Insurance Principles

Ralph O. Felberg
South Dakota State University

Follow this and additional works at: http://openprairie.sdstate.edu/econ_comm
Part of the Agricultural and Resource Economics Commons, and the Regional Economics Commons

Recommended Citation
http://openprairie.sdstate.edu/econ_comm/27

This Newsletter is brought to you for free and open access by the Department of Economics at Open PRAIRIE: Open Public Research Access Institutional Repository and Information Exchange. It has been accepted for inclusion in Economics Commentator by an authorized administrator of Open PRAIRIE: Open Public Research Access Institutional Repository and Information Exchange. For more information, please contact michael.biondo@sdstate.edu.
INSURANCE PRINCIPLES

Insurance is only financial protection. The protection provided does not guarantee that your property will never be damaged or that you will live a certain number of years. The purpose of insurance is to restore financial well-being after a financial calamity. It can restore some of the money lost which may be caused when things are lost, stolen or destroyed. It can be used to replace the income lost when the wage-earner dies or is disabled. In that sense insurance does provide protection.

Every day a person encounters many risks, possibilities of loss, or undesirable happenings. Insurance, however, is concerned only with risks defined as being insurable. An insurable risk is an exposure to financial loss to a person or organization (the insured party). Insurance claims cannot be paid when there is deliberate action on the part of the insured to create risk.

There are three ways to deal with insurable risks: (1) take preventative measures to reduce or eliminate risk, (2) retain the risk and assume financial responsibility for absorbing the loss yourself, or (3) transfer the risk and potential financial burden to someone else.

You can eliminate or reduce risk by being cautious. Thus, careful behavior may remove the need for insurance or if protection is still desired, lessen the cost of insurance. Insurance rates are set according to the degree of risk. The greater the risk, the higher the premium you must pay to obtain coverage for that risk. Fire insurance premiums, for example, are higher where the fire protection is considered less than adequate.

Governments at all levels are active in reducing risk and preventing financial loss. Many governmental agencies provide information which describe precautionary measures you can take around the home, in your car, and concerning your health. Since the cheapest insurance is careful behavior, you would do well to read some of the pamphlets and follow the advice given.

After trying to prevent financial loss by reducing risk, you must decide whether to retain the remaining risk of financial loss or transfer the risk to an insurance company. Retaining the risk is called self-insuring. A degree of self-insurance can be obtained by taking advantage of policy options which require you to pay some part of the loss. The $100 deductible option in the auto collision policy is an example of self-insurance.

The decision to retain or transfer the risk should be decided after an examination of your personal loss experience and your financial position. Your personal loss experience is a record of how much money or monetary value you have lost because of insurable risks.

Your personal balance sheet and income statement can be used to determine your financial position. How great is
your financial capacity to assume risk? Do you have enough in your savings account, for example, to replace your automobile if it is damaged beyond repair? Do you have sufficient income and the determination to set aside adequate funds to protect yourself against possible losses?

Larger organizations, such as governmental units and business firms, often use self-insurance. Their insurable risks are so dispersed that it is cheaper to suffer an occasional large loss than to pay the premiums needed to obtain adequate coverage by an insurance company. Individuals or smaller organizations could do the same thing by forming a cooperative type organization. By joining the organization, each individual member agrees to be assessed a proportionate share of the financial cost when losses to members do occur. The assessments may be less than the total premiums that would have to be paid to an insurance company but there are also obvious disadvantages to this type of self-insurance.

To the individual, it is generally best to retain those risks that involve relatively small financial losses and are likely to occur frequently. The risks that are best transferred involve relatively large financial losses that can be very burdensome if and when they do occur.

Previous loss experience plays no part in life insurance planning. When determining the financial effects of your premature death, you must consider the financial position of your beneficiaries as well as your own. How much money will they need to support themselves after your death and how many of your financial assets can be used to satisfy their needs? But the principle of self-insurance should be considered in your life insurance planning. If you are able to do so, building a life insurance reserve on your own rather than transferring the entire risk to an insurance company could save you a considerable sum of money during your lifetime.

Some of the points to be considered when it is necessary to transfer risks of potential financial burden to someone else will be discussed in another letter.

Ralph O. Felberg - Associate Professor, Economics