

Insurance and How Insurance Companies Operate

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### Insurance and How Insurance Companies Operate

Countless risks exist in every sphere of life. For instance, properties face a risk of fire while human life is always at risk of disability or even death. The concept of insurance is based on these risks. Insurance is a contract whereby a certain sum (known as a premium) is charged by an insuring party (insurer) in consideration, and against which the insurer guarantees to pay a large amount as compensation (Williams, Smith & Young, 2002). When making an insurance decision, one needs to know why they need it and the amount that will be involved. Based on the previously mentioned factors, there are two types of insurance; whole life and term insurance. Term insurance is temporary while whole life insurance is permanent and valid until one dies or attains 120 years, whichever comes first. Most people prefer whole life insurance as opposed to term insurance that only lasts for a specified number of years.

Like other businesses, insurance companies are profit oriented. An insurance company can only make profit when premiums surpass the total cost of paying claims and other operational expenditures. Insurance companies make money based on the concept of spreading risk and the concept of independent losses (Levine & Carson, 2012). Under independent loss, an insurance company identifies a particular loss that is unlikely to affect a group of different policyholders. Robbery or burglary is a perfect example here where only one policyholder may suffer burglary loss. Since only one policyholder is affected, the cost of their loss is spread among many policyholders. Under the spreading risk concept, the insurance company spreads a particular risk among many policyholders. In this case, one kind of loss is unlikely to affect an entire group of policyholders. Consequently, the loss experienced by one policyholder is covered by all policyholders despite them not experiencing any loss. By achieving these two concepts on a large scale, an insurance company can realize good profits.

Insurance companies are primary market participants that benefit the society by allowing single entities to share risks faced by many entities. Additionally, accessible and affordable insurance enables banks to offer loans with an assurance that the collateral is covered against damage. Insurance companies also provide vital capital that society needs to recover quickly from natural disasters. Despite being significant market players, insurance companies are usually regulated by the state. There are well-spelt guidelines used by state authorities to regulate rates. For instance, one guideline requires the rates to be adequate. In this case, the company must maintain solvency and manage to compensate even in large claims. Regulatory guidelines also dictate that rates should not be excessive and the companies should have enough to remit but not in excess that they make exorbitant profits. The state regulators play a vital role in preserving the companies' long-term solvency and shield the insured against discriminatory and unfair treatment (Williams et al., 2002).

However, insurance companies are faced with challenges that may cause them to run at a loss. Both moral hazard and adverse selection refer to market failure situations that are occasioned by asymmetric information between sellers and buyers (Pauly, 2007). To control moral hazard, insurance firms avoid insuring for the full amount and make the process of claiming money difficult. Usually, the client has to pay some substantial amount of their insurance claim. The insurance company also provides incentives that motivate customers to insure their property. The companies do these to make the client more reluctant to raise claims hereby compelling them to be more careful to avoid loss. On the other hand, an insurance company experiences adverse effects after accepting applicants who falsify or conceal information about their real conditions (Pauly, 2007). For instance, a life insurance company may find that people at greater risk of death are more willing to buy life insurance premiums. In

this case, the insurance company would control adverse selection by identifying particular groups of people and charging them different rates depending on their status. The aim here is to charge higher premium rates to people who are at most risk.

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