Risk Management in Personal Finance

Whether you are investing for your retirement or for more immediate financial needs, there are only three things that can keep you from achieving your goals: inflation, taxes, and risk. It is easy to plan for inflation and to reduce taxes, but risk is another matter because it is so unpredictable. It can come in many forms, but the results are always the same: loss of money. It might be due to loss of family income from death, disability, illness, legal action, or other circumstances beyond your control.

Risk is the possibility of loss. Sometimes the loss is trivial, while at other times it may cause major personal and financial hardship. There is no way to eliminate all risk, but there are ways to avoid, minimize, or protect yourself and your family from risk. When risk is low, or the cost is not too high, it is easy to assume risk. When it is too costly to assume risk, you need other ways to manage it. Insurance provides a convenient way to manage financial loss due to catastrophic risk.

You can manage risk in four ways:

- Assume risk
- Avoid risk
- Share risk
- Transfer risk to someone else

When you assume risk, you do nothing to minimize the financial impact of loss should a hazard occur. For example, you don't buy fire or flood insurance on your home or you don't have life, disability, or health insurance coverage. Should a risk occur, you must pay the full cost of the loss out of your own assets. This can adversely affect your financial goals for you and your family.

Avoiding risk may not be easy, but there are ways to lower risk management costs by doing so. Risk avoidance can lower the financial cost of risk, which is why insurance premiums are lower for persons and businesses that take measures to lower risk. For example, automobile insurance premiums are lower for drivers with good driving records (no accidents and no cited violations of driving laws), and non-smokers pay lower medical insurance and life insurance premiums than smokers do.

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Sharing risk divides the cost of risk among those who participate. In a household where there are two earners, although the family income might be reduced should one earner lose his or her income, all is not lost, especially if only one earner's income is necessary to achieve the financial goals. Some insurance policies allow you to share the risks with the insurer in order to get a lower premium. If you can assume a certain amount of financial risk, then the insurance premium on the balance of the risk will be lower. For example, some automobile policies have lower premiums if you are willing to take responsibility for the first $500 of liability, known as a deductible. Medical insurance premiums can also be lowered if you have higher co-payments.

Finally, for those who cannot tolerate any financial risk, risk can be transferred to someone else, usually an insurance company, who assumes full responsibility for it. Of course, this method of risk management has the highest premium cost. An insurer will pay the costs of loss to an insured in consideration of a fee called a premium, which is usually a very small fraction of the benefits to be paid.

Insurance works because an insurer can determine the mathematical probability of a risk occurring, and the financial risk at stake. Anyone who owns an automobile knows that he or she is required to have automobile insurance to cover the risk of damage to someone else. With many years of statistics on automobile damage costs, insurers are able to determine the amount of premium necessary to provide benefits to insure automobile owners. Using the same principles, one can buy insurance to minimize financial loss due to accident, natural disaster, legal liability, illness, disability, and even death. The purpose of insurance is to provide financial relief from catastrophic losses. Money from many people is pooled to pay for losses incurred by a few.

When planning your financial goals, you need to consider the risks to your income, capital, and investments. Prudent investors evaluate their risk tolerance and make appropriate investments to assure that they will achieve their goals despite the potential risks that may befall them.