

The Five Necessary Conditions for Insurance

- *HealthDecisions*, Greg Dean

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Insurance is an effective way of protecting against financial risk in some circumstances, but not others. Why? What makes the difference?

For insurance to operate successfully, these five conditions are required:

- Uncertainty of loss,
- measurability of loss,
- a large number of insureds,
- a significant size of potential loss, and
- an equitable method of sharing the risk.

Uncertainty of Loss

Insurance is possible only for an event that is unpredictable. If an event is predictable, it makes no sense to buy or sell insurance to protect against it. For example, a person cannot buy a homeowner's insurance policy covering termite infestations for a house that already has termites. Since the payment of repair costs is a certainty in such a case, the insurance company would have to charge the insured the full amount that it would soon be called upon to pay, plus a charge for its services, so that the insured would actually pay more than if she were not insured.

In addition, loss must be uncertain in the sense that it is beyond the control of the insured. The insured must not be able to deliberately cause a loss and be compensated. For this reason, insurance does not cover, for example, self-inflicted injuries.

Measurability of Loss

Measurability of loss means that an insurer must be able to place an exact dollar value on a loss. In many cases this is easy to do—the price of a surgical procedure or hospitalization, or the cost of repairing a car damaged in a collision is known. In other cases the actual dollar amount of loss cannot be determined, but an approximate amount can be agreed upon in advance. For example, it is impossible to put a price tag on the unexpected death of a person. Even if we limit the role of insurance to compensating for the lost earnings of the deceased, it will not be possible to determine just what he would have earned during a normal working life. Therefore, the amount is set in advance. The insured purchases a life insurance policy for a stated amount, which the insurer agrees to pay in case of the insured's death. In either case, whether actual costs or a predetermined amount is used, there must be a basis for determining the exact amount of the benefit due to the insured.

Large Number of Insureds

The essence of insurance is spreading risk across large numbers of people. This allows the cost of compensating losses to be shared. It also allows the accurate prediction of the occurrence of losses, which in turn allows the insurer to know how much must be charged in premiums in order to create a pool large enough to cover those losses. A large number of insured makes this prediction possible. An insurance company has no way of knowing if any particular person will suffer a serious and costly illness, but the company can, based on past experience, make a reasonable estimate of the total number of people out of a large group who will incur medical expenses. For example, statistics based on past experience show that of 100,000 persons of a certain age, a certain number will be hospitalized over a given period of time.

Significant Size of Potential Loss

The potential loss must be large enough to make a significant impact on the financial well-being of the insured. No one needs to purchase insurance to cover the cost of a ball-point pen. If it is lost or broken, it can easily be replaced without affecting one's budget. But paying a hospital bill of several thousand dollars could bankrupt many people. Similarly, many people may never re-cover financially if the most valuable thing they own—a house, a car, or their earning power—is destroyed. It is against catastrophic losses that insurance is most necessary.

Some people want to have insurance to cover even a \$50 loss. For someone living on a very low income, even this seemingly insignificant amount may be difficult to pay. Insurers can and do provide insurance for people who want coverage for low-cost items, but it is not a very efficient use of insurance. The insurer must collect funds from its insureds that are sufficient to cover not only the losses insured against, but also its own expenses of handling the transaction and a reasonable profit. It costs the insurer almost as much to pay a \$50 claim as to pay a claim many times larger. The efficient use of premium dollars is to purchase insurance to cover potential losses that will significantly affect the insured's financial status.

Equitable Sharing

Insurance is based on sharing risk—that is, sharing the cost of losses. Equitable sharing means that the risk is shared in a fair way. If everyone has the same potential loss, then premiums should be the same for all. However, if some people have a greater potential loss, they should pay more. In the case of fire insurance for example, a person with a more expensive house will have a greater loss in case of fire than others with less expensive houses and will be compensated more. Therefore, that person should pay higher premiums.

To learn more about the fundamentals of health insurance, read the AHIP book **The Health Insurance Primer: An Introduction to How Health Insurance Works**.