Chapter 33: Risk Management & Insurance Basics

Understanding risk and how to protect yourself financially

TYPES OF RISK

Personal Risk

Threats to health, life, or income

Examples: Illness, disability, death

Property Risk

Damage, destruction, or theft of possessions

Examples: Fire, theft, auto accidents

Liability Risk

Legal responsibility for harm to others

Examples: Car accident injuries, property damage

Financial Risk

Potential monetary losses

Examples: Investment losses, inflation

FOUR RISK MANAGEMENT STRATEGIES

Strategy	Description	When to Use
Avoidance	Eliminate risk by avoiding the activity	Severe potential loss, no significant benefit
Reduction	Take steps to minimize likelihood or impact	Risk can be managed with precautions
Acceptance	Acknowledge risk and prepare to handle losses	Small potential loss, cost of protection too high
Transfer	Shift financial responsibility to another party	Significant but unlikely losses (insurance)

Example - Managing Bike Riding Risk:

- **Avoidance:** Don't ride in ice storms
- **Reduction:** Wear a helmet, use lights
- **Acceptance:** Accept minor scrapes may happen
- **Transfer:** Buy insurance for major injuries

KEY INSURANCE TERMS

Premium
Regular payment to maintain insurance coverage (monthly, quarterly, or annual)

Deductible
Amount you pay out-of-pocket before insurance coverage begins

Coverage Limit
Maximum amount the insurance policy will pay for a covered loss

Claim
Formal request to insurance company for payment of a covered loss

Exclusion
Specific conditions or circumstances NOT covered by the policy

Higher Deductible = Lower Premium

You pay more out-of-pocket if something happens, but less each month

HOW INSURANCE WORKS

1. **Risk Pooling:** Many people pay premiums into a shared fund
2. **Risk Assessment:** Insurance company evaluates your risk level
3. **Premium Calculation:** Your rate is based on likelihood and potential cost of claims
4. **Claims Payment:** Fund pays for losses of the few who file claims

Example: 1,000 homeowners each pay $1,000/year in premiums = $1,000,000 pool. If 10 homes have $50,000 in damage, insurance covers it from the pool. Most people pay but don't claim, which funds those who do.

When Insurance Makes Sense

- High-impact, low-probability events
- Legally required (auto liability)
- Protecting essential assets
- Loss would be financially devastating
- Peace of mind has value

When Other Strategies Are Better

- Small, manageable losses
- Insurance cost exceeds risk
- Risk can be effectively reduced
- Risk can be avoided without hardship

RISK TOLERANCE

Your personal willingness and ability to withstand potential losses

Factors Affecting Risk Tolerance:

- **Personal temperament:** Natural comfort with uncertainty
- **Financial situation:** Stable income and savings increase tolerance
- **Knowledge:** Familiarity increases comfort with related risks
- **Time horizon:** Longer timelines allow more risk tolerance
- **Potential impact:** Severe consequences lower tolerance

Note: Your risk tolerance may vary across different areas of life (financial vs. physical risks). Choose risk management strategies that align with your comfort level.

COMMON INSURANCE TYPES OVERVIEW

Type	Protects Against
Health Insurance	Medical expenses from illness/injury
Auto Insurance	Vehicle damage, liability from accidents
Homeowner's/Renter's	Property damage/theft, liability
Life Insurance	Financial loss to dependents after death
Disability Insurance	Income loss due to inability to work

Key Takeaway: Effective risk management isn't about eliminating all risk - it's about making conscious choices about which risks to take and how to minimize potential negative impacts. Use all four strategies appropriately based on the specific risk and your personal situation.