RISK MANAGEMENT AND INSURANCE PLANNING

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Topics 22–32

[**Note:** This textbook, along with the other Keir textbooks (General Financial Planning Principles, Investment Planning, Tax Planning, Retirement Savings and Income Planning, and Estate Planning), is structured to follow CFP Board's 72 Principal Topics list. Risk Management and Insurance Planning consists of Topics 22-32 in that list. Therefore, this publication, rather than being broken into chapters and starting with chapter 1, will be presented as Topics 22-32.]

RISK MANAGEMENT AND INSURANCE PLANNING

Principles of Risk and Insurance (Topic 22)

CFP Board Student-Centered Learning Objectives

(a) Explain the risk management process.

(b) Provide examples of the four primary risk management techniques available to clients.

(c) Describe how insurers use risk pooling to pay for losses incurred by policyholders.

(d) Explain the factors that affect policyholder premiums and recommend appropriate methods for reducing household insurance costs.

Principles of Risk and Insurance

PURPOSE AND BENEFITS OF RISK MANAGEMENT AND INSURANCE

A significant element of the planning process involves identifying potential obstacles to goals and threats to accumulated wealth. As financial planning clients achieve more success in their lives and careers, there is often a tendency to forget the importance of protecting assets and of safeguarding income. Many individuals fail to realize the impact that the added cost of a long-term disability, major illnesses, long-term care, or property losses can have on their family relationships as well as financial resources.

Risk management and insurance planning are part of a well-developed financial plan and when properly designed can lessen the impact of potentially catastrophic life events. By performing a thorough analysis of a client's loss exposures (losses that might occur), the planner and client are able to work together proactively to employ the best and most efficient methods for dealing with loss exposures.

THE RISK MANAGEMENT PROCESS

The risk management process is a process for identifying and measuring risks (possibilities of loss) and for making decisions on how to deal with those risks. It involves a series of six steps an individual or business can follow to manage risk. The six steps are similar to the six steps in the financial planning process (see the definitions section at the end of this topic for more details on the financial planning process). The steps are adjusted to apply specifically to risk management. The risk management process requires the following steps:

1) Establish the risk management objectives
2) Gather information to identify the loss exposures
3) Analyze and evaluate the loss exposures and the risk management techniques available
4) Develop a plan, selecting appropriate risk management techniques to achieve the objectives
5) Implement the plan
6) Monitor the plan

The acronym EGADIM can be used to help remember these six steps.

Large businesses frequently hire full-time risk managers to manage business loss exposures on a regular and continuing basis. Individuals and small businesses, on the other hand, often rely on financial planners, insurance brokers, or consultants to assist periodically with the process. In this textbook, our focus will be primarily on risk management for individuals and families.

Step 1: Establish the Risk Management Objectives

In personal financial planning, the risk management objectives are typically to protect assets, earning capacity, human life value, and health of the client. Objectives may also include less tangible aspirations, such as providing peace of mind or protecting family relationships. For example, a parent who plans to leave a family business to the child who works in the business might choose to leave life insurance death benefits of equal value to a child who is not working in the business in order to prevent animosity between siblings. Sometimes, the risk management objective may be simply to meet legal requirements, such as with the purchase of required auto liability insurance.

Initially, an individual's risk management objectives will tend to be somewhat general, e.g., protect assets and income. Greater specificity is provided in the later steps of the risk management process. Specificity becomes possible for the client and financial planner as more information is gathered and as more analysis is provided concerning the client's situation.

Step 2: Gather Information to Identify the Loss Exposures

In the risk management process, the information gathering step requires a planner to make use of a broad net to catch as many of the potential loss exposures as reasonably possible. The financial planner cannot assist a client with loss exposures until they are identified, so it is important to uncover and identify exposures that can impact the client's risk management objectives.

At this stage of the process, loss exposures are defined as potential reductions in value, without regard to probability. In other words, for now we are more concerned about what *could* happen than what is *likely* to happen. Perils are causes of loss, such as a fire that burns the house down. Losses may be direct or indirect results of the peril. For example, the cost to rebuild the house following a fire is a direct loss as a result of the peril of fire. An indirect loss from the same fire would be the cost incurred for temporary living arrangements while the house is being rebuilt. In some cases, indirect losses may occur without direct losses; for example, a family may incur expenses for temporary living arrangements when forced to evacuate due to the threat of wild fires in the area. The fires may not actually reach the home and destroy it, but the cost of temporary living arrangements is still incurred.

Gathering information to identify exposures can be approached in a number of ways. Businesses may use checklists, questionnaires, operation flow charts, financial statements, and on-site inspections of the plant, its equipment, and general layout of operations to help in identifying the entity's various exposures to loss.

Individuals and families may use checklists, survey forms, questionnaires, financial statement analysis, personal inspections, or contract analysis to assist with identifying loss exposures. Using one or more of these systematic approaches will help to avoid overlooking potential losses.

Identifying loss exposures through financial statement analysis involves a review of the Statement of Financial Position to identify property loss exposures and a review of the Statement of Cash Flows to identify income loss exposures. Each item on the statement is examined to determine potential loss exposures for that item. As an example, a review of the simplified Statement of Financial Position for Jane Buck (below) might look as follows:

Exhibit 22 – 1
Analysis of Statement of Financial Position for Loss Exposures

Account	**Perils Exposed To**	**Consequences**
Cash (on hand)	Fire Burglary	Loss of cash
Retirement Assets	Superannuation (outliving assets in retirement) Diminishing health	Insufficient income to support needs Need/cost of long-term care
Primary Residence	Fire Vandalism Water damage Trees in close proximity Injury of others on premises	Loss of use/cost of repair Reduction in value/cost of repair Cost to repair or replace Cost to repair dwelling due to damage from falling trees Medical costs to be paid
Boat	Damage to boat Damage to property of others Injury of others or self	Loss of use/cost of repair Cost to repair or replace Medical costs to be paid
SUV	Damage to vehicle Damage to property of others Injury of others or self	Loss of use/cost of repair Cost to repair or replace Medical costs to be paid
Jewelry	Fire Burglary Misplacement	Loss of value/cost to replace Loss of value/cost to replace Loss of value/cost to replace

Jane Buck
Statement of Financial Position
As of December 31, 20XX

Assets	
Cash & Cash Equivalents	
Cash on hand	$ 15,000
Checking account	40,000
	$ 55,000
Retirement Assets	
401(k)	$ 440,000
Roth IRA	210,000
	$ 650,000
Use Assets	
Residence	$ 350,000
Boat	47,000
SUV	28,000
Jewelry	25,000
Household items	175,000
	$ 625,000
Total Assets	**$1,330,000**
Liabilities	
Short-term Liabilities	
Chase credit card	$ 3,000
HSBC credit card	5,300
	$ 8,300
Long-term Liabilities	
Boat loan	$ 18,000
SUV loan	20,000
Student loan	28,000
Mortgage on residence	198,000
	$ 264,000
Total Liabilities	**$ 272,300**
Net Worth	**$1,057,700**
Total Liabilities and Net Worth	**$1,330,000**

The above analysis of the Statement of Financial Position may be combined with property inspections to obtain a more complete view. For example, an inspection of the primary residence may reveal old and decaying trees very near to the dwelling. These inspections are often performed by an insurance agent or consultant with specialized knowledge of perils involving those particular assets.

The use of contract analysis to identify loss exposures might include analyzing contracts such as rental agreements.

Another method of systematically identifying loss exposures is to break them down into personal loss exposures, property loss exposures, and liability loss exposures. For the category of "Property Loss Exposures," for example, a survey form might ask the following questions:

- Do you own a home?
- When was the cost to rebuild or replace the home analyzed?
- Are there any collectibles or high value items within the home?
- Are there any collectibles or high value items located elsewhere?
- How is the home heated?
- Is the electrical wiring up to code?
- Do you own a secondary residence or property?

This approach of reviewing each of the three broad categories of loss exposures (personal, property, and liability) is discussed in more detail in Topic 32 of this textbook.

Class Exercise 22 – 1

Students should review the Personal Balance Sheet for the Loudon case in Appendix A of this textbook. Using this Balance Sheet, students should develop questions to ask the client and write up discussion points that may help to identify potential loss exposures.

APPLICATION QUESTIONS

1. Which of the following perils best meets the ideal requirements for an insurable risk?

A. Sickness
B. Flood
C. Nuclear radiation
D. Lightning
E. Unemployment

2. (Published question released December, 1996)

Regarding the characteristics of insurance, which of the following is/are fundamental?

(1) Probability (possibility and predictability of a loss)
(2) Law of large numbers
(3) Transfer of risk from individual to group
(4) Insurance is a form of speculation

A. (1) and (2) only
B. (1), (2), and (4) only
C. (1), (2), and (3) only
D. (4) only
E. (1), (2), (3), and (4)

3. (Published question released November, 1994)

Conditions that increase either the frequency or severity of loss are called:

A. Subrogation
B. Risks
C. Hazards
D. Perils
E. Extenuating circumstances

4. For which of the following loss exposures is the insurance technique best suited, based on loss frequency and loss severity?

A. Damage in coastal North Carolina due to hurricanes
B. Breakage of eyeglasses
C. Losses of a grocery store owner due to shoplifters
D. Burning out of household light bulbs
E. Legal liability for bodily injury in an auto accident

5. Which of the following is (are) consistent with the principle of indemnity?

(1) Settlement of property losses on an actual cash value basis
(2) Award of damages for pain and suffering
(3) Payment of the face amount of a life insurance policy at the death of the insured

A. (1) only
B. (1) and (2) only
C. (1) and (3) only
D. (2) and (3) only
E. (1), (2), and (3)

6. Which of the following persons has (have) an insurable interest?

(1) A small business owner in the life of a key employee
(2) A homeowner in his or her household contents
(3) The operator of a private plane in the safety of his or her passengers

A. (1) only
B. (2) only
C. (3) only
D. (1) and (2) only
E. (1), (2), and (3)

Risk Management and Insurance Planning – Application Questions – Topic 22

For practice answering case questions related to Topic 22, please answer the following questions in the cases included in Appendix A at the back of this textbook.

Case	**Questions**
Black Hills P&L	1
Brodinski	
Haurilick	
Beals	1
Mocsin	
Loudon	
Connor	1 and 2
Seidelhofer	1, 2, and 3
Loomis Company	
Michael and Diana Eastman	
Gary and Judy Parker	1, 2, 3, 4, and 5

ANSWERS AND EXPLANATIONS

1. D is the answer. A is not always definite and measurable or completely accidental for the insured. B and C present severe catastrophe potentials. E is not always accidental and presents possible catastrophic losses for an insurer.

2. C is the answer. (4) is incorrect because insurance deals with an existing risk of loss, rather than creating a risk of loss.

3. C is the answer, by definition. Snow and ice on the walk is a hazard because it increases the probability of an occurrence of a loss. A snow storm is a peril because it is a loss-producing agent. Stepping on the walk is a risk because risk is the possibility of loss. Subrogation is the right of the insurance company after it pays an insured the amount of a loss to collect from a third party that caused it. If the insured's house caught on fire while the neighbor was burning leaves, the insurance company will pay the insured for the loss and then sue the neighbor under the right of subrogation to recover the amount it paid the insured.

4. E is the answer. Insurance works best for exposures that represent low loss frequency and high loss severity, as in E. A represents high loss frequency and high loss severity. B and C represent moderate loss frequency and low loss severity. D represents high loss frequency and low loss severity.

5. A is the answer. (2) is not designed to place the individual in about the same financial condition as he or she was in prior to the loss since pain and suffering are not financial losses. (3) is not correct because the face amount may have little relationship to the size of the loss incurred by the beneficiary due to the insured's death.

6. E is the answer. An insurable interest is present when the individual stands to lose, usually financially, by the occurrence of a peril. In A, the loss might be reduced earnings of the firm. In B, it is the reduction in the value of the contents. In C, the potential loss might be from liability for negligence.