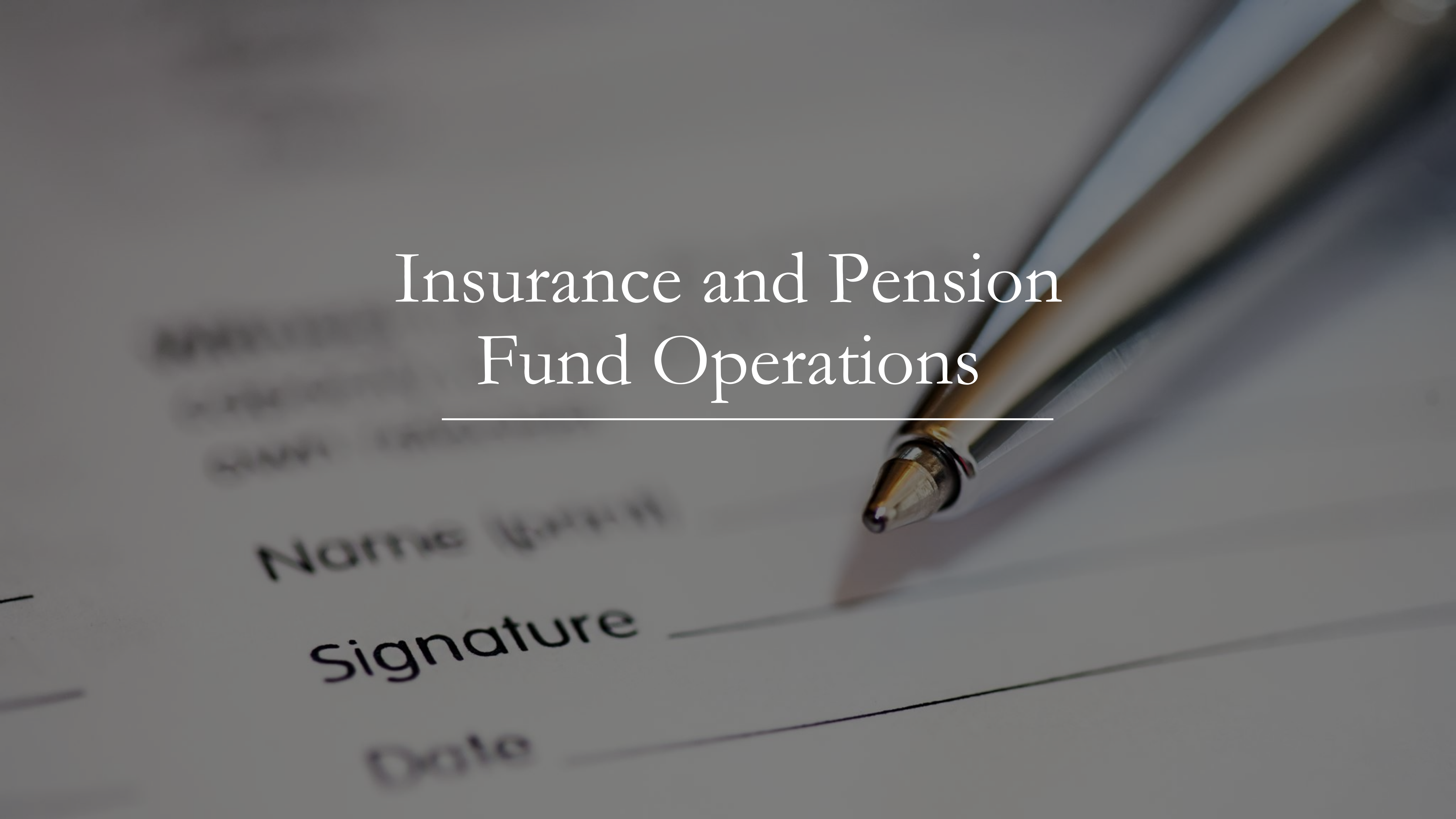
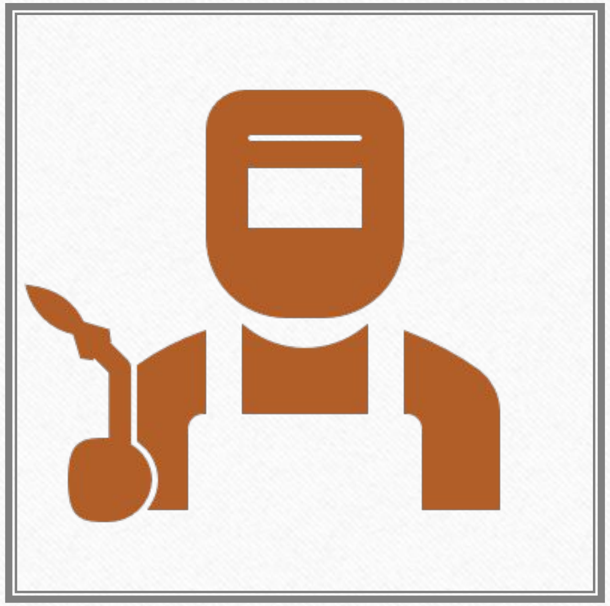
Insurance and Pension Fund Operations



Insurance

A financial risk management tool in which the insured transfers a risk of potential financial loss to the insurance company that mitigates it in exchange for monetary compensation known as the premium

Insurance



- financial protection from possible hazards in the future.
- Insurance companies provide various forms of insurance and charge a fee (called a premium)
- The insurance provides a payment to the insured (or a named beneficiary) under conditions specified by the insurance policy contract.
- Adverse selection
- Moral hazard problem

Setting Insurance Premiums (2 of 2)

Adverse Selection

- The **adverse selection** problem means that people who have insurance are more likely to suffer losses (and therefore to file claims) than people who do not have insurance.

Moral Hazard

- There is a **moral hazard** problem which means that some people take more risks once they are insured.

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Setting Insurance Premiums (1 of 2)

The premium charged by an insurance company for each insurance policy is based on the probability under which the company will have to provide a payment to the insured (or the insured’s beneficiary) and the potential size of the payment.

The premium charged is determined by the present value of a payment that they will have to make for a specific insurance policy.

The premium will also contain a markup to cover overhead expenses and to provide a profit beyond expenses.

Determinants of Insurance Premium

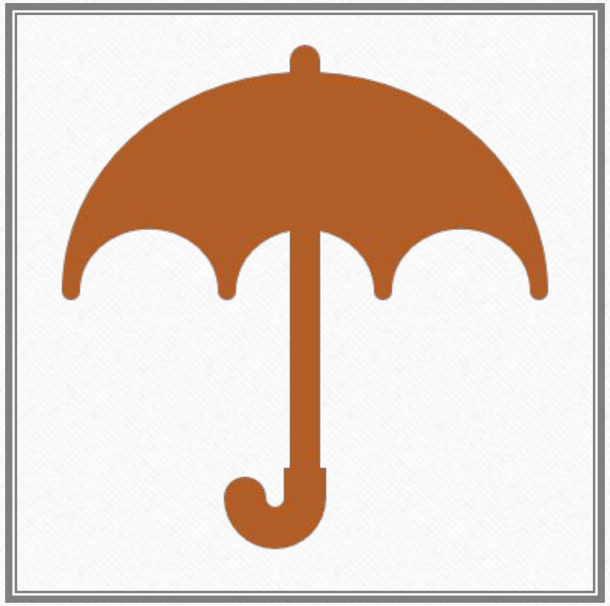
- Probability of disaster and size of the payment
- Degree of competition
- Premium= PV of expected payment + Markup
- Uncertainty
- Group Plans (Discount)

Types of Insurance

- LIFE INSURANCE
- GENERAL INSURANCE
- MICRO INSURANCE
- ISLAMI INSURANCE (takaful)

Insurance corporations

- Insurance corporations **are financial intermediaries** which offer direct **insurance or reinsurance services**, providing financial protection from possible hazards in the future.



Why are they important?

Insurance policies are an important cornerstone of many households' income and wealth.

Insurance corporations also play an important role in financial markets as institutional investors and investment targets.

Pension Fund

- A pension plan is an employee benefit that commits the employer to make regular contributions to a pool of money that is set aside in order to fund payments made to eligible employees after they retire.

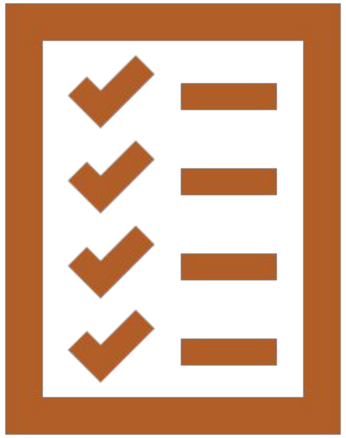
Understanding Pension Plans

- requires contributions by the employer
- may allow additional contributions by the employee.
- employee contributions are deducted from wages.
- employer may also match a portion of the worker's annual contributions up to a specific percentage or amount.
- There are two main types of pension plans:
  - defined-benefit
  - the defined-contribution plans

Public versus Private Pension Funds

- Public pension funds can be either state, local, or federal
- Many public pension plans are funded on a pay-as-you-go basis
- Private pension plans are created by private Institutions

Defined-Benefit versus Defined-Contribution Plans



Defined-Benefit plan:

- With a defined-benefit plan, contributions are dictated by the benefits that will eventually be provided.
- These payments are dependent on salary levels, retirement ages, and life expectancies.
- The future pension obligations of a defined benefit plan are uncertain because the obligations are stated in terms of fixed payments to retirees.
- The amount the plan needs today will be uncertain because of the uncertain rate of return on today’s investments.

Defined-Benefit versus Defined-Contribution Plans

Defined-Contribution plan:

- Are determined by the accumulated contributions and the fund's investment performance.
- With this type of plan, a firm knows with certainty the amount of funds to contribute, however, the benefits to the participants are uncertain.
- Allow employees more flexibility to choose what they want.