Convergent Financial Strategies

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Insurance Basics

November 2018

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Welcome to the latest edition of our quarterly education pieces aimed at providing our clients additional insight into some of the issues we address throughout the year. In this article, we've compiled information from the Insurance Information Institute to help you learn more about insurance. As you read through this article you may have questions about how these matters affect you. We are ready to answer your questions or discuss your thoughts at your convenience.

Overview

There are four main types of insurance. Life consists mainly of traditional life insurance and annuity products. Disability principally includes long-term disability insurance, as well as Social Security Disability benefits. Property/casualty consists mainly of auto, home and commercial insurance. Health/long-term care insurance includes products from private insurers, as well as government programs. In this article, we will focus on life insurance as well as homeowners and auto insurance in the property/casualty category.

Life Insurance Basics

Many financial experts consider life insurance to be the cornerstone of sound financial planning. It can be an important tool in the following situations:

> <u>Replace income for dependents</u>
> If people depend on an individual's income, life insurance can replace that income if the person dies. The most common example of this is parents with young children. Insurance to replace income can be especially useful if the government- or employer sponsored benefits of the surviving spouse or domestic partner will be reduced after their companion dies.
>
> <u>Pay final expenses</u>
> Life insurance can pay funeral and burial costs, probate and other estate administration costs, debts and medical expenses not covered by health insurance.
>
> <u>Create an inheritance for heirs</u>
> Even those with no other assets to pass on, can create an inheritance by buying a life insurance policy and naming their heirs as beneficiaries.
>
> <u>Make significant charitable contributions</u>
> By making a charity the beneficiary of their life insurance policies, individuals can make a much larger contribution than if they donated the cash equivalent of the policy's premiums.

Types of Life Insurance

There are two major types of life insurance—term and whole life.

Term Life

Term insurance is the simplest form of life insurance. It pays only if death occurs during the term of the policy. There are several types of term life insurance policies—level term, annual renewable term, and decreasing term. Level term means that the premium and death benefit stay the same throughout the duration of the policy. Annual renewable term maintains a constant death benefit for a defined length of time but the annual premium increases. Decreasing term means that the death benefit drops, usually in one-year increments, over the course of the policy's term.

Whole Life / Permanent Life

Whole life or permanent insurance pays a death benefit whenever the policyholder dies. There are three major types of whole life or permanent life insurance—traditional whole life, universal life, and variable universal life, and there are variations within each type.

In the case of traditional whole life, both the death benefit and the premium are designed to stay the same (level) throughout the life of the policy. The insurance company keeps the premium level by charging a premium that, in the early years, is higher than what is needed to pay claims, investing that money, and then using it to supplement the level premium to help pay the cost of life insurance for older people.

By law, when these "overpayments" reach a certain amount, they must be available to the policyholder as a cash value if he or she decides not to continue with the original plan.

Universal Life

Universal life, also known as adjustable life, allows more flexibility than traditional whole life policies. The savings vehicle (called a cash value account) generally earns a money market rate of interest. After money has accumulated in the account, the policyholder will also have the option of altering premium payments—providing there is enough money in the account to cover the costs.

Variable Life

Variable life policies combine death protection with a savings account that can be invested in stocks, bonds and money market mutual funds. The value of the policy may grow more quickly but involves more risk. If investments do not perform well, the cash value and death benefit may decrease. Another variant, universal variable life, combines the features of variable and universal life policies. It has the investment risks and rewards characteristic of variable life insurance, coupled with the ability to adjust premiums and death benefits that is characteristic of universal life insurance.

Homeowners Insurance Basics

Homeowners insurance is a package policy. This means that it covers both damage to property and liability or legal responsibility for any injuries and property damage policyholders or their families cause to other people. This includes damage caused by household pets.

Damage caused by most disasters is covered but there are exceptions. Standard homeowners policies do not cover flooding, earthquakes or poor maintenance. Flood coverage is provided by the federal government's National Flood Insurance Program, although it is purchased from an insurance agent. Earthquake coverage is available either in the form of an endorsement or as a separate policy. Most maintenance related problems are the homeowners' responsibility.

A standard homeowners insurance policy includes four essential types of coverage. They include:

1. <u>Coverage for the structure of the home</u>
   This part of a policy pays to repair or rebuild a home if it is damaged or destroyed by fire, hurricane, hail, lightning or other disaster listed in the policy. It will not pay for damage caused by a flood, earthquake or routine wear and tear. Most standard policies also cover structures that are not attached to a house such as a garage, tool shed or gazebo.

2. <u>Coverage for personal belongings</u>
   Furniture, clothes, sports equipment and other personal items are covered if they are stolen or destroyed by fire, hurricane or other insured disaster. Most companies provide coverage for 50 to 70 percent of the amount of insurance on the structure of a home. This part of the policy includes off-premises coverage. This means that belongings are covered anywhere in the world, unless the policyholder has decided against off-premises coverage. Expensive items like jewelry, furs and silverware are covered, but there are usually dollar limits if they are stolen. To insure these items to their full value, individuals can purchase a special personal property endorsement or floater and insure the item for its appraised value.

   Trees, plants and shrubs are also covered under standard homeowners insurance—generally up to about $500 per item. Perils covered are theft, fire, lightning, explosion, vandalism, riot and even falling aircraft. They are not covered for damage by wind or disease.

3. <u>Liability protection</u>
   Liability covers against lawsuits for bodily injury or property damage that policyholders or family members cause to other people. It also pays for damage caused by pets. The liability portion of the policy pays for both the cost of defending the policyholder in court and any court awards—up to the limit of the policy. Coverage is not just in the home but extends to anywhere in the world. Liability limits generally start at about $100,000. An umbrella

or excess liability policy, which provides broader coverage, including claims for libel and slander, as well as higher liability limits, can be added to the policy.

4. Additional living expenses
   This pays the additional costs of living away from home if a house is inhabitable due to damage from a fire, storm or other insured disaster. It covers hotel bills, restaurant meals and other living expenses incurred while the home is being rebuilt. Coverage for additional living expenses differs from company to company.

Types of Homeowners Insurance Policies

The different types of homeowners policies are fairly standard throughout the country. However, individual states and companies may offer policies that are slightly different or go by other names such as "standard" or "deluxe." The one exception is the state of Texas, where policies vary somewhat from policies in other states.

People who own the home they live in have several policies to choose from. The most popular policy is the HO-3. It provides coverage for the structure of the home and personal belongings as well as personal liability coverage. It also provides the broadest coverage, protecting against 16 disasters or perils listed below.

• Fire or lightning	• Windstorm or hail
• Explosion	• Riot or civil commotion
• Damage caused by vehicles	• Damage caused by aircraft
• Smoke	• Theft
• Vandalism or malicious mischief	• Volcanic eruption
• Falling object	• Weight of ice, snow or sleet
• Accidental discharge or overflow of water or steam from within a plumbing, heating, air conditioning, or automatic fire-protective sprinkler system, or from a household appliance	• Sudden and accidental tearing apart, cracking, burning, or bulging of a steam or hot water heating system, an air conditioning or automatic fire-protective system
• Freezing of a plumbing, heating, air conditioning or automatic, fire-protective sprinkler system, or of a household appliance	• Sudden and accidental damage from artificially generated electrical current (does not include loss to a tube, transistor or similar electronic component)

Owners of multifamily homes generally purchase an HO-3 with an endorsement to cover the risks associated with having renters live in their houses. Other types of policies for home owners are the HO2, which provides more limited coverage, the HO-1, a bare bones policy that is not widely available, and the HO-8, designed for older homes. There is also a version of the HO-2 designed for mobile homes.

The HO4-policy was created specifically for those who rent the home they live in. It covers a policyholder's belongings against all 16 perils. It also provides personal liability coverage for damage the policyholder or dependents may cause to third parties. The HO-6 policy was designed for owners of condominium and cooperative units. It provides coverage for belongings and the structural parts of the condominium or co-op that the policyholder owns. It protects against all 16 perils and provides personal liability coverage. Both cover additional living expenses.

Auto Insurance Basics

Auto insurance provides property, liability and medical coverage:

- Property coverage pays for damage to, or theft of, the car.
- Liability coverage pays for the policyholder's legal responsibility to others for bodily injury or property damage.
- Medical coverage pays for the cost of treating injuries, rehabilitation and sometimes lost wages and funeral expenses.

Most states require drivers to have auto liability insurance before they can legally drive a car. All states have laws that set the minimum amounts of insurance or other financial security drivers must pay for the harm caused by their negligence behind the wheel if an accident occurs. Most auto policies are for six months to a year.

A basic auto insurance policy is comprised of six different kinds of coverage, each of which is priced separately (see below).

1. <u>Bodily Injury Liability</u>
   This coverage applies to injuries that the policyholder and family members listed on the policy cause to someone else. These individuals are also covered when driving other peoples' cars with permission. As motorists in serious accidents may be sued for large amounts, drivers can opt to buy more than the state-required minimum to protect personal assets such as homes and savings.

2. <u>Medical Payments or Personal Injury Protection (PIP)</u>
   This coverage pays for the treatment of injuries to the driver and passengers of the policyholder's car. At its broadest, PIP can cover medical payments, lost wages and the cost of replacing services normally performed by someone injured in an auto accident. It may also cover funeral costs.

3. <u>Property Damage Liability</u>
   This coverage pays for damage policyholders (or someone driving the car with their permission) may cause to someone else's property. Usually, this means damage to someone else's car, but it also includes damage to lamp posts, telephone poles, fences, buildings or other structures hit in an accident.

4. Collision
   This coverage pays for damage to the policyholder's car resulting from a collision with another car, object or as a result of flipping over. It also covers damage caused by potholes. Collision coverage is generally sold with a deductible of $250 to $1,000—the higher the deductible, the lower the premium. Even if policyholders are at fault for an accident, collision coverage will reimburse them for the costs of repairing the car, minus the deductible. If the policyholder is not at fault, the insurance company may try to recover the amount it paid from the other driver's insurance company. If the company is successful, policyholders will also be reimbursed for the deductible.

5. Comprehensive
   This coverage reimburses for loss due to theft or damage caused by something other than a collision with another car or object, such as fire, falling objects, missiles, explosions, earthquakes, windstorms, hail, flood, vandalism and riots, or contact with animals such as birds or deer. Comprehensive insurance is usually sold with a $100 to $300 deductible, though policyholders may opt for a higher deductible as a way of lowering their premium. Comprehensive insurance may also reimburse the policyholder if a windshield is cracked or shattered. Some companies offer separate glass coverage with or without a deductible. States do not require the purchase of collision or comprehensive coverage, but lenders may insist borrowers carry it until a car loan is paid off.

6. Uninsured and Underinsured Motorist Coverage
   Uninsured motorist coverage will reimburse the policyholder, a member of the family or a designated driver if one of them is hit by an uninsured or a hit-and-run driver. Underinsured motorist coverage comes into play when an at-fault driver has insufficient insurance to pay for the other driver's total loss. This coverage will also protect a policyholder who is hit while a pedestrian.

All insurance policies should be reviewed and updated periodically to be certain that coverage levels remain appropriate in light of changing family finances and demographics.