Retirement: Principles of Insurance

Understanding the Principles of Insurance

By: Joe the Investor

Where did insurance come from? Before there were large companies, insurance was handled within a community. If a person needed something in a community or a person had a disaster, the rest of the community would band together and provide for that person what was difficult for them to do themselves. Examples are rebuilding the barn after a fire, or taking care of someone who was disabled. As communities got larger, this service was provided by companies rather than communities to spread the risk among more people, and to have a larger pool of resources to handle larger problems. If a typhoon wiped out a community, help would have to come from outside the community to rebuild. There may not be enough money or resources to pay for this kind of help. Where this idea gets interesting is trying to provide this service for profit. As in any business, costs exist to pay staff and overhead, and to handle risks like people not paying, regulations or unexpected events. Back in the days of the community, there was no profit motive as everything balanced out in the end for everyone involved.

This article is written to gain a better understanding of the dynamic of the insurance world, so that someone can know what questions to ask with respect to insurance. There are a number of things to remember when balancing the ideas of insurance, profit, risk, needs and time. Two additional factors to consider are taxes and investment options. This article does not cover all aspects of insurance, but it serves to get the reader to ask questions and understand what value insurance is providing.

Profit on Average

Profit will always be made somewhere by the insurance company *on average.* This means that if 100 people have fire insurance, and one person's house burns down and claims it, the insurance company will pay the claim and still be solvent. If 20 people have their houses burn down, there may be enough to pay all of the claims, but solvency may be at risk. If all 100 people make a fire insurance claim, the insurance company would likely go bankrupt. If the average claim for a certain event stays the same, and there is money to be made based on this average, then the business can be sustained as long as this is true. If this average suddenly rises, then the profitability would fall, or the converse would happen. Insurance companies will always endeavor to make money. In terms of claims, it depends on how many claims there are, how much they cost and who gets to the pot of money first. The customers who make claims first in a group of claims will make more money than the average. The customers who make claims last may find that there is little money left for them.

Risk and Probability

Since an average is what is being dealt with, the *risk or probability* of someone making a claim would be examined by an insurance company for each type of event – in this case a fire. If the probability of an event is so low that it only happens every 1000 years, then insurance may not be valuable to the customer. If an event happens once or twice in a lifetime, it is likely you would have to insure against it. Every event will have their own average, which is why companies will not cover certain events but will have no problem covering others.

Amount of a Claim

Going hand in hand with the probability and risk of an event happening is *how much an event or claim costs*. If you are insuring against nuclear war, and a war does in fact break out, the damages could be huge. The cost of settling this claim could be large enough to soak up all of the assets of the insurance company. A balancing question to ask is "if there is a nuclear war, will I survive it? Will I care about having insurance?" The answer is likely no, so insurance against nuclear war is not a great idea. If the cost of a claim is small, there can be many more claims made with few issues of being able to pay for them.

What Are Your Needs?

Needs refers to your actual needs as the client. These actual needs should be weighed against your fears or perceived needs. If you believe you will have a house fire every 20 years, and this is what typically happens on average, then fire insurance will be a need for you. If the average person has a house fire every 100 years, but you tend to have a house fire every 20 years, then fire insurance is more of a need for you compared to the average person. If you have a house fire every 100 years, and the average person has one every 20 years, insurance will not be as critical for you as for the average person. If you believe that you may have a house fire but your experience shows that you have never had a house fire, are your needs justified for insurance or is this paranoia? Conversely, insurance can also represent peace of mind. Even if you likely will never need to use the insurance, the fact that you can sleep easier would be worthwhile just for the psychological benefit from having not having to worry about a house fire.

Time

Another component to think about with insurance is time. Money given to an insurance company will not sit in a bank account. It will typically be used to make money somewhere else. If this is being done prudently, there will be ample funds available to pay for claims. If the money is not invested properly, will the money be there for a claim? This is like the bank run situation – will my money be at the bank if I want to withdraw it? Having no money for claims is rare, but it does happen with large disasters. A large disaster is an insurance company's "bank run". If it is true that they are investing money and earning interest, can you do the same thing and get some of that reward by holding the money yourself? In some cases the answer is yes, but in other cases this will not be possible due to the possibly huge size of a claim, like an auto accident lawsuit. The longer it takes for a claim to come to fruition, combined with how much the claim costs, can be balanced against whether you can put aside money yourself to pay for a future claim. If the amount of a claim is small in amount, doing it yourself is possible. In the case of large claims, having insurance is a better idea.

Tax Benefits and Investment

Tax benefits are referring to insurance products that allow the payouts to be tax free. This benefit can be useful for passing wealth to the next generation and other estate planning strategies. Investments can also be utilized with insurance products to make interest tax deductible, or to have tax deferred growth on your investments which can supplement the RRSP, LIRA and TFSA products. This type of insurance fulfills the needs of coverage against some future event, but also serves as an investment vehicle and a tax shelter. The value in this case should be assessed for all of the components and whether they serve your individual requirement. The needs should also be revisited more frequently because tax and investment rules change more quickly than typical insurance needs.

An Example of How to Assess Insurance Needs

Using an example of a house fire, can something happen where insurance would be useful? Yes, a house fire can happen, and a home can have expensive damage. Can a house fire happen in my lifetime? Yes, definitely. What are the odds that it will happen to me? You can examine typical house fire causes like smoking, candles left unattended, cooking fires, faulty wiring or carelessness with flammable liquids. Do any of these causes apply to me? If the answer is yes, insurance is a good idea. If none of them do, a house fire will be very unlikely. Can I save up enough money to pay form damages should a fire occur? If you own the house, replacing your house in its entirety may not be possible for you to do unless you are very wealthy. If you are renting, and what you are insuring is not worth very much, having a lot of insurance is not going to benefit you very much even should a fire occur. If insurance is purchased and a claim is made, will the insurance company pay? This is a difficult to answer question, but here are some parameters to think about. Does the insurance handle its investments well? If it does, there will be money for claims. If not, the opposite is true. Do they have a history of paying claims without issue? If yes, having a claim satisfied is more likely than not. The best way to find this out is to talk to people who have actually filed claims with your insurance company and see their experiences. Ideally the claim that was paid out should be identical to the one you are insuring against. If there is a scenario where the whole city is on fire, and everybody claims, will I get paid? This scenario is extremely unlikely, but it may be actually happen for insurance against earthquakes, floods or windstorms.

Insurance is a necessary and versatile tool not only for insuring against events, but also to create other benefits like tax deferral and investments. Each type of insurance should be analyzed for your needs and the benefits provided to you.

Contact me, Joe Barbieri by email at joetheinvestor.today@gmail.com, or by telephone at 647-286-8020 for an independent consultation on what your options are. **Note: This site is intended**

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