

THE PURPOSE OF INSURANCE

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Insurance is purchased to pay for losses, for peace of mind, and to benefit society by reducing social burdens. When insurance companies fail to live up to their part of the bargain they often magnify and compound the very loss they have promised to cover.

Some of the basics and fundamentals of insurance date back several thousand years. Benjamin Franklin started one of the first insurance companies in America. Over time, many companies have been founded and now supply insurance for virtually any type of risk that one can imagine. Personal lines insurance has enabled individuals to secure a certain degree of protection from the uncertainty of loss, such as loss to one's property, liability exposures for acts of negligence and protection from sickness, injury, disability or death.

One type of protection that is very prevalent among individuals is a policy to cover the largest purchase and investment most individuals ever make, their home. Most individuals cannot afford to suffer a large loss to their largest investment, especially if they have a mortgage to pay off and a family to provide for. A Homeowners policy will provide peace of mind and security to protect their family and their investment.

The purpose and philosophy behind insurance in general is to reduce the uncertainty of a loss to an individual by spreading the risk over a large number of individuals.

“The sharing of losses - unpredictable in the individual case but predictable on a group basis - is the fundamental mission of insurance.” Principles of Insurance, (Robert I. Mehr & Emerson Cammack, Third Edition, 1961, Richard D. Irwin, Inc., The Irwin Series in Risk and Insurance) page 1

“It may be an economic system for reducing uncertainty through pooling of losses; a legal method of transferring risk in a contract of indemnity; a business conducted for profit and providing many jobs in a free enterprise economy; a social device in which the losses of a few are paid by many; or an actuarial system of applied mathematics. It is all of these and more, depending upon how one views the major purposes, methods, and results of insurance.” General Insurance, (John H. Magee & David L. Bickelhaupt, Seventh Edition, 1964, Richard D. Irwin, Inc., The Irwin Series in Risk and Insurance) on page 22

Two of the primary benefits of insurance are:

*“A. Peace of mind.
B. Keeps families and businesses together.”*
General Insurance, on page 44

One of the primary reasons people purchase insurance is to compensate them for the

losses they might suffer.

“From the point of view of the individual, insurance is a device that makes it possible for him to substitute a small, definite cost (the premium) for a large but uncertain loss (up to the amount of the insurance) under an arrangement whereby the fortunate many who escape loss will help to compensate the unfortunate few who suffer loss.” Principles of Insurance, pages 33-34

“Insurance in its essence is a contract of indemnity, or replacement. By this is meant that insurance provides for compensation or reimbursement for actual damage sustained by the insured.” General Insurance, page 62

A multitude of policyholders pay a small premium each for an insurance policy that is to provide them with peace of mind and indemnity for loss. Policyholders are willing and do pay relative small premiums to protect them from the uncertainty of suffering a loss they cannot afford. While it cannot be predicted when or where an individual will suffer a loss, the law of large numbers does enable an insurance company to reasonably accurately predict the frequency and severity of the losses that will be suffered by one or a few out of a very large number of policyholders. This ability to predict that, for example, one loss of a certain severity out of one thousand individuals enables an insurance company to collect sufficient small premiums from one thousand people and be able to pay the claim of the one and still stay in business.

When viewed as a business, an insurance company collects premiums from the many and pays claims to the few. In order to stay in business, the insurance company is entitled to collect premiums sufficient to pay the cost of doing business (sales, underwriting, administration, etc), pay the claims that occur and make a reasonable profit.

Insurance companies, having collected the premium up front and before making payment on claims, will normally have a large cash flow available which is often used for profitable investments. An insurance company may make most or all of its profits from the investment of the substantial cash flow. A underwriting profit can also be realized when the cost of doing business and the cost of claims payouts is less than the premiums collected.

Underwriting profits legitimately can be increased when the cost of doing business is reduced. It is improper for an insurance company to increase profits by intentionally paying less on claims than should be paid.

“The adjuster’s job is not to turn a profit for the company, to advance the company’s A.M. Best rating, or to max out on the incentive compensation plan. Once these factors seep into the adjuster’s consciousness at the file-handling level, mischief creeps in. Dysfunctional incentives drive suspect claims practices.” Slouching to Gomorrah: Adjuster Pay Plans and Bad Faith (by Kevin Quinley, CLAIMS magazine, October 2004)

Many different plans and programs, under many different names have been tried by various insurance companies to induce the adjuster to reduce or cut back on the claims payout. Programs to train the adjuster to perform the job better and to handle the claim better are acceptable. Programs designed to induce the adjuster to arbitrarily focus on paying less regardless of the merits of the claim are unacceptable. A number of companies have focused on what they call "leakage." "Leakage" is generally described as overpayment of a claim. However, "leakage" is often determined by having an audit performed which looks at closed files, based only on what is recorded in the file and alleging that the claim could or should have been settled for less than what the adjuster actually paid. The second-guessing of the adjuster, by people who may not have a full view of the actual day to day claims handling and the personalities involved and the local judicial climate, may only serve to force the adjuster to arbitrarily focus on reducing any and all claims payouts in order to either save his job or to maximize incentive payments.

A claims department is not a profit center and many attempts to turn it into a profit center convey to the adjuster that the adjuster's job is primarily to maximize company profits rather than to individually investigate and properly evaluate each claim that is handled. An adjuster can have very little impact on the reduction of operating expenses (which often encompass about 20% of the premium dollar) but the adjuster can have a very large impact on the claims payout (which often encompasses about 80% of the premium dollar.)

Policyholders, following a loss, are vulnerable and dependant on insurance companies to deliver on the promise to pay. When an insurance company fails to provide the protection, peace of mind and indemnity that is inherent in an insurance policy, the insurance company may be increasing or compounding the loss and injury the policyholder suffered in the initial loss. If the adjuster is focused on minimizing claims payouts and maximizing insurance company profits, the adjuster may intentionally or unwittingly shortchange the policyholder.

The policyholder should receive prompt payment for a covered loss in order to minimize the loss and reduce or eliminate further injury or loss.

"A substantial part of the protection purchased by an insured is the right to receive policy benefits promptly. Unwarranted delay can precipitate the precise economic hardship that the insured sought to avoid by the purchase of the policy." Insurance Claims & Disputes, (Allan D. Windt, Third Edition, 1995, Shepard's/McGraw-Hill, Inc.) page 74

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