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Risk Management: Transfer Risk to Insurance Company

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What is it?

Introduction

You have to deal with numerous risks throughout your life. These include everything from the risk of an auto accident every time you drive your car to the risk of having your home burglarized by thieves while you're away on vacation. And, although you probably don't like to think about it, you face the most dreaded risk of all every day that you get out of bed and go about your business--the risk of death. The thought of death, particularly premature death, is frightening because of its finality but also because of the considerable financial losses that your surviving dependents would incur as a result. Thus, while the chances of dying an untimely death are relatively small compared with other risks you face, you still might want to guard against the possibility for the sake of your loved ones' future.

One alternative to living with the risk is to avoid it altogether. However, this is clearly not a realistic option for those average citizens who must work, travel, and otherwise put themselves at risk on a daily basis. So, as a functioning member of the real world, how do you handle the ever-present risk of death? Or, more to the point, how do you shield your dependents from the kinds of losses that your premature death could produce? One method is with life insurance , of course. But how exactly does life insurance work? Or, more specifically, how does it provide protection from the risks associated with death? The answer lies in the idea of transferring risk. Since you can never completely eliminate risk, the most effective way to cope with it may be by shifting it to a large institution--your insurance company.

How do you transfer your risk?

Risk transfer is and always has been one of the fundamental principles of life insurance and all other types of insurance. This is the way it generally works. In consideration of a specific payment (the premium) made by you, your insurance company contracts to indemnify you up to a certain amount for a specified loss (death) that may or may not occur. The insurance contract thus serves as the medium of risk transfer. You purchase the policy by paying the required premium, and your insurance company must fulfill its part of the contract in return. That is, by taking your money (a form of consideration), the company becomes obligated to pay your designated beneficiary(ies) the specified amount in death benefits if you die. If you have put time and effort into figuring out how much money your dependents might need to meet their various expenses, then you can take comfort in knowing those death benefits will provide them with adequate resources when you're gone.

Example(s): *Say you and your financial planner determine that your spouse and children would need $200,000 if you died prematurely. Unfortunately, your investments and the other existing assets that your dependents would inherit (worth, say, $100,000) are not of sufficient value to give them the amount of money they would need to carry on. Without life insurance, your spouse might have to lower his or her standard of living, and your children might not be able to go to college as planned. So you take out a life insurance policy with the appropriate level of death benefit coverage. If you unexpectedly die a year later, your dependents will be entitled to receive resources beyond what you would have been able to leave them on your own. Thus, the value of life insurance is that it provides much-needed, otherwise unavailable protection in the form of coverage for potentially devastating financial losses that your dependents could suffer if you died. You pay a few dollars in premiums in order to ensure that your insurance company will come through with many more dollars if you meet an untimely end. Since you are financially incapable of combating the risk associated with premature death by yourself, in effect you transfer that risk to the insurance company, which shoulders it for you.*

Risk pooling: the basis of risk transfer

Of course, the insurance company assumes not only your risk but also that of numerous other policyholders. In terms of life insurance, a typical insurance company collects millions of dollars in premium payments over the course of a year and uses that money to meet its expenses and to pay death claims when insured parties die. In many cases, death claims will be substantial and will therefore cost the company a lot of money. But companies rely on actuarial statistics as well as other information to determine mortality rates and project how many people will die in a given year. Since the number of policyholders expected to die is generally relatively small, the company counts on receiving total premium payments that will exceed the amounts they have to pay out in death benefits.

Usually they're right, and that's how they make their profits. In effect, when your insurance company takes on the risks associated with the possibility of your death, its chances of sustaining any net financial loss in the event of your death are minimal compared with what your family's chances of suffering loss from the same event would be. Both sides benefit: The insurance company makes money, and you obtain the protection and peace of mind you desire. The reason is simply that you have reduced your risk by transferring it to a larger entity--the insurance company--that is in a better position to deal with that risk than you are as an individual.

This is known as the principle of risk distribution or risk pooling. The insurance company spreads its risk out over a large group of people and so takes advantage of the law of averages. While it's impossible for the insurance company to predict losses on an individual basis, the insurance company can predict losses from the total pool with a fair degree of accuracy. The pooling of similar risks among a large number of homogeneous units makes it easier to predict the losses that could occur to the group as a whole. From the insurance company's perspective, pooling enables them to minimize their overall risk of loss, just as you have minimized your risk of individual loss. From your standpoint, you can think of pooling as simply sharing risk with other individual policyholders. Just as your premium payments and those of other policyholders may pay the death claim on someone else's individual policy, so premium payments from the pool may ultimately provide the death benefits payable to your beneficiary(ies).

Clearly then, one strategy to protect yourself from the risk of premature death is to share the risk with others--namely, the insurance company and other policyholders. With this in mind, it might be just as accurate to refer to risk transfer as risk sharing.

Caution: *Transferring or sharing risk is usually the best strategy for risks that occur with low frequency but are of high severity, such as death. That's why risk transfer works so well as a means of protecting your dependents against losses that could result from your premature death. That, in turn, is why life insurance is so important. However, there may be other more appropriate strategies for dealing with certain kinds of high-frequency, low-severity risks. In some cases, depending on the type of risk, it may even be advisable to retain or live with the risk. You should consult additional resources for more information.*

Tip: *If risk transfer makes sense to you and you feel that you should have life insurance to reduce your risk, bear in mind that there are different types of policies within the broad field of life insurance. Consult additional resources to determine what type of policy offers the best match for your circumstances.*

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