Insurance 101

About the Industry

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Growth and role of property/casualty insurance

Sharing, or pooling, of risk is the central concept of the business of insurance. The idea has the beauty of simplicity combined with practicality.

If risks?chances of loss?can be divided among many members of a group, then they need fall but lightly on any single member of the group. Thus, misfortunes that could be crushing to one can be made bearable for all. Viewed as a form of mutual aid, risk-sharing can be seen not only as sound business practice, but as enlightened social behavior rooted in accepted principles of ethics.

Beginnings

The idea, and the practice, of risk-sharing originated in antiquity. Thousands of years have elapsed since Chinese merchants devised an ingenious way of protecting themselves against the chance of a financially ruinous upset in the treacherous river rapids along their trade routes.

They simply divided their cargoes among several boats.

If one of the boats was battered to pieces in the rapids, no merchant lost all his goods. Each stood to lose only a small portion. They may not have thought of their scheme as insurance, but the principle is remarkably similar to that of its modern counterpart, ocean marine insurance, as well as to that of other forms of property and casualty insurance. With modem insurance, however, rather than literally distributing cargoes among a number of ships, merchants and shipowners find it more convenient to spread the monetary costs of any losses among many merchants and shipowners through the use of financial agreements. Again for the sake of convenience, these agreements usually take the form of an insurance policy, with insurance underwriters or an insurance company acting as financial intermediary. In return for a payment called a premium, the insurer assumes the risks?that is, obligates itself to pay the losses?of all the policyholders.

Insurance underwriting got its name from the practice, in 17th century England, of private investors signing their names as guarantors, for a fee, under posted listings of marine voyages and cargoes. They would state the portion of the financial risk assumed.

This group of underwriters, who gathered initially at a London coffee house owned by one Edward Lloyd, formed themselves into the association which came to be known, after the coffee house, as Lloyd?s of London. Long before it celebrated its three hundredth anniversary in 1988, Lloyd?s had grown into a major force on the global insurance scene. Still adhering to the practice of individual underwriting by members, Lloyd?s has become known as a source of coverage for almost any conceivable kind of risk.

Although it took a different direction from the activities at Lloyd?s, modern fire insurance also had its beginnings in 17th century England. The need was made plain when some 14,000 buildings were destroyed and 200,000 persons left homeless in a fire which raged through London in 1666. The first fire insurance company was founded in London the following year. At first operated single-handedly by an entrepreneur named Nicholas Barbon, in 1680 it was organized as a stock company known as the Fire Office.

In the New World, the first fire insurance firm was formed in 1735 but lasted a scant five years. It was Benjamin Franklin who got fire insurance off to its real start?in 1752?with the successful formation of the Philadelphia Contributionship for the Insurance of Houses from Loss by Fire. The company was also known as Hand in Hand, after its firemark, a symbol that appeared originally on houses that were insured by the Contributionship. That company still exists today.

When the automobile came along, insurance wasn?t far behind?to provide financial protection and peace of mind to car owners whose accidents, though few in the early days, nevertheless could be costly. What is said to be the first auto liability policy written?actually a policy for horse-drawn carriages made applicable to an automobile?was issued in 1887 to one Gilbert Loomis of Westfield, Connecticut. The cost was $7.50 per $1,000 of liability coverage. Five years later, a Bostonian named Ralph Emery wanted to insure his Stanley

Steamer against the risk of fire. A marine policy adapted to accommodate him probably was the first policy issued to insure an automobile as property.

Over the years, property/casualty insurers have expanded their horizons to provide coverage against many perils, ranging from the violence of hurricane winds and tornadoes to identity theft to the consequences of one person?s negligence resulting in harm to another. And repeatedly, insurers have found a way to deal with the highly specialized insurance demands of advancing technology?the airplane, nuclear energy, offshore oil rigs, spacecraft.

Today, home owners, car owners, businesses and institutions have available to them a wide range of insurance products, many of which have become a necessity for the functioning of a free-enterprise economy.

Functions of property/casualty insurance

Our society could hardly function without insurance. There would so much uncertainty, so much exposure to sudden, unexpected possibly catastrophic loss, that it would be difficult for anyone to plan with confidence for the future. Most importantly, it would be difficult to obtain credit or financing since few lenders or investors would be willing to risk funds without a guarantee of safety for their investments.

Purpose of insurance

Technically, the basic function of property/ casualty insurance is the transfer of risk. Its aim is to reduce financial uncertainty and make accidental loss manageable. It does this substituting payment of a small, known fee?an insurance premium?to a professional insurer in exchange for the assumption of the risk a large loss, and a promise to pay in the event of such a loss.

Spreading the risk

Transfer of risk also is referred to as ?spreading the risk:? because the large losses of a few are distributed through an insurer to a large number of premium payers, each of whom pays a relatively small amount. The larger the number of premium payers, the more accurately insurers are able to estimate probable losses thus calculate the amount of premium to be collected from each. Because loss incidence may change, insurers are in a constant process of collecting loss ?experience? as a basis for periodic reviews of premium needs.

How insurance benefits society

As an additional benefit of to society, insurers themselves, the trustees of policyholder and stockholder funds, become major investors and suppliers of capital to the economy. In this respect, insurers perform a capital formation function similar to that of banks. Thus, business enterprises obtain a double benefit from insurance?they are enabled to operate by transferring potentially crippling risk, and they also may obtain capital funds from insurers through the sale of stocks and bonds, for example, in which insurers invest funds. Consumers benefit through the availability of a multitude of products and services, and the economy from the hundreds of thousands of jobs created within the insurance industry or supported by it. For more on the insurance industry?s contributions to society and the economy see A Firm Foundation: How Insurance Supports the Economy.

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