Ruminations on Insurance

We don't sell insurance, but we do work with insurance professionals to ensure that risks of all types are adequately addressed for our clients. We have found that many people use insurance improperly, and some financial professionals recommend it inappropriately. It is important to understand that *on average* (a very important caveat) absent government interference through tax policy or some other market distortion, purchasers of insurance will be worse off than they would be without the insurance. Individuals may be better off, but as a group, all customers will have less money than they would without insurance (assuming, of course, that they prudently use their premiums saved). This *must* be so, or the insurance companies would not be profitable. In other words, to the extent insurance companies have profits, administrative costs, and other overhead, etc., it is a net loss across all their customers. Indeed, insurance companies *cannot* pay out more in claims than they receive in premiums, or in the long run, they would go bankrupt. However, this does not imply that insurance is not needed. It is vitally important but must be used judiciously and appropriately to reduce risk.

Risks may be categorized two ways: by their severity and by their frequency. To simplify, we could think of four combinations of these two factors:

1) For risks that have **high severity and high frequency**, absent government distortions in the market, no insurance will be available. You should try to reduce or avoid these risks. Take, for example, drivers who have accidents every month or homes that flood annually. Those homes should not be rebuilt, and obviously, those people shouldn't be driving.

2) For risks that have **low severity and low frequency**, you simply accept them. For example, I have carried the same pen for many years. Losing it would obviously not be catastrophic to my financial situation, and since I have had it so long, I must not be prone to losing pens. These types of risks should simply be accepted. They rarely happen, and when they do, it is of no great consequence.

3) Some risks have **low severity and high frequency**. For example, suppose I *were* prone to losing pens. The solution here would be to reduce the risk. I might start carrying cheap plastic pens, or if I am a bank, I might chain the pens to the table.

4) The fourth category of risks, **high severity and low frequency**, is the one for which insurance is the appropriate answer. The odds of you having a serious auto accident, dying in the prime of life, or having your home burn down are small, but if those events should occur it could be catastrophic to your family. For these risks, insurance is vitally important.

In short, if you can afford a risk, you should not insure it. But, if you can't afford it, and the chance of it occurring is low, insurance is frequently the correct solution.

Notes:

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