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Core principles of insurance

Concept of risk and risk transfer

Definition of risk

Consider the following statements, each giving a different slant to the term ‘risk’:

- The possibility of an unfortunate occurrence.
- Doubt concerning the outcome of a situation.
- Unpredictability.
- The possibility of loss.

The accepting of an unknown future potential risk by an insurer for an agreed premium is a way of defining insurance as a **risk transfer** mechanism.

Other meanings of the term ‘risk’

There are three other ways in which the term is used in the insurance marketplace:

- The **peril** or contingency that is insured – the fire risk, the theft risk and so on.

- The thing (or liability) actually insured. In this context the 'risk' could be a factory or a manufacturer's liability to the public.
- When an underwriter quotes for 'a risk' an even wider definition is implied. The underwriter will mean both the thing insured, such as the property itself, and the range of contingencies or scope of cover required.

Attitude to risk

Some people are willing to carry certain risks themselves and are termed **risk-seeking**, while others lean more towards being **risk-averse**, minimising the risk they are exposed to.

Risk management

There is a continuing trend towards taking control and developing a formal strategy for managing the various risks that affect businesses.

Commercial risk management is important for several reasons:

- It reduces the potential for loss by identifying and managing hazards.
- It gives shareholders a greater degree of confidence in a company's ability to manage its risks.
- It provides a disciplined approach to quantifying risks.

In order to make informed decisions about the risks that a business faces, there are three key steps in the risk management process:

- risk identification;
- risk analysis; and
- risk control (including the possibility of risk transfer).

Risk identification

Risk identification involves discovering the threats that may already exist, and the potential threats that may exist in the future.

Risk analysis

Risk managers will examine past data to evaluate or analyse the risk and so predict future trends.

Risk control

If the risk is seen to have the potential for adverse consequences, some course of action should be put in place to control, reduce or even eliminate the risk.

Physical control measures	For example, putting specific locks on the doors of a factory to reduce the theft risk.
Financial control measures	Such as transferring the risk by either taking out insurance or by contract (e.g. arranging for a security firm to accept responsibility for cash whilst in its control).
Developing a good risk culture	Key to improving risk awareness and managing risk. This can be achieved by educating employees or clients on how to avoid or reduce risks.

Fraud and cyber crime

Fraud is a key risk that insurers also need to manage and mitigate, and this has resulted in the creation of various industry bodies and databases for use in the recording and detection of fraudulent activity.

One initiative has been the Motor Insurance Anti-Fraud and Theft Register (MIAFTR).

Components of risk

Uncertainty

Uncertainty about the future is at the centre of risk. If we always knew exactly what was going to happen, there wouldn't be any risk. Because we don't, we can't be certain of anything.

Level of risk

Risk is assessed by insurers in terms of **frequency** (how often something might happen) and **severity** (how costly it would be if it did happen).

Peril and hazard

This relates to the causes of losses:

- A **peril** can be defined as that which gives rise to a loss.
- A **hazard** can be defined as that which influences the operation or effect of the peril.

Physical and moral hazard

Physical hazard relates to the physical characteristics of the risk and includes any measurable dimension of the risk.

Moral hazard arises from the attitude and behaviour of people. In insurance, this is usually the conduct of the insured.

Categories of risk

Not every type of risk or eventuality is insurable. It will help our understanding if we look at (and contrast) different types of risk to identify those that are insurable and those that are not. The groupings that we will look at are:

- financial and non-financial risks;
- pure and speculative risks; and
- particular and fundamental risks.

Financial and non-financial risks

For a risk to be insurable the outcome of an adverse event must be measurable in **financial** terms.

Examples:

- Accidental damage to a motor car.
- Theft of property.
- Loss of business profits following a fire.
- Legal liability to pay compensation for personal injury to others.

Some of the risks that we face are not capable of financial measurement – these are **non-financial risks**.

Pure and speculative risks

Pure risks are those where there is the possibility of a loss but not of gain. It is these types of risk that are generally insurable.

Examples:

- The risk of fire.
- The risk of machinery breakdown.
- The risk of injury to employees at work.

Speculative risks may involve three possible outcomes: loss, break-even or gain. Insurers do not insure speculative risks, since they are undertaken voluntarily, in the hope that there will be a gain.

Particular and fundamental risks

Particular risks are localised or even personal in their cause and effect. Sometimes the cause may be more widespread (e.g. a storm over a whole region), but the effect is localised.

Examples:

- A factory fire.
- A car collision.
- Theft of personal possessions from a home.

Fundamental risks arise from a cause outside the control of any one individual or group of individuals and their effects are usually widespread. The loss associated with them is often catastrophic.

Examples include economic recession, war, earthquake and famine.

Features of insurable risks

A fortuitous event

To be insurable, the occurrence must be a fortuitous event, i.e. accidental or unexpected.

Insurable interest present

Insurable interest is the legally recognised financial relationship between the insured and the object or liability that is being insured.

Not against public policy

It is commonly recognised in law that contracts must **not be against public policy**, i.e. go against what society considers to be the right or moral thing to do. Insurers should not, therefore, cover risks that are against public policy.

Homogeneous exposures

Given a sufficient number of exposures to similar risks, known as **homogeneous exposures**, the insurer can forecast the expected frequency and likely extent of losses.

Pooling of risk

The basic principle of insurance is that the losses of the few are met by the contributions of the many. An insurance company gathers together relatively small sums of money from people who want to be protected from similar kinds of perils. The insurer sets itself up to operate a **common pool**.

In fact, insurers operate a number of separate pools for different classes of insurance. Contributions, in the form of premiums from all of those insured, go into this pool. Out of the pool come payments to compensate the losses of the few.

Law of large numbers

Applying the **law of large numbers** to insurance enables the insurer to predict the final cost of claims in any one year fairly confidently. This is because insurers provide cover for a large number of similar risks and the final number of actual loss events (claims) tends to be very close to the expected number.

Equitable premiums

To operate a pooling system successfully, a number of pools must be set up, one for each main group of risks. Each person wishing to join the pool must be prepared to make an equitable (fair) contribution to that pool.

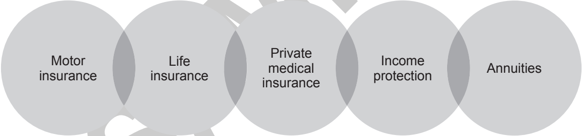
EU Gender Directive

At the start of 2011, the Court of Justice of the European Union (CJEU) ruled that insurers could no longer use gender as a premium calculation tool or in determining which benefits could be offered. This led to the **EU Gender Directive**.

Be aware

The EU Gender Directive was transposed into UK law by the **Equality Act 2010 (Amendment) Regulations 2012** so it continues to apply in the post-Brexit landscape.

The original ruling affected:



Although insurers can no longer use gender as a rating criterion, there is some evidence that women continue to enjoy cheaper motor insurance premiums due to better claims history and less exposure to high risk occupations.

Co-insurance

Part of an insurer's job is to manage the pool of money from which valid claims are to be paid. Each insurer will therefore decide upon the maximum limits of acceptance for particular categories of risk.

When a risk is offered to an insurer but the amounts at risk are greater than the insurer's retention limits for that category, the insurer has two choices:

- decline to offer insurance for the risk; or
- find a way of sharing the risk with others – one of the principal ways of doing this is **co-insurance**.

'Co-insurance' is used in two distinct ways in the insurance market:

- risk sharing between insurers; and
- risk sharing with the insured.

Risk sharing between insurers

In this context, co-insurance is a risk-sharing mechanism which applies mainly, but not exclusively, in the London Market (including Lloyd's).

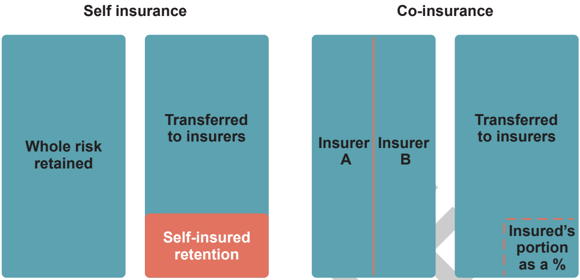
Risk sharing with the insured

The term 'co-insurance' is also used in relation to the amount of a risk that the insured may retain. A small fixed sum retained by the insured is called an 'excess'; a large fixed sum tends to be called a 'deductible'. However, where an insured is responsible for a substantial proportion of each loss, either through choice or by necessity, the term co-insurance is used.

Dual insurance
This term is used when there are two or more policies in force which cover the same risk.

Self-insurance

The term '**self-insurance**' means that an individual or company has decided to carry the risk themselves. The term can also be used when referring to the part of a loss that the insured retains.



The individual or company has decided to retain the whole risk itself

The insured retains part of the loss – often referred to as a 'self-insured retention'

Risk is shared between several insurers – each taking a stated proportion

The insured is responsible for a percentage of losses – called an excess or deductible

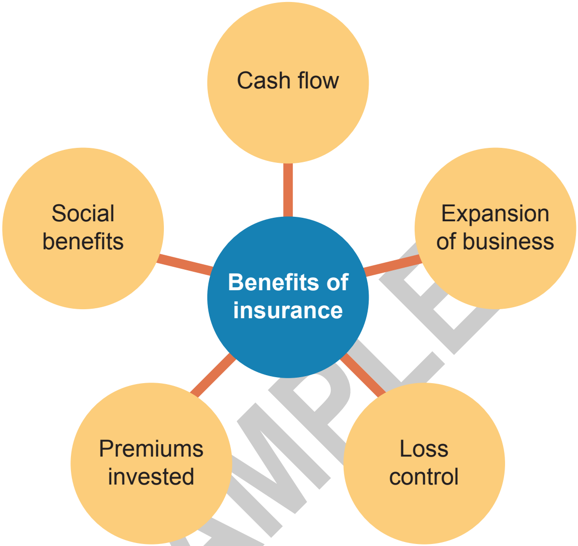
Reasons for buying insurance

An individual (or a business) will decide whether or not to purchase insurance based on:

- their attitude to the potential risk;
- whether insurance for the risk is a legal requirement;
- the price they are prepared to pay for the peace of mind insurance provides; and
- whether they feel they have a choice about insuring the risk.

Benefits of insurance

Insurance brings many benefits to policyholders, and to society as a whole. In addition to peace of mind, and the enabling of risk transfer, there are some other key benefits to be aware of:


Cash flow
Social benefits
Expansion of business
Benefits of insurance
Premiums invested
Loss control