Writing insurance to cover small losses may not make sense when the expense of providing the insurance probably exceeds the amount of potential losses. Insurance covering the disappearance of office supplies, for example, could require the insurer to spend more to investigate and to issue claim checks than it would for the insured to simply absorb the cost of replacing the supplies.

It also may not make sense to write insurance to cover losses that are almost certain to occur. The premiums would probably be as high as or higher than the potential amount of the loss. For example, insurers generally do not cover damage because of wear and tear on an automobile because automobiles are certain to incur such damage over time.

Apply Your Knowledge

Jim's summer job is to work as an intern for an insurance agency. When preparing a listing of the agency's homeowners book of business, Jim notes that seventy-five clients' homes are located within one-half mile of the river in a designated flood plain. Jim is concerned because one of the agents told him that flood exposure is not covered under the homeowners policy. Jim proposes to his manager that the agency sell a flood coverage endorsement to each of the homeowners clients. Jim's manager reviews with Jim the six characteristics of an ideally insurable loss exposure. Jim determines that the exposure of flood possesses only three of the six characteristics: pure risk, fortuitous losses, and definite and measurable.

If you were in Jim's position, how would you arrive at this determination?

Feedback: The exposure is a pure loss because a loss that occurs as a result of a flood does not result in financial gain for the insured; thus, there is either a loss or no loss. It is fortuitous because the insured does not have control over whether and when a flood loss will occur. It is definite in time, cause, and location, and flood data are available that can be measured. Conversely, there is not a large number of similar exposure units. Additionally, the loss is not independent because all of the homes in the flood plain will be exposed. Finally, because only those who believe they are at risk for a flood loss would purchase the flood endorsement, the insurer will not be able to offer an economically feasible premium.

BENEFITS OF INSURANCE

Insurance is a prominent risk management technique, and several risk financing measures involve the use of insurance to some degree. It is therefore important for risk management and insurance professionals to consider the benefits of insurance when selecting the most appropriate techniques for meeting risk management goals.

When used as a risk financing measure, insurance can help an individual or organization achieve risk financing goals such as paying for losses, managing cash flow uncertainty, and complying with legal requirements. Insurance also provides benefits to individuals, organizations, and society as a whole by promoting insureds' loss control activities, enabling insureds to use resources efficiently, providing support for insureds' credit, providing insurers with a source of investment funds, and reducing social burdens.

Paying for Losses

The primary role of insurance is to indemnify individuals and organizations for covered losses. This benefit is consistent with the risk financing goal of paying for losses. Provided that the loss is to a covered loss exposure and a covered cause of loss, insurance will indemnify the insured, subject to any applicable deductibles and policy limits.

Managing Cash Flow Uncertainty

Insurance also enables an individual or organization to meet the risk financing goal of managing cash flow uncertainty. Insurance provides the insured with some degree of financial security and stability. The insured can be confident that as long as a loss is covered, the financial effect on the insured's cash flow is reduced to any deductible payments and any loss amounts that exceed the policy limits. The remainder of the loss will be paid by the insurer, reducing the variation in the insured's cash flows.

Meeting Legal Requirements

The final risk financing goal that insurance meets is the goal of meeting legal requirements. Insurance is often used or required to satisfy both statutory requirements and contractual requirements that arise from business relationships.

For example, all states have laws that require employers to pay for the job-related injuries or illnesses of their employees. Employers generally purchase workers compensation insurance to meet this financial obligation. In addition, certain business relationships require proof of insurance. For example, building contractors are usually required to provide evidence of liability insurance before a construction contract is granted.

Promoting Risk Control

A major benefit of insurance is the promotion of risk control. Insurance often provides the insured with the incentive to undertake cost-effective risk control measures. Insurers provide this incentive through risk-sharing mechanisms such as deductibles, premium credit incentives, and contractual requirements.

Because these incentives can lead to a reduction in losses paid by the insurer and therefore lower premiums, they benefit not only the individual insured but also all other insureds. Furthermore, risk control measures can save not only financial resources but also the lives of individuals or employees. Therefore, society as a whole benefits.

Enabling Efficient Use of Resources

People and businesses that face an uncertain future often set aside funds to pay for future losses. However, insurance makes it unnecessary to set aside a large amount of money to pay for the financial consequences of loss exposures that can be insured. In exchange for a relatively small premium, individuals and organizations can free up additional funds. As a result, the money that would otherwise be set aside to pay for possible losses can be used to improve an individual's quality of life or to contribute to the growth of an organization.

Providing Support for Insured's Credit

Insurance can also provide support for an insured's credit. Before making a loan, a lender wants assurance that the money will be repaid. For example, when loaning money to a borrower to purchase property, the lender usually acquires a legal interest in that property. This legal interest enables the lender to take actions such as repossessing a car or foreclosing a home mortgage if the loan is not repaid. Without this ability to recover the loan amount, the lender would be less likely to make the loan. Insurance facilitates loans to individuals and organizations by guaranteeing that the lender will be paid if the collateral for the loan (such as a house or a commercial building) is destroyed or damaged by an insured event, thereby reducing the lender's uncertainty.

Providing Source of Investment Funds

Insurance provides a source of investment funds for both insureds and insurers:

- Insureds are not required to set aside large retention funds to pay for losses that are covered by insurance.
- The premiums collected by insurers are invested until needed to pay claims. Such investments can provide money for projects such as new construction, research, and technology advancements.

Insurers also invest in social projects, such as cultural events, education, and economic development projects. Investment funds promote economic growth and job creation that, in turn, benefit individuals, organizations, and society. Also, because investment brings additional funding to insurers in the form of interest, this additional income helps keep insurance premiums at a reasonable level.