# Rationale for insurance: How do I get the most out of my insurance arrangements?

Insurance plays an enormous role in global financial services markets. From the electric car in Cairo to the full-service corporate insurance arrangements in Tokyo, insurance helps individuals and businesses to operate more effectively, by removing part of the risks that they face. Why does insurance exist? How do these markets work? And how do I determine what insurance I need and whether I have the best deal from my insurer? In this article, we focus on short-term (non-life) insurance, but the principles apply equally to long-term (life) insurance, as we will see next week.

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At its heart, insurance is no more than an exchange of risk. One party chooses to parcel part of the risk to which it is exposed to another, in return for a consideration, typically referred to as a premium.

## Clear market rationale

Why would a market for such an exchange exist? Many reasons could be put forward. Here we consider three of them: (1) financial capacity, (2) specialised pooling, and (3) portfolio diversification.

Probably the most important reason for a customer to insure a risk is that she does not have the financial capacity to absorb the loss should that risk materialise. An individual or small business with one vehicle cannot typically manage a write-off of that vehicle, or its loss through theft. Its owner prefers the known smaller expense of a monthly premium to the unknown much larger loss of her vehicle. The insurer, on the other hand, has the capacity to absorb the cost of the claim, assuming that the premiums that it collects are adequate overall to cover this cost.

Herein lies the second rationale for the insurance market. An insurer that covers only one vehicle may have capacity to pay the claim, but then it bears the same risks as the customer did prior to taking out the insurance. If that insurer instead were to cover thousands of vehicles, using its experience and expertise to set a premium for each vehicle that is sufficient, in the long run, to cover its claims costs, then its exposure to each such vehicle is relatively small. With sufficient capital available to manage its risk, it offers this service to its customers through specialised pooling. It focuses on those types of risks on which it has sufficient experience to provide a sound price, or it outsources to a reinsurer. More about reinsurance in a later article.

And the third reason for insurance is that the insurer can diversify its risk by spreading it. This it achieves not just over many thousands of similar units, but also over alternative types of risks like household, business interruption, marine, engineering and others. As it is unlikely to experience high claims in all categories at the same time, it can offer reasonable value to customers whose primary care lies in just one of these categories. The insurer also diversifies its risks geographically.

Insurers do not offer this exchange of risk for nothing. The premium paid by the customer should reflect the insurer's best view of that customer's share of the risk to which the insurance portfolio is exposed. But the insurer must also cover several other costs. It must administer the policy, receive premiums, answer queries and pay valid claims. It must also hold sufficient capital to absorb the risk of many claims occurring simultaneously. It must employ specialists to ensure legislative compliance and oversee its risk. It must report to the regulator on a regular basis. And its shareholders expect it to make a profit.

## Smart customers

With all these additional costs, is there still scope for effective value for money to customers? There certainly is. I would still rather pay a reasonable monthly premium than bear the risk of replacing my vehicle after a crash. Similarly, a business exporting fruit to foreign markets would rather cover the cost of insuring its precious cargo on the high seas than run the risk of losing it all. If those margins are reasonable, customers will typically find the benefit worth the cost. Mostly. And South African insurers are well run and tightly regulated. Again, mostly.

So how do I know that I am getting a good deal? Be thoughtful. Make sure that you need the cover you are being offered. Insurance on your pricey vehicle is probably worthwhile. On the fridge you just bought? Perhaps not so much. Read the fine print. And shop around, whether by yourself or with the help of a broker, though that broker must be transparent with you about his costs to you.

Insurers want your business. They exist to protect those assets whose losses you cannot easily absorb. They will compete for this opportunity. Make them work for it. Find the product that best suits your risk management needs. Shop around for the best price, terms and service standards. Make sure you understand exactly what you have signed up for. This is a market that works. Do the best you can to ensure that it works for you as well. Rob Rusconi