.

Managing risk involves the identification and evaluation of the risks that you face and determining the best way to handle them. Unlike investing which deals with *speculative risk* (the possibility of a financial gain or loss), insurance covers *pure risk* (the possibility of a financial loss with no potential for financial gain).

Before you buy insurance, evaluate your situation to determine your risk exposure or sources of risk. *Second*, determine what the possible financial loss would be if you encountered each risk, and how often you may encounter the risk. *Third*, determine the most appropriate strategy for managing each risk.

Risk Management Strategies

Avoid Risk

You avoid risk when you choose not to own items or expose yourself to activities that will cause a financial loss. Because some risks are a part of life, it is not possible to avoid all types of risks. Even though we all face the risk of illness, injury, and death, you can avoid the risk of injury or death while parasailing if you don't go parasailing. There are other risks you can avoid. Not owning a vicious dog will prevent you from the risk of a lawsuit from someone bitten by the animal. If you don't have a swimming pool, you avoid being sued by a parent if their child falls into it and is seriously injured or drowns. Even though you can avoid certain risks, you may decide to accept the risk because you enjoy that particular activity or have a desire to own that item.

Retain Risk

You retain risk by accepting that if the financial loss occurs, you will have to cover the cost yourself. It is all right to retain certain risks if the financial loss associated with the risk is small. For example, you may choose not to have collision insurance on your car when it is an older vehicle. If you are in an accident that's your fault, and your car is damaged, you will have to pay to have it fixed. Financial losses as a result of someone using your credit card are another example since your liability is limited to \$50 per card if you report the card lost or stolen.

Control Loss/Reduce Risk

When you control loss or reduce risk, you take steps to reduce the frequency or size of a financial loss to affordable levels. You can reduce the loss of theft in your home and automobile by locking doors. You can reduce the loss of serious injury or death by wearing seat belts and making sure other safety devices in your car work properly. Keeping your dog in a locked room or other secure location when you have visitors can reduce the risk of a dog bite. Security systems and fire alarms in your home, fencing around your backyard with the pool, parking your car in the garage, exercising, and eating nutritiously are all ways of controlling loss or reducing risk. Some insurance companies provide discounts for loss control measures and do not cover certain financial losses if you do not use loss control measures. You can also reduce risks by transferring a part of your financial losses to an insurance company. Insurance may cover all of your financial losses, but in most cases, it covers part and not all.

Transfer Risk

Transferring risk means you pay someone else to cover your financial loss if you encounter the risk. Although not the only way, the most common way of transferring risk is to pay an insurance company. For a fee, known as a premium, the insurance company agrees to cover the financial loss. If you purchase a health insurance policy and become ill, the insurance will cover some or all of the loss if the illness is covered by your policy. If you purchase homeowner's insurance, the insurance company will pay for financial losses to your home as a result of any covered event such as a fire, theft or vandalism.

Necessity or Nuisance

Insurance is only one way of handling risks. Insurance should be considered when the chances of financial loss are low, but the dollar amount of the loss is high. For example, the likelihood of becoming ill enough to require a hospital stay for an extended period of time is low, but the size of the potential financial loss is enough to justify the cost of the policy.

Health, disability, life, homeowners, automobile, and liability insurance each cover specific risks. Using the sources of risks you identify, examine the different types of insurance to determine if you should transfer any or all of your risks to an insurance company. You have to decide, based on your circumstances, if buying the insurance is a NECESSITY or if paying the premiums for the insurance would be a NUISANCE.

You can purchase insurance to protect against every imaginable risk, but it is not always wise.

Purchasing insurance is a necessity when the potential financial loss you encounter is so large that it could lead to financial ruin, loss of savings and investments, or inability to accumulate wealth. Paying premiums for insurance is a nuisance when the potential financial loss could be covered by current income or emergency savings. Remember, the risks that you face can change over time, so you should reevaluate your situation periodically.



notes:

Acknowledgments

The author expresses special thanks to the following people who reviewed the manuscript and shared their comments and suggestions:

A. Michael Rupured

Former Consumer Economics Specialist
University of Georgia Cooperative Extension

Denise Everson

Northeast District Extension Director
University of Georgia Cooperative Extension

Nathan Harness, Ph.D., CFP®

TD Ameritrade Director of Financial Planning
Texas A&M University

The permalink for this UGA Extension publication is extension.uga.edu/publications/detail.html?number=C1111