PacificCPE

COURSE
40854A

Advising Clients on Insurance and Risk Management

Insurance is often one of the most overlooked components of a client's financial plan—and one of the most important. This course explores risk management principles and personal insurance strategies, giving CPAs and tax professionals the knowledge to have informed conversations with clients about coverage needs and gaps. From life and disability to liability considerations, you'll come away better equipped to identify insurance-related issues and collaborate effectively with other members of a client's planning team.

CREDIT HOURS 2 | FIELD OF STUDY BUSINESS | EXAM QUESTIONS 10

Start Course ↓ | Final Exam Copy ↓

LEARNING ASSIGNMENTS AND OBJECTIVES

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Recognize the characteristics of various types of insurance policies.

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Chapter 1: DISPENSING ADVICE ON INSURANCE

Chapter Objective

After completing this chapter, you should be able to:

- Recognize the characteristics of various types of insurance policies.

Once cash flow is determined to make objectives happen for the client so they can be on their way, the client needs to understand, evaluate, and gain a handle on the other financial planning disciplines. Some will be relevant while others will not. However, without question, the most important of these areas that affects all clients is being properly insured. It's the old joke. Why? Because my insurance agent told me it was!

In all seriousness, if insurance is not properly analyzed, exposures determined, and possible solutions disclosed, there is little to no chance of making a full recovery and accomplishing anything in the client's financial plan. Here's why. Many years ago, when I was a CPA working on taxes in New York City, I had a tax client visit me during tax season. He said, "Jeff, I have a significant issue I need help with. My house burned down this past year and I had no insurance. I owe a lot of people a lot of money, so I need you to help me get a refund." (Mind you, this was when casualty losses in general could be written off on the Form 1040.) I went through the numbers with him. I asked him what he paid for the house. He answered $19,000 (yes, a long time ago). I said, did you make any improvements to the house? He said yes, I put in $29,000, which made his adjusted basis $48,000. I asked him what the value of the house was before the fire and he stated $190,000. I then asked him what he sold it for and he said $92,000. Excluding personal effects, he had a gain on the loss of his house (capital gain rules were different back then). He had to cash out his retirement account, withdraw all of his investment accounts, pull the college savings plans from the kids, because the bottom line was, he and his family needed a place to live.

And that's the point. None of the other financial planning areas can be done properly without taking care of the basics. I have never had a client over the years tell me they have had too much insurance at the time of a claim. However, I have seen the opposite many times. And unfortunately, by that time, it's too late to make any adjustments or changes to the client's financial plan, which results in nothing being accomplished.

Risk Management and Personal Insurance Perspectives

- Risk Management
- Life Insurance
- Disability Income Insurance (Individual)
- Health Insurance
- Long-Term Care Insurance (Individual)
- Homeowners Insurance
- Automobile Insurance
- Personal Umbrella Liability Insurance
- Directors and Officers (D&O) Liability

RISK MANAGEMENT

The risk management process incorporates the LIADPIM financial planning process from Chapter 1 of course 40853A, generally, as part of the overall personal financial planning process. It is important to understand risk as it relates to insurance issues. Transferring risk is only one method of managing risk, although it is the most frequent method.

Rattiner's Secrets

I have a basic rule that I recite to my students and in my lectures about the purchase of insurance. "If you can't afford to write the check to cover an item/issue, or it will kill you to write that check, you need insurance!" For example, if your client ends up in the hospital for two months with a total bill of $500,000 (been there, done that), a safe bet is that the client will not be able to pay out of pocket to fully cover that expense, which is why health insurance would be necessary. On the flipside, let's assume your client's 10-year-old car is totaled in an auto accident. The client is not injured, but the car loss per Kelley Blue book value is $15,000. I say to the client, "I know you have $15,000 to cover the loss because I manage your investments, I know what you earn, I do your tax return," etc. And then I ask the million-dollar question: "How do you feel about writing a check to cover the $15,000 loss?" Pretty regularly, clients tell me that it would kill them to write that check. As a result, the client sees the significance and purpose of carrying collision and comprehensive insurance and can answer that question directly.

Now let me backtrack a little. Insurance (risk transfer) is only one way of dealing with client risk. Risk is a condition of the world, even if we are not aware of it. Risk can be briefly defined as the possibility of an unfavorable departure from a desired outcome that the client is clinging to,

expecting, or hoping for. In other words, if something does not go according to plan, how can clients protect themselves? Risk management addresses the ways to deal with it.

There are other risk management options the client needs to be aware of to respond to risk. Once a risk is identified, it can be managed in one of the following ways:

Retention (a method of risk financing): This means that if the loss occurs, the client will absorb it. If we put leftovers in the refrigerator with the intention of eating them later, we run the risk of forgetting about them until it is too late and we will have to throw them out. Also called risk retention, self-insurance is the concept of insuring oneself or others (such as company employees) without transferring the risk to a third party. Sometimes, large companies may self-insure (for example, the medical needs of their employees) by establishing a separate fund for losses (known as an insurance reserve) and assuming the ability to predict future losses. Risk retention involves a client's son who recently got his license to drive. The client bought his son a 2012 Honda. He purchased liability insurance but no damage protection. The car gets totaled. The client assumed that risk.

Diversification (a method of risk control): This is closely related to risk avoidance and reduction. It is the process of spreading the risk over several or many potential possibilities for loss. It is most frequently observed in the context of investments, where a collection of assets (known as a portfolio) is spread over several investment categories or sectors and several stocks within those categories (see Chapter 1 of course 40856A).

Sharing (a method of risk financing): This states that the client can absorb some but not all of the loss. A good example would be the use of a deductible. Client says, "Jeff, I can cover the first $100, $300, $500 deductible or whatever amount with an out-of-pocket capped at $3,000, but after that I need to turn that payment responsibility to someone who is in a better financial position than I am."

Reduction (a method of risk control): This is any attempt to lessen the chance that a loss will occur. With a car, you can protect the likelihood of a loss by prepping in advance. By installing a car alarm, the client minimizes the chance of the vehicle getting stolen, or by taking driver's education, the client minimizes the chance perhaps of getting into an auto accident; a homeowner who installs a burglar alarm, sprinkler system in the house or lives near a firehouse; a building owner who is tired of having his front window broken and items stolen so installs a protective grill and shatterproof glass.

Avoidance (a method of risk control): This means making changes or not engaging in the activity so the loss will not occur. If an individual is concerned that they will be severely injured while climbing a mountain, avoiding the climb will eliminate the possibility of that injury. It won't eliminate the possibility of getting hurt doing something else, but they won't get hurt climbing a mountain.

Transfer (a method of risk financing): This is the mechanism of insurance as discussed above. When a loss is big enough that we can't afford to retain it, we let someone else deal with the potential loss. For example, the client pays an insurance company a premium for a home in exchange for potential coverage worth hundreds of thousands of dollars.

There are four elements for a risk to be insurable (or permitting the risk to be transferred to a third person or entity, such as an insurance company). These elements are:

- There must be a sufficient number of large and similar (homogeneous) types of events to make the loss reasonably predictable and certain to occur.
- The losses must be definite and measurable.
- The losses must be fortuitous or accidental (not intentional).
- The losses must not be catastrophic to society.

The classic risk management process chart I have used for more than 30 years attempts to match the severity of the potential loss with the probability that the loss will occur. As a result, the following matrix may be used in practical application:

Severity with probability	High probability of loss	Low probability of loss
High severity of loss	*Avoid* the risk	*Transfer* the risk
Low severity of loss	*Reduce* the risk	*Retain* the risk

Finally, a few other pointers to consider. As distinguished from a risk, a peril is an event that causes a loss, such as fire, windstorm, theft, hail. A hazard is a condition or situation that either increases or creates the likelihood or chance that a loss will occur from a given peril. For example, building a house in a flood plain increases the chance that a loss from flood (the peril) will occur. The law of large numbers recognizes that as the more trials of a certain activity are observed, the greater the reliability is in predicting the outcome. Adverse selection says that individuals who are most likely to need insurance benefits are the ones most likely to buy it. Adverse selection happens when poorer-risk individuals are permitted to purchase insurance without paying adequate premiums for the risk assumed.

How much insurance is necessary?

Many times, the calculation for any type of insurance considered is not thorough. Working through the client's potential risk exposures is the surefire way to make sure coverage is adequate. The value of the asset, the additional liability exposure, both personally and professionally, the replacement of income to continue in the event of disability, the cost of practical health care now and in the future, the need to pay off debt such as a house or car, the financial situation that must continue for the family after death are all examples of aspects that should be taken into account.

Remember, when purchasing life insurance, the amount of coverage needed is more important than the type. My lineup is:

- Amount of coverage needed
- Resources available
- Product type

Purchasing what may be a better type of insurance but in a lesser amount really doesn't address the need.

Rattiner's Secrets

In calculating the amount of life insurance necessary, I bring up this question during the data-gathering and goal-setting stage of the financial planning process. I would say to the client, "If you or your spouse were to die today, what would you want to continue in your absence?" A sampling of responses may include, "Jeff, I want enough money to pay for my children's education and enough money to give them while they are in college. I want money for my surviving spouse till he/she turns retirement age and from retirement age until death; money for an emergency fund; the ability to pay off all of the outstanding and perhaps anticipated debt; money to cover payments for estate taxes, for succession planning issues for our business, for child support, legacies, other obligations, and for many other significant issues which could arise." I then take the present value of each of these cash flows and total them up to determine the proper amount of life insurance needed now. Note that not all of these items are present today, but you need to figure out which exposures will be present at some point in the future. And the importance of monitoring the client's financial plan, including the amount of life insurance needed, is essential because things change. What may be an issue today may not be in the future, and vice versa.

LIFE INSURANCE

Life insurance is a unique and critical part of any financial plan. It is often compared to other products in an attempt to prove its superiority or inferiority. All of the comparisons only compare part of what life insurance is all about. More than anything, life insurance is the only product in existence that promises to deliver a specified amount of cash upon the death of the insured. It has other attributes, but it is this one attribute that makes it stand alone as part of the foundation of any viable financial plan.

Life insurance guarantees that time (dying too soon) is not a factor. All other alternatives require time combined with experienced investment advice and a cooperative economy to provide what life insurance provides from the day it is issued.

There are two primary types of life insurance: term insurance (also known as temporary insurance) and cash value insurance (also known as permanent insurance). Which one of these types of insurance is best for the client depends on the consideration of a number of factors:

- **Duration of the need:** If the need is short-term, term life insurance is likely best; if the need is longer-term, cash value insurance is preferable.
- **The amount of life insurance needed:** Either type of policy may be used in addressing this need, although term insurance provides the maximum benefit per unit of premium cost.
- **The amount of disposable income of the proposed policy owner:** If the client has little disposable income, term insurance is preferable.
- **The financial self-discipline of the policy owner:** Since cash value insurance requires fixed premiums for a longer period of time, the client must be disciplined enough to make the payments to ensure coverage.
- **The risk tolerance level of the policy owner:** If the owner demonstrates more risk tolerance, the client may wish to purchase a certain type of cash value policy known as a variable policy.
- **The attitude of the client with respect to life insurance:** If, for some reason, the policy owner exhibits a prejudice against life insurance as a viable financial product, he or she should likely purchase only a term policy, as it will provide for much *shorter* protection.

In practice, many clients will have a variety of short-term and long-term needs, thus a combination of term and cash value insurance is most appropriate.

Types of term insurance

Term insurance comes in a number of forms. Yearly or annually renewable term (YRT or ART) is a policy that typically has the lowest first-year premium, but it increases every year as the insured gets older. Some term forms have guaranteed level premiums (also known as level term) for up to 30-plus years. For competitive reasons, few companies actually guarantee premiums for more than 10 years. To do so requires substantially greater reserves, which force the premium to be much higher than for policies with only a 10-year guarantee. A small number of term policies sold are *decreasing term*. These are generally sold as mortgage policies. Most are designed to have straight-line reductions rather than mirror the decrease in a mortgage balance. These typically have a level premium. Finally, there is also *reentry* term, a policy where the insurance company may renew coverage at a lower rate than would otherwise apply, provided that, at the time of renewal, the insured furnishes evidence of continued insurability.

Types of cash value insurance policies

Cash value insurance also has a number of variations and hybrids since many companies put their own spin on them, but there are too many to mention here. There are traditional “whole life” forms

and universal life forms. Either of these can be either fixed or variable. There are also many types of hybrid policies available. Our discussions will focus on the traditional types of policies. With fixed traditional forms of permanent insurance, there are participating and nonparticipating policies.

Participating policies pay dividends; nonparticipating policies do not. Among nonparticipating policies, there can be interest adjusted or excess interest forms. Since the mid-1980s, there have been very few traditional permanent, nonparticipating policies sold that do not have some method of crediting excess interest to them.

Whole life insurance

Whole life (WL) is the basic form of traditional permanent insurance. It features a guaranteed death benefit, a guaranteed premium, and a guaranteed cash value. These policies generally are designed to have premiums paid and benefits continue, many times to age 121, at which time the policy endows. It endows when the face amount of the policy and guaranteed cash value are the same.

Whole life insurance provides protection for the "whole" of one's life. That means for the entire lifetime of the insured. Whole life policies can take the form of a straight whole life policy and a limited pay life policy.

A straight whole life policy provides protection for the whole of life, with level premium calculated on the assumption that it will be payable over the insured's entire lifetime. Variations of traditional whole life insurance include ordinary whole life, limited pay whole life, graded premium or modified whole life, and current assumption whole life (CAWL), a type of whole life where the interest rate credited to the policy owner fluctuates with the investment experience of the insurer. At one time the single premium whole life policy, where all future premiums are paid at once with a lump sum or at the time of initial issuance, was hugely popular. The single premium was for the amount a policy owner would pay to have the policy fully paid at issue date. This type of policy is rarely used today.

Limited pay whole life policies are a form of whole life insurance whose premiums are payable only for a limited number of years. Continuous protection is provided for the whole of one's life, but premiums are payable only for a limited period. These policies come in different endowment variations, such as a life paid up at 65 policy. This is essentially a whole life policy with premiums increasing so that they stop at age 65, but the policy is guaranteed to last until the age at endowment. The policy becomes a paid-up policy at the end of the premium paying period.

For either type of WL policy, the insured pays more money upfront than necessary to cover the costs, so when mortality costs become higher in the later years, there is sufficient money to dip into the policy and use those funds for the whole of one's life.