

LESSON 5.3 INSURABLE RISKS

Today we will look at which exposures are insured by standard insurance markets. We will compare the perspectives of the insurance company, the underwriter, and the risk manager as it relates to an insurable risk.

By standard insurance markets, we mean that large numbers of insurers, such as the ones that you see on television, offer these products. For example, life, auto, homeowner's, and commercial liability and property are common insurance products that are offered in the standard insurance markets. These are what we refer to as insurable risks, or those that are definite, measurable, and statistically predictable.

Insurance does not extend to cover events that are "sure things." There is always an element of risk underlying the purpose of the policy. Your house could catch fire. You could be involved in an automobile accident. Insurance companies have actuaries who analyze a mountain of data to determine the probabilities associated with these types of losses. This makes it possible for the insurance companies to calculate premiums for policies in a manner that will ensure profitability.

Elements of Insurable Risk for the Insurance Company's Perspective

To determine which risks are insurable for standard markets, insurance companies look at six major elements. Let's look at each of these elements to understand the insurance company's perspective.

Definite Loss

The first element of an insurable risk is definite loss. A loss causes a decline or loss of value. To be able to insure such a loss, it must be definite in time, place, and amount so the insurance company can verify and measure the loss. How can insurers agree to pay for losses if they cannot determine if a covered loss took place or how much the loss was worth?

Accidental Loss

The second element is accidental loss. A loss must be accidental from the viewpoint of the insured. If an insured can deliberately cause a loss, it distorts loss predictability and may create a financial gain for the insured. The purpose of insurance is to transfer risk, which is the uncertainty of loss. A planned loss is not uncertain.

Large Enough to Cause Economic Distress

The third element is that the loss must be large enough to cause economic distress. If a loss is not large or severe enough to cause economic or financial distress, then a person or organization is less inclined to purchase insurance. They will simply pay out of pocket. Remember, an insurance company must receive enough premium to make it economically feasible to provide insurance. Few people would want to insure the loss of paper clips or the breakage of a shoestring. The premium, while small in dollar amount, is too large relative to the potential loss payment under the policy. Obviously, few individuals would buy this policy, so it is not worthwhile for the insurance company to offer this product.

Large Group of Similar Exposure Units

The fourth element for an insurable risk is a large group of similar exposure units with exposure to the same perils or causes of loss. Otherwise, the Law of Large Numbers will not operate effectively. For example, an insurance company writing auto coverage on trucks cannot base their operations on seventy-five to one hundred trucks. There must be a large number of homogeneous exposures to loss in order to accurately calculate the probability of loss.

Chance of Loss Must Be Calculable

The fifth element is that the probability of loss must be calculable by gathering the loss history of similar acts, properties, and/or causes of loss. Otherwise, it is impossible to predict aggregate losses and determine what premiums to charge. For example, think of a nuclear accident. There have simply not been enough of these accidents for the insurance company to understand how extensive the losses could be, or what premium to charge and remain solvent.

Not Like to Produce Loss to a Great Many Units at the Same Time

The last element is that the risk is not likely to produce loss to a great many units at the same time. For example, property located near rivers is prone to flood damage. In an extreme case, literally hundreds of thousands of properties could be damaged in one event or in a series of closely related events. Therefore, private insurance companies do not usually insure flood-prone property for flood losses. There is too much of a chance that these losses would be severe enough to put them out of business.

Discuss what you remember about why insurance companies would consider these items to be elements of an insurable risk.

Elements of Risk from an Underwriter's Perspective

Now let's look at the elements of an insurable risk from an underwriter's perspective. As you will notice, it is very closely aligned with the insurance company's perspective. However, there are a few subtle differences worth noting.

Risk Shared by Many

The first element is that the risk is shared by many, for example, damage to an automobile.

Fortuitous Risk

Another element would be that the risk was fortuitous, meaning that it was unexpected and unintended. For example, a building fire caused by a lightning strike would be a fortuitous risk.

Reasonably Calculable (Law of Large Numbers)

The third element is a risk that is reasonably calculable to the industry as to likelihood. This means that the Law of Large Numbers would apply, for example, the number of back injuries among hospital staff across the entire industry.

Premiums of Many Pay for Losses of Few

Underwriters would also like to ensure that the risk generates enough premium paid by the many to pay for the losses of the few. For example, insurance for customer injuries, commonly called premises liability insurance, is frequently offered by insurers because it can be actuarially determined that the losses of the few would be paid for by the many.

Not Catastrophic

Underwriters would also exclude risks that are catastrophic or likely to strike many insureds simultaneously. A good example here would be property damage due to hurricane winds. For example, standard insurers in the state of Texas may exclude windstorm damage associated with hurricanes in areas along the Gulf coast that can be impacted by hurricanes.

Insurable Risks from a Risk Manager's Perspective

A risk manager's perspective of insurable risks differs greatly from those of the insurance company and underwriters.

Not Reasonably Calculable

A risk manager wants to insure risks that are not reasonably calculable by the organization.

Crippling Severity

In many cases, these types of risks could be of such severity that they would cripple the organization. For example, think again of hurricane insurance.

Needs Additional Services Provided by the Insurer

A risk manager would also like to insure risks for which the insurer provides additional services, particularly those services that can be provided more efficiently or conveniently by an insurer. For example, the risk manager may find that it will be better to outsource claims responsibilities to an insurance company, rather than having an internal claims department. An internal claims department will require experienced and licensed claims staff, as well as a supervisor. The company will also need to provide continuing education for the staff so that their licenses remain in good standing. In addition, they will need to purchase a claims management system, as well as a system that will allow the risk manager to analyze the loss data. All of this will be expensive and time-consuming, which may be why the risk manager would like to outsource this to the insurance company.

Less Costly than Retention

Another element that is important to risk managers is that the cost of insuring the risk is less costly than retention. During times where soft market conditions prevail in insurance markets, the premium prices may be less expensive than they are at other times. During these types of markets, insurance is more attractive to risk managers as a risk financing option. Imagine that a new insurance company enters the market. They want to grow their pool of insureds swiftly to cover operating expenses and produce some profit. The company may offer insurance at a rate which is not actuarially sound — undercutting the competition.

A risk manager may find the low premium very attractive. This is where due diligence on the part of the risk manager is required. He will be concerned with the financial solvency and reputation of this new company. You will have recognized that the

insurance company is taking a speculative risk. The company is hoping for an upside — that many consumers will be attracted to its low premiums and leave their current insurance carriers. The downside is also present. If enough of the policyholders sustain losses which must be paid, the company may have a significant financial loss, perhaps even go bankrupt.

As we have said before, cost is one thing and value is another. The risk manager will weigh these considerations and may decide to purchase insurance from this company after all. But she will not do so without exercising due diligence when it comes to the cost vs. value equation.

Exceeds Organization's Risk Appetite

The last element of an insurable risk from the risk manager's perspective is that many risks may exceed an organization's risk appetite. That means that these risks are simply too expensive or difficult to retain, which is why the risk manager is interested in insuring them.

As you can see, many things that risk managers would like to insure meet all of the elements required by insurance companies to offer insurance in the standard market.