

What is insurance?



Taking insurance is a process by which a person, called the policyholder passes on a

risk of loss that they would like to avoid to an insurance company in return for a payment, called an insurance premium. People use insurance to guard against the risk of a possible, but uncertain, loss. A policyholder takes on a known cost (the premium) in return for the insurance company contracting to cover larger costs should a specified adverse event occur.

Types of insurance: there are many different types of insurance. People can insure against almost any potential risk – at a price. However, the following are the four main types of insurance that most people would consider taking and the main risk that is being insured against for each one.

Type of insurance	Type of risk being covered
Life insurance	Early death
Motor insurance	Accident or theft
Property insurance	Fire or other property damage
Accident and Health insurance	In case of illness and personal accident

Insurance policy: The policyholder will receive a contract, usually called an insurance policy, that will set out the conditions of the policy and the circumstances under which the insured will be compensated. The policy may also list exemptions or exceptions, which will not be compensated. For example, health insurance policies will often list as exceptions that will not be compensated illnesses or injuries arising from self-inflicted conditions or from participating in

dangerous activities, such as sky-diving. A person needs to read the policy carefully before signing. Insurance policies can be complex and many policyholders may not understand all the fees, coverage and exemptions in the policy. You should pay particular attention to the exemptions. They may include some of the important risks and the insurance company will not compensate the policyholders even if they suffer significant damage.

The nature of insurance: events that private insurance companies will commonly insure against, usually have the following broad characteristics:

- **Large numbers:** there are a large number of people exposed to the same risk. This allows the company to spread the cost of the risk over a large number of people;
- **Known loss:** the size of the loss if the event occurs is known. If the size of the loss is not known with reasonable certainty, the insurance company will have difficulty in setting an appropriate premium;
- **Accidental events:** the event, if it occurs, will be 'accidental', if the policyholder can't determine or influence the event. If the policyholder does trigger the event, such as by arson, the insurance will usually be invalidated;
- **Possibility of a significant loss:** the loss must be a relatively large one for the policyholder. If the loss arising from an adverse event is quite low, it is probably better for the person to 'self-insure'.

In some areas, such as health insurance, a mixture of the two is often used. By agreeing to what is called a deduction, the person agrees to insure himself for small medical events such as occasional visits to a doctor. The larger the deduction, the lower the premium. What the person is insuring against is major medical costs that could be difficult to finance;

- **Affordable premiums:** if the premium is relatively high compared to the size of the potential loss the policy holder thinks he faces, he may decide 'self-insurance' is a better option for him;
- **Limited risk of catastrophically large losses:** certain events, such as earthquakes, may lead to very large losses if they occur, as they will affect a large number of people simultaneously. Often, some form of government insurance is necessary in these types of areas, as the risk is too concentrated and unpredictable for a private company to insure against.



Insurance involves pooling funds from the premiums paid by many policyholders to pay for the losses that a small proportion of them will incur. Not every policyholder will have an accident or fall ill at the same time. The larger the number of policy holders a company can get who are insuring against the same type of risk, the more they can benefit from the 'law of large numbers' to spread their own risk and the lower the premiums will be for each individual policy holder.

It is sensible for people to insure against some of the major risks that they face in life, as insurance can help families and individuals to prepare for and offset the impact of adverse events on their own financial position. If a person is uninsured, adverse events like ill-health, loss of their property by fire or a major traffic accident can damage or even destroy the person or family's financial situation.

How do insurance companies decide on the premiums they will charge?

Insurance companies usually use people called actuaries to help them set their premiums. Actuaries use statistics of past events and probabilities of future events to estimate the rate of future claims and thus determine a premium that should allow the company to meet these future claims and still make a profit. The more frequently an adverse event is likely to occur, the higher the premium will be.

In deciding which insurance company to take out an insurance policy with, a person should consider the relative premiums they would charge. However, this is not the only element a person should consider in choosing an insurance company. They should also consider the financial soundness of the company (a weak company may be unable to pay compensation when the policyholder has a right to it) and the company's past record in paying claims on time.

