

PERSONAL LOSS EXPOSURES AND RISK MANAGEMENT (555-1)

[The material in this assignment does not track perfectly with the Educational Objectives ... but is presented to facilitate and maximize your understanding and learning.]

PERSONAL RISK MANAGEMENT is the identification, analysis, and treatment of the pure loss exposures of an individual or family. A **loss exposure** is a situation that presents the *possibility* of loss, *even if* the exposure is not identified *or if* the loss never occurs. **Personal objectives** are the goals of an individual or family. Risk management helps people identify loss exposures and decide how to handle losses, thereby reducing anxiety and minimizing the financial impact of losses.

THE SIX STEPS OF THE PERSONAL RISK MANAGEMENT (RM) PROCESS:

1. **IDENTIFY LOSS EXPOSURES**--Use **questionnaires and checklists to identify exposures in six general areas:** property, liability, illness and injury, death, retirement, and unemployment. Merely 'thinking through' a list of loss exposures helps an individual brainstorm, but will *not* identify all exposures. Questionnaires provide a systematic approach to exposure identification, but do *not* allow flexibility.
2. **ANALYZE LOSS EXPOSURES**--Determine potential causes of loss (**perils**) and the consequences of loss for each exposure. **The cause of loss** is the actual event or means by which damage is inflicted. **Consequences (or results) of a loss may be** a) **critical** (prevent personal goals), b) **severe** (delay personal goals), *or* c) **bearable** (not affect personal goals).
3. **EXAMINE ALTERNATIVE RISK TREATMENT TECHNIQUES**--avoidance, control (prevention and reduction), noninsurance transfer, insurance transfer, and retention. *[See below.]*
4. **SELECT THE BEST RISK MANAGEMENT TECHNIQUE(S)**--Develop the RM plan.
5. **IMPLEMENT BEST TECHNIQUE(S)**--Follow the plan. Buy any needed insurance. Establish a fund to pay for any retained loss exposures.
6. **REVIEW AND REVISE THE PLAN AS NEEDED**--Go back to Step 1.

There are **TWO TYPES OF RISK MANAGEMENT TREATMENT TECHNIQUES:**

1. **Risk control**--changes the loss exposure to prevent loss (to lower loss frequency) or changes the conditions after loss to reduce the financial impact of the loss (to lower loss severity).
 - a. **Avoidance**--Avoid exposures which don't have to be assumed and/or eliminate exposures that already exist. *Example:* Avoid or eliminate auto ownership and use *or* avoid auto ownership but not auto use (lease a vehicle).
 - b. **Loss control**--Use **loss prevention** to lower loss frequency. *Example:* Quit smoking to reduce the frequency of fire losses and lung cancer. Use **loss reduction** to lower loss severity. *Example:* Buy a fire extinguisher to lower the severity of fires that do occur.
 - c. **Segregation of loss exposures**--Use **duplication** (creation of spare or duplicate property) or **separation** (division of activities or of property at separate locations) so no single peril can cause total loss. *Example:* Copy important documents (duplication) and store them in your safe deposit box as well as in your files (separation).
 - d. **Noninsurance transfer for risk control**--Transfer all elements of a pure loss exposure. *Example:* Sell your vacation home and rent when you vacation.
2. **Risk financing**--determines who will pay for those losses that do occur.
 - a. **Personal insurance**--Transfer the financial consequences of a pure loss exposure to an insurer or a government agency.

Personal insurance can have three layers:

 - 1) **Social insurance** provides the base layer of protection against *some* losses--workers' compensation, unemployment insurance, and social security.

- 2) **Group (employment) benefits** provides the second layer--retirement plans, life insurance, medical expense insurance, disability income insurance, salary continuation plans, and, sometimes, even auto and home insurance.
 - 3) **Individual insurance** provides the final, most customized, layer of coverage and hence is the most important for financial planning--may include virtually any type of personal insurance that meets the requirements of commercial insurability.
- b. **Noninsurance transfer for risk financing**--Transfer the financial consequences of a pure loss exposure. *Examples:* Incorporate your sole proprietorship. Transfer your premises liability exposure to your landlord by lease.
 - c. **Retention**--Bear exposures totally or partially with deductibles, coinsurance, underinsurance, and selective transfer of subjects, perils, and consequences. Avoid unintentional retention of any exposure.
 - In partial retention**, part of the risk is kept and part is transferred.
 - In total retention**, all of the risk, the entire cost of the loss, is retained. None is avoided or transferred.

Guidelines for determining how to finance personal loss exposures:

1. Consider the level of loss severity the family can retain,
2. compare each potential loss severity to the cost of treating it, *and*
3. consider the effect of frequency on aggregate loss severity.

Risk management techniques for given loss frequencies and loss severities:

1. **high frequency/high severity**--avoid, control, transfer, or retain;
2. **high frequency/low severity**--prevent or retain;
3. **low frequency/high severity**--avoid, control, transfer, or insure; *and*
4. **low frequency/low severity**--retain or prevent.

PROPERTY LOSS EXPOSURES: **Property** is anything that is owned.

REAL PROPERTY includes **unimproved land** (real property without permanent improvements) and **improved land** (real property with permanent improvements affixed--buildings, septic tanks, towers, pools). Unimproved land may contain valuable resources.

Fixtures are personal property that became a part of land or part of a dwelling when attached to it. People can live in single-family homes, row houses, townhouses, apartments, cooperatives, condos, mobile-homes, rented dwellings, and even on farms!

PERSONAL PROPERTY, which may be **tangible** (clothing, pets) or **intangible** (contract rights, patents), is any property that is *not* real property.

Personal property is what you'd take with you if you moved.

Real property is what you'd leave behind if you moved.

The causes of property loss include fire, theft, vandalism, flood, and anything else that causes loss.

If one of several perils leads to a single loss, each peril is referred to as a **concurrent cause**.

The consequences of loss to property include its **direct loss** (reducing its value) and its **indirect loss** (loss of its use). Consequences of loss of use include additional expenses and emotional distress.

In a bailment, one person (the **bailor**) transfers possession (but *not* ownership) of personal property to another (the **bailee**) with the expressed intent that the property will be returned at the end of the bailment.

LIABILITY LOSS EXPOSURES: Liability arises under civil and/or criminal law.

Civil liability results from interference with another's rights--either a breach of contract or a **tort** (any civil wrong other than breach of contract).

Unintentional torts are usually based on **negligence** (failure to use the degree of care a reasonably prudent person would have used under the circumstances).

Vicarious liability imposes liability on one person for the act of another in some situations--employer-employee, principal-agent, parent-child, and partnerships. Some statutes, for example workers' compensation (**WC**) statutes, impose **absolute liability** (liability without regard to fault).

Criminal liability results when a person is found guilty of a crime.

A single act may result in ***both*** criminal ***and*** civil liability.

Examples: Arson and battery both violate ***both*** the law ***and*** another's rights.

Liability loss consequences:

1. **Damages in civil liability--Damages** (restitution by a liable party) **include**
 - a. **nominal damages**--a minimal amount (often \$1) reflecting that the plaintiff suffered harm, but is ***not*** entitled to substantial monetary relief;
 - b. **compensatory damages**--compensation for harm to the **plaintiff** (party who sued):
 - 1) **special damages** (out-of-pocket expenses) and
 - 2) **general damages** (pain and suffering, emotional distress, loss of consortium);
 - c. **punitive (exemplary) damages**--punishment for intentional or outrageous conduct.

If payment of monetary damages is inadequate or inappropriate, the court may order equitable relief, such as

 - a. **specific performance** (a court order to perform a certain activity) ***or***
 - b. **injunction** (a court order to refrain from a certain activity).
2. **Punishment for criminal acts**--includes fines, community service, and incarceration.
3. **Legal costs**--include attorneys' fees and costs of investigation.
4. **Court costs**--include costs of bonds and filing fees.

Liability loss exposures may arise from several situations, including

1. **premises** (unrepaired sidewalk, unfenced swimming pool);
2. **personal activities** (borrowing a friend's chainsaw, babysitting a neighbor's child, playing golf);
3. **libel, slander, and other intentional offenses** (causing loud noise at night, a landlord's entering a leased area without his tenant's permission);
4. **employment of domestics** (injury of a nanny in the course of her duties, a chauffeur's auto accident while on the job);
5. **autos** (speeding, running a red light, driving under the influence);
6. **watercraft** (collision, striking a swimmer);
7. **business activities** (use of an auto for business purposes, volunteer work); ***and***
8. **host liquor liability** (cocktail party, New Year's Eve party, company picnic).

Common risk treatment plans:

1. **Property loss exposures**--avoidance, prevention, reduction, and insurance with a small retention (subject to a small deductible).
2. **Liability loss exposures**--prevention, reduction, insurance, and avoidance or retention of uninsurable exposures. Avoidance of all liability loss exposures is ***very*** difficult.

TYPES OF RISK MANAGERS AND FINANCIAL PLANNERS:

Risk managers and risk management consultants provide risk management advice and services to commercial accounts.

Financial planners and financial planning consultants provide financial planning advice and services.

Single-purpose financial planners specialize in one area, such as insurance, investment, tax, accounting, banking, or trusts.

Comprehensive financial planners are generalists who help with the personal financial planning process with and on behalf of their clients.