HOW TO PROTECT OUR MONEY

MODULE 6

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Topics In This Module

1. **Financial Risks**
2. **Insurance**

Dear learners, welcome to the sixth module of our financial literacy program. In this module we will learn how to protect our money. In other words, we will learn how to handle our risks. Therefore, we will start with learning what risk is and the different types of risks. After that, we will learn the steps of risk management and the different methods of handling risk.

The main goal of this module is to learn how to handle the risks successfully to protect our hard-earned money.

In order to learn how to protect our money, we will learn the meanings of concepts such as risk, pure risk, speculative risk, risk management, insurance and the risks of investing. Understanding these concepts will help us protect our money better.

Let's explain these concepts.

Risk

Pure Risk

Speculative Risk

Risk Management

Insurance

Investment Risk

What is Risk?

First of all, let's learn what risk means.

Simply, a situation involving harm or loss is called risk. Almost all situations involve a certain degree of risk. Even while we are riding a bicycle there is a risk. The level of risk may be low, moderate, or high depending on many factors such as the speed, the traffic, time of the day, the rain or snow, and the robustness of the bicycle along with unexpected factors.

Risky situations may cause our money or assets to be lost. Assets are useful and valuable things that we own. Our car and bank accounts are examples of assets. The value of our assets may change over time. For example, the value of our car or scooter may go down if we have an accident. The value of a mobile phone is reduced when it is damaged. Such things mean that our money may be lost due to risks.

Sources of Risks

The risks may come from different sources.

For example, natural disasters such as earthquakes and floods may cause serious damages.

Malicious or ignorant acts of some humans such as theft or arson may also cause harm.

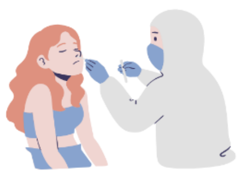
The prices in markets may fluctuate a lot creating losses for the buyers and sellers. For example, energy prices change often thus create losses.

Some microorganisms such as viruses and bacteria may also cause harm to health and life. Covid-19 was the latest example for this.

Finally, nonliving materials such as machineries and computers may break down causing serious damages.

So, risks are everywhere, but they are all uncertain because they are related to the future. We are not certain that they will cause loss, because we do not know what will happen in future. However, there is a possibility that they will cause loss and reduce our money. This is why we need to learn to handle them before they occur.

We will start by finding out the types of risks.



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Types of Risk

Although there are many risks, risk can be divided into two major categories in general. They are called Pure risk and Speculative risk.

Let's start by explaining the pure risk.

Pure risk refers to situations that result in a loss or no loss. In these situations, there is no possibility of financial gain. Not all, but most of the pure risk situations are beyond human control such as natural disasters. When there is a flood or big earthquake, they cause great damages. Other examples of pure risk are accidents, fire and thefts. They also cause loss and harm to people. There are no gains in these negative events.

Now let's go on with the speculative risk.

Speculative risk refers to situations that could generate either a gain or a loss. Most investments involve speculative risk, because they may end up either with a gain or with a loss. Remember the example of investing in bitcoin we covered in Module 3. There, we had seen that investing in Bitcoin could result in either income or a loss for us.

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Pure Risks

Now let's look at the pure risks in more detail.

Pure risks can be divided into three major classes. They are the personal risks, property risks and the liability risks.

Personal risks are the risks that directly affect an individual such as death, poor health, and unemployment. They are all unwanted and harmful events.

Property risk is the risk of having our property damaged or lost. For example, our bicycle, tablet, or mobile phone can be damaged or lost because of an accident or theft. These events cause our money to be reduced.

Liability risks are another important type of pure risk that most of us may face. We can be held legally liable if we do something that results in bodily injury or property damage to someone else. For example, if we hurt someone or damage their scooter, even by mistake, then we may be held responsible for that incident and may be charged for this damage.

As a result, we can see that none of the events bring a gain or income to us. Pure risks only cause harm, loss, and damage. They reduce our money and assets. Therefore, it is essential that we need to learn to manage these risks. We will start learning this in the topic.

Risk Management

First of let's start with understanding the meaning of risk management.

Risk management represents decisions about whether and how to protect against risks. So, it is about taking decisions regarding uncertain future events that may be harmful.

We often assume that risk is beyond our control. This is not totally true. We can measure most of the risks and handle them effectively by following the steps of the risk management process.

If we manage our risks well then, we can protect most of our money and assets. Otherwise, our money might be reduced or lost.

We will learn the steps of the risk management process in the following page.

Steps of Risk Management

There are four major steps in the risk management process.

First, we should identify possible losses. This step involves an analysis of all potential losses such as property, liability and personal losses. For example, our bicycle, tablet, mobile phone, scooter, house, car, health and all other valuable items should be listed. Because they are all faced with loss due to an uncertain future event caused by any of the sources of risk.

Second we should analyze those possible losses. This step involves an estimation of how often and how serious the loss can be. For example, a big earthquake may not happen often but when it occurs its consequences are very serious. We should analyze all of the possible losses that we idenfied in the first step one by one like this.

Third, we should select the proper methods of risk management that are listed and explained in the following topic.

Finally, we should implement and monitor our risk management program. If necessary we should make changes in our program.

Now we will go on with the methods of risk management mentioned in the third step.

Methods of Risk Management

Now let's describe the major methods of risk management.

Let's start with the Acceptance method. When the possibility of an event that could cause a loss is very low and the potential loss due to the event is small then we may use the acceptance method. For example, if we ride an inexpensive scooter or bicycle, we may be willing to accept the financial loss in case of an accident that results in damage. In that case, we take no action before and thus accept financial loss if it occurs.

Another method is called Avoidance. If the risk is very likely and the consequence may be very serious, then we may simply choose to avoid it. For example, we may avoid investing in highly risky crypto currencies. We should also avoid playing bets on games. By the way, a serious risk for us may be unimportant for a very wealthy person. So, the same method has different meanings for different people.

Loss Control is another method of risk management. This method consists of certain activities that reduce how often the risk occurs and how much loss it causes. Thus, loss control has two objectives. They are the loss prevention and the loss reduction.

Loss prevention aims at reducing the probability of loss. For example, auto accidents can be reduced if motorists take a good driving course. The number of heart attacks can be reduced if individuals eat healthy diets and give up smoking. Financial losses can also be reduced by being more financially literate.

Although loss prevention efforts are useful, some losses will inevitably occur. Thus, the second type of loss control is to reduce the negative impact of a loss after it occurs. For example, a department store or a school can install a sprinkler system so that a fire will be immediately extinguished. We should use seatbelts while driving to reduce the severity of injury in case of a collision.

We can also use diversification as a risk management method. Diversification is a strategy designed to reduce risk by spreading across the investments. Diversification reduces variability. There is an old saying don't put all your eggs in one basket. Diversification allows good and bad events to cancel each other out, thereby reducing total variability without affecting expected return. For example, selling umbrellas is a risky business. Selling ice cream is also risky. If we invest in both umbrella business and ice-cream business, then we can make an average level of income in case of rain or sunshine.

Another important method for managing pure risk is called insurance. It is one of the most practical methods of handling a major risk. Insurance involves the transfer of pure risk to an insurance company.

Insurance

Now let's go on with explaining insurance.

We may face the risk of losing our money during many of our daily activities.

Insurance is a pool of money that each participant contributes to this pool by a small amount of money. This small amount of money is called an insurance premium. A contract is signed between the insured and the insurance company. This contract is called insurance policy. The insurance policy indicates what will be paid by the insurance company to the insured in case of an occurrence. The insured promises to make the insurance payments, that is the insurance premium, and the insurance company promises to pay for the damage or loss.

The main aim of insurance is to maintain our existing level of wealth. It protects us against losses we face as a result of unexpected events.

Insurance may seem costly, but it is well worth the cost. The decision to obtain insurance is determined by weighing the costs and benefits.

The cost of obtaining insurance is the premium that is paid for a policy each year. The benefit of obtaining insurance is that it can protect our assets or our income from events that otherwise might cause a financial loss. Without insurance we could lose some of our assets if we are involved in an accident that causes major repair expenses.

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There are different types of insurance to cover different types of risk. Insurance companies offer insurance policies that can protect us against financial losses. When there is a high likelihood that an event will cause a financial loss and the potential loss from that event is way too large then insurance should be considered. However, we cannot insure against all types of risk as some types of insurance are either unavailable or too expensive.

Types of Insurance

The most popular forms of insurance for individuals are property and casualty insurance, life insurance, and health insurance. Understanding our insurance needs is important in determining the type of insurance that we should use.

Property and casualty insurance is used to insure property and therefore consists of auto insurance and home insurance. Auto insurance insures against damage to an automobile. In this way it protects one of our main assets, which is the car, and also limits our potential expenses due to an accident. If our car is damaged because of an accident, then the insurance company gives us the money for repairing the car. Similarly, the homeowner's policy covers the damages to the house. For example, if our house is damaged due to a fire or an earthquake then we will get the money to repair it from the insurance company. If the damages cost 100,000 euros, the insurance company will pay us this 100,000 euros.

Health insurance covers healthcare expenses incurred by us. When we are young and healthy, even though health insurance seems unneeded, it should not be ignored at all. If something negative happens to our health, this insurance limits our expenses and ensures that we will receive necessary medical care. Without health insurance the high expenses of health care could quickly eliminate most of our wealth.

Life insurance provides a payment to a specified person in case of death. A 500,000 euro policy means that in the event of death the beneficiary person will receive 500,000 euros. Life insurance is critical to protect a family's financial situation in the event that a provider of the family dies. If no one else relies on our income, then life insurance may not be necessary.

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Investment Risks

We have already seen that most of the investments involve speculative risks, because they might result in either loss or gain.

Thus, it is clear that investing is risky. It means that there is a possibility that we will lose our money when we make investments.

In general, we are faced with two kinds of major risk for our investments. They are called diversifiable and non-diversifiable risks.

In order to understand the difference between these risks, let's look at an example.

Assume that we want to set up a business firm. Remember the example given previously about the umbrella and ice-cream businesses. Rain helps the umbrella business while sunshine and hot weather help the ice-cream business. We can invest in one of those businesses or we can invest in both of them.

If we invest in only one of them, we might be faced with the risk of no rain in umbrella or no hot weather in the ice-cream business. This will mean that we will not be able to earn any money and our investment money will be lost.

If we invest in both businesses, then it means that we have diversified our money across these two investments. The risk of no rain or no hot weather will be lessened by making more than one investment. Because these risks cannot happen simultaneously, we will still earn an average amount of money instead of losing our money.

However, even though we have invested in both businesses there is still a risk we cannot avoid. For example, if the umbrellas and ice cream we are producing are not demanded at all by people because they prefer other products, then it means we will not make any money from these investments. Such risks may affect all markets or businesses at the same time thus it is not possible to reduce the losses by diversifying as in the example. Those risks are called non-diversifiable risks. People care more about non-diversifiable risks because the other risks can be reduced by diversifying.

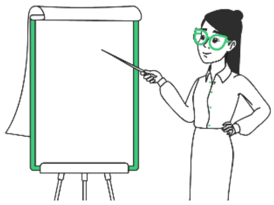
Investment alternatives have different amounts of risk and expected returns. Every individual investor would like investments that offer a very high return and have no risk. However, such investments do not exist. The more risk an investment has, the higher will be its expected return. For example, when we deposit our money in a savings account, we will get the interest income as we discussed in Module 3. This is a relatively safe investment. But if we buy Bitcoins instead, this will be a relatively risky investment which may end up either with capital gain or capital loss. Therefore, we would expect to earn more from this risky investment than the interest income we are supposed to get from our savings account in the bank.

As a final word we should keep in mind the following quote by Benjamin Franklin.

"An investment in knowledge pays the best interest "

What Did We Learn?

- **CONCEPTS ABOUT RISK**
- **METHODS OF RISK MANAGEMENT**
- **INVESTMENT RISKS**

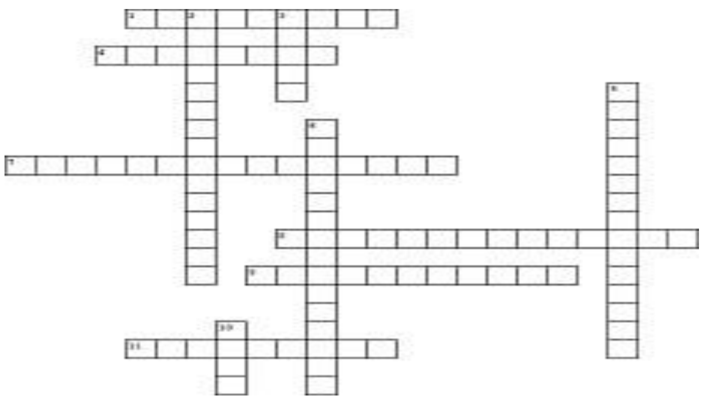


In this module, we learned the meaning of risk and the different types of risk. We learned how to manage our risks by following the steps of risk management. We also learned the investments risks and the different types of risk associated with investments and returns. As a result, we learned how to protect our money and assets.

Now, Let's solve the crossword puzzle.

CROSSWORD PUZZLE

risk, asset, pure risk, speculative risk, risk management, insurance, avoidance, diversification, health insurance, loss control, insurance policy



Across

A pool of money that each participant contributes to this pool by a small amount of money

A situation that results in a loss or no loss

A strategy designed to reduce risk by spreading across the investments

Decisions about whether or how to protect against risks

Certain activities that reduce how often the risk occurs and how much loss it causes

If the risk is very likely and the consequence may be very serious then we may use this method

Down

A situation that can generate either a loss or a gain

Useful and valuable things that we own

A contract signed between the insured and the insurance company

It covers healthcare expenses incurred by us

A situation involving harm or loss

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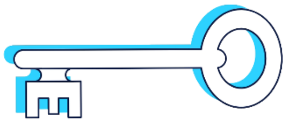
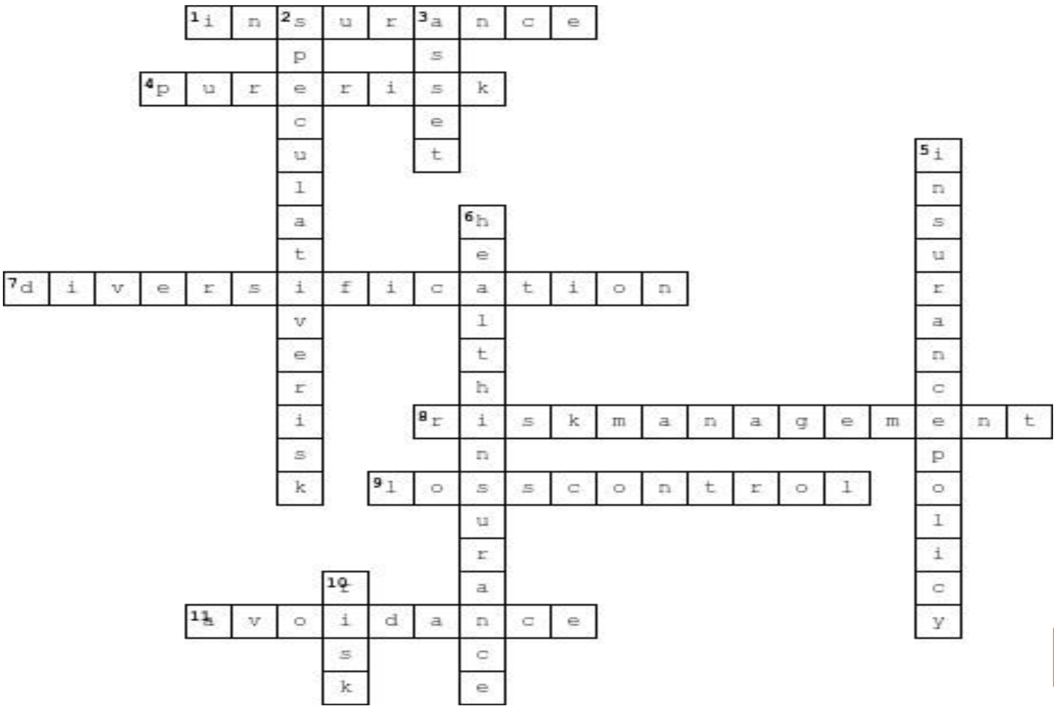
- These are the answers. How did we do?



ANSWERS OF CROSSWORD PUZZLE



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Congratulations – Module 6 ✓

- Module 1: How to Manage Money (Financial Literacy)
- Module 2: How to Make Decisions About Money (Financial Concepts and Decisions)
- Module 3: How to Make Money (Earning Income)
- Module 4: How to Spend and Pay (Payment systems)
- Module 5: How to Make a Financial Plan (Budgeting)
- Module 6: How to Protect our Money (Risk Management)
- Module 7: How to Protect our Rights (Consumer Rights)

- Congratulations we have completed Module 6 where we discussed how to protect our money.
- Good luck in your journey to being a financially literate person.

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