Taken from : https://www.investopedia.com/terms/i/insurance.asp

What Is Insurance?

Insurance is a contract, represented by a policy, in which a policyholder receives financial protection or reimbursement against losses from an insurance company. The company pools clients' risks to make payments more affordable for the insured. Most people have some insurance: for their car, their house, their healthcare, or their life.

Insurance policies hedge against financial losses resulting from accidents, injury, or property damage. Insurance also helps cover costs associated with liability (legal responsibility) for damage or injury caused to a third party.1

Key Takeaways

- Insurance is a contract (policy) in which an insurer indemnifies another against losses from specific contingencies or perils.
- There are many types of insurance policies. Life, health, homeowners, and auto are among the most common forms of insurance.
- The core components that make up most insurance policies are the premium, deductible, and policy limits.

Investopedia / Daniel Fishel

How Insurance Works

Many insurance policy types are available, and virtually any individual or business can find an insurance company willing to insure them—for a price. Common personal insurance policy types are auto, health, homeowners, and life insurance. Most individuals in the United States have at least one of these types of insurance, and car insurance is required by state law.

Businesses obtain insurance policies for field-specific risks, For example, a fast-food restaurant's policy may cover an employee's injuries from cooking with a deep fryer. Medical malpractice insurance covers injury- or death-related liability claims resulting from the health care provider's negligence or malpractice. A company may use an insurance broker of record to help them manage the policies of its employees. Businesses may be required by state law to buy specific insurance coverages.2

Important

Most insurance is regulated at the state level.

There are also insurance policies available for very specific needs. Such coverage includes business closures due to civil authority, kidnap, ransom, and extortion (K&R) insurance, identity theft insurance, and wedding liability and cancellation insurance.

Insurance Policy Components

Understanding how insurance works can help you choose a policy. For instance, comprehensive coverage may or may not be the right type of auto insurance for you. Three components of any insurance type are the premium, policy limit, and deductible.

Premium

A policy's premium is its price, typically a monthly cost. Often, an insurer takes multiple factors into account to set a premium. Here are a few examples:3

- **Auto insurance premiums**: Your history of property and auto claims, age and location, creditworthiness, and many other factors that may vary by state.
- **Home insurance premiums**: The value of your home, personal belongings, location, claims history, and coverage amounts.
- **Health insurance premiums**: Age, sex, location, health status, and coverage levels.
- **Life insurance premiums**: Age, sex, tobacco use, health, and amount of coverage.

Much depends on the insurer's perception of your risk for a claim. For example, suppose you own several expensive automobiles and have a history of reckless driving. In that case, you will likely pay more for an auto policy than someone with a single midrange sedan and a perfect driving record. However, different insurers may charge different premiums for similar policies. So finding the price that is right for you requires some legwork.

Policy Limit

The policy limit is the maximum amount an insurer will pay for a covered loss under a policy. Maximums may be set per period (e.g., annual or policy term), per loss or injury, or over the life of the policy, also known as the lifetime maximum.

Typically, higher limits carry higher premiums. For a general life insurance policy, the maximum amount that the insurer will pay is referred to as the face value. This is the amount paid to your beneficiary upon your death.

The federal Affordable Care Act (ACA) prevents ACA-compliant plans from instituting a lifetime limit for essential healthcare benefits such as family planning, maternity services, and pediatric care.4

Deductible

The deductible is a specific amount you pay out of pocket before the insurer pays a claim. Deductibles serve as deterrents to large volumes of small and insignificant claims.

For example, a $1,000 deductible means you pay the first $1,000 toward any claims. Suppose your car's damage totals $2,000. You pay the first $1,000, and your insurer pays the remaining $1,000.

Deductibles can apply per policy or claim, depending on the insurer and the type of policy. Health plans may have an individual deductible and a family deductible. Policies with high deductibles are typically less expensive because the high out-of-pocket expense generally results in fewer small claims.

Types of Insurance

The National Association of Insurance Commissioners (NAIC) compiles an index of complaints about insurance companies. This information comes from state insurance regulators. The NAIC then compares the number of complaints to the insurance company's market share.

There are many different types of insurance. Let’s look at the most important.

Health Insurance

Health insurance helps covers routine and emergency medical care costs, often with the option to add vision and dental services separately. In addition to an annual deductible, you may also pay copays and coinsurance, which are your fixed payments or percentage of a covered medical benefit after meeting the deductible. However, many preventive services may be covered for free before these are met.5

Health insurance may be purchased from an insurance company, an insurance agent, the federal Health Insurance Marketplace, provided by an employer, or federal Medicare and Medicaid coverage.

The federal government no longer requires Americans to have health insurance, but in some states, such as California, you may pay a tax penalty if you don't have insurance.6

Tip

If you have chronic health issues or need regular medical attention, look for a health insurance policy with a lower deductible. Though the annual premium is higher than a comparable policy with a higher deductible, less-expensive medical care year-round may be worth the tradeoff.

Home Insurance

Homeowners insurance (also known as home insurance) protects your home, other property structures, and personal possessions against natural disasters, unexpected damage, theft, and vandalism. Homeowner insurance won't cover floods or earthquakes, which you'll have to protect against separately. Policy providers usually offer riders to increase coverage for specific properties or events and provisions that can help reduce deductible amounts. These adders will come at an additional premium amount.

Renter's insurance is another type of homeowners insurance.

Your lender or landlord will likely require you to have homeowners insurance coverage. Where homes are concerned, you don't have coverage or stop paying your insurance bill your mortgage lender is allowed to buy homeowners insurance for you and charge you for it.7

Auto Insurance

Auto insurance can help pay claims if you injure or damage someone else's property in a car accident, help pay for accident-related repairs on your vehicle, or repair or replace your vehicle if stolen, vandalized, or damaged by a natural disaster.

Instead of paying out of pocket for auto accidents and damage, people pay annual premiums to an auto insurance company. The company then pays all or most of the covered costs associated with an auto accident or other vehicle damage.

If you have a leased vehicle or borrowed money to buy a car, your lender or leasing dealership will likely require you to carry auto insurance. As with homeowners insurance, the lender may purchase insurance for you if necessary.8

Life Insurance

A life insurance policy guarantees that the insurer pays a sum of money to your beneficiaries (such as a spouse or children) if you die. In exchange, you pay premiums during your lifetime.

There are two main types of life insurance. Term life insurance covers you for a specific period, such as 10 to 20 years. If you die during that period, your beneficiaries receive a payment. Permanent life insurance covers your whole life as long as you continue paying the premiums.9

Tip

We compared price, policy types, financial stability, customer satisfaction, and other factors to find the best life insurance companies.

Travel Insurance

Travel insurance covers the costs and losses associated with traveling, including trip cancellations or delays, coverage for emergency health care, injuries and evacuations, damaged baggage, rental cars, and rental homes.10 However, even some of the best travel insurance companies do not cover cancellations or delays due to weather, terrorism, or a pandemic. They also don't often cover injuries from extreme sports or high-adventure activities.

What Is Insurance?

Insurance is a way to manage your financial risks. When you buy insurance, you purchase protection against unexpected financial losses. The insurance company pays you or someone you choose if something bad occurs. If you have no insurance and an accident happens, you may be responsible for all related costs.1

Why Is Insurance Important?

Insurance helps protect you, your family, and your assets. An insurer will help you cover the costs of unexpected and routine medical bills or hospitalization, accident damage to your car or injury of others, and home damage or theft of your belongings. An insurance policy can even provide your survivors with a lump-sum cash payment if you die. In short, insurance can offer peace of mind regarding unforeseen financial risks.

Is Insurance an Asset?

Depending on the type of life insurance policy and how it is used, permanent or variable life insurance could be considered a financial asset because it can build cash value or be converted into cash. Simply put, most permanent life insurance policies have the ability to build cash value over time.11

The Bottom Line

Insurance helps to protect you and your family against unexpected financial costs and resulting debts or the risk of losing your assets. Insurance helps protect you from expensive lawsuits, injuries and damages, death, and even total losses of your car or home.

Sometimes, your state or lender may require you to carry insurance. Although there are many insurance policy types, some of the most common are life, health, homeowners, and auto. The right type of insurance for you will depend on your goals and financial situation.

Taken from: https://www.investopedia.com/ask/answers/051915/how-does-insurance-sector-work.asp

A Brief Overview of the Insurance Sector

Where to Exchange Currency Without Paying High Fees

Close

The insurance sector is made up of companies that offer risk management in the form of insurance contracts. The basic concept of insurance is that one party, the insurer, will guarantee payment for an uncertain future event. Meanwhile, another party, the insured or the policyholder, pays a smaller premium to the insurer in exchange for that protection on that uncertain future occurrence.

As an industry, insurance is regarded as a slow-growing, safe sector for investors. This perception is not as strong as it was in the 1970s and 1980s, but it is still generally true when compared to other financial sectors.

Key Takeaways

- The insurance industry is made up of different types of players operating in different spaces.
- Life insurance companies focus on legacy planning and replacing human capital value, health insurers cover medical costs, and property, casualty, or accident insurance is aimed at replacing the value of homes, cars, or valuables.
- Insurance companies can be structured either as a traditional stock company with outside investors, or mutual companies where policyholders are the owners.
- Owning equity in an insurance company may lead to dividends, inflation protection, and stable company revenue.
- The industry sector is highly regulated which may protect investors while also creating compliance barriers that may limit growth opportunities.

How Insurance Companies Work

The insurance sector is fundamentally rooted in risk management. All policies written are analyzed with various risks considered, and actuarial analysis is performed to understand the statistical likelihood of certain outcomes better. Based on variances between statistical data and projections, policyholder premiums are adjusted, or benefits are reevaluated. Generally, premium amounts paid within the insurance sector are a function of the risk associated with the related individual, property, or item being insured.

In some cases, insurance companies will partner with banks to market their products to the bank's customers. This practice, known as "bancasurance" is more common in Europe, but is finding a foothold in the United States.

One of the more interesting features of insurance companies is that they are essentially allowed to use their customers' money to invest for themselves. This makes them similar to banks, but investing happens to an even greater extent. This is sometimes referred to as "the float."

Float occurs when one party extends money to another party and does not expect repayment until after a circumstantial event. This mechanism essentially means insurance companies have a positive cost of capital. This distinguishes them from private equity funds, banks, and mutual funds. For investors in stock insurance companies (or policyholders in mutual companies), this means the potential for lower-risk, stable returns.

Insurance plans are the principal product of the sector. However, recent decades have brought a number of corporate pension plans to businesses and annuities to retirees. This places insurance companies in direct competition with other financial asset providers on these types of products. Many insurance companies now have their own broker-dealer either in-house or in partnership.

Main Types of Insurance Companies

Not all insurance companies offer the same products or cater to the same customer base. Among the largest categories of insurance companies are accident and health insurers; property and casualty insurers; and financial guarantors. The most common types of personal insurance policies are auto, health, homeowners, and life. Most individuals in the United States have at least one of these types of insurance, and car insurance is required by law.

Accident and health companies are probably the most well-known. These include companies such as UnitedHealth Group, Anthem, Aetna and AFLAC, which are designed to help people who have been physically harmed.

Life insurance companies mainly issue policies that pay a death benefit as a lump sum upon the death of the insured to their beneficiaries. Life insurance policies may be sold as term life, which is less expensive and expires at the end of the term or permanent (typically whole life or universal life), which is more expensive but lasts a lifetime and carries a cash accumulation component. Life insurers may also sell long-term disability policies that replace the insured's income if they become sick or disabled. Well-known life insurers include Northwestern Mutual, Guardian, Prudential, and William Penn.

Property and casualty companies insure against accidents of non-physical harm. This can include lawsuits, damage to personal assets, car crashes and more. Large property and casualty insurers include State Farm, Nationwide and Allstate.

Businesses require special types of insurance policies that insure against specific types of risks faced by a particular business. For example, a fast-food restaurant needs a policy that covers damage or injury that occurs as a result of cooking with a deep fryer. An auto dealer is not subject to this type of risk but does require coverage for damage or injury that could occur during test drives.

Other Types of Insurance Companies

There are also insurance policies available for very specific needs, such as kidnap and ransom (K&R), medical malpractice, and professional liability insurance, also known as errors and omissions insurance.

Some companies engage in reinsurance to reduce risk. Reinsurance is insurance that insurance companies buy to protect themselves from excessive losses due to high exposure. Reinsurance is an integral component of insurance companies' efforts to keep themselves solvent and to avoid default due to payouts, and regulators mandate it for companies of a certain size and type.

For example, an insurance company may write too much hurricane insurance, based on models that show low chances of a hurricane inflicting a geographic area. If the inconceivable did happen with a hurricane hitting that region, considerable losses for the insurance company could ensue. Without reinsurance taking some of the risks off the table, insurance companies could go out of business whenever a natural disaster hits.

Investopedia / Hilary Allison

Mutual vs. Stock Insurance Companies

Insurance companies are classified as either stock or mutual depending on the ownership structure of the organization. There are also some exceptions, such as Blue Cross Blue Shield and fraternal groups which have yet a different structure. Still, stock and mutual companies are by far the most prevalent ways that insurance companies organize themselves.

A stock insurance company is a corporation owned by its stockholders or shareholders, and its objective is to make a profit for them. Policyholders do not directly share in the profits or losses of the company. To operate as a stock corporation, an insurer must have a minimum of capital and surplus on hand before receiving approval from state regulators. Other requirements must also be met if the company's shares are publicly traded. Some well-known American stock insurers include Allstate, MetLife, and Prudential.

A mutual insurance company is a corporation owned exclusively by the policyholders who are "contractual creditors" with a right to vote on the board of directors. Generally, companies are managed and assets (insurance reserves, surplus, contingency funds, dividends) are held for the benefit and protection of the policyholders and their beneficiaries.

Management and the board of directors determine what amount of operating income is paid out each year as a dividend to the policyholders. While not guaranteed, there are companies that have paid a dividend every year, even in difficult economic times. Large mutual insurers in the U.S. include Northwestern Mutual, Guardian, Penn Mutual, and Mutual of Omaha.

Fast Fact

As of March 2023, the latest information assembled from the Insurance Information Institute stated the U.S. insurance industry wrote a total of $1.4 trillion net premiums in 2021.1

Advantages and Disadvantages of Investing in Insurance Companies

Pros of Equity Ownership in Insurance Company

Purchasing stock in insurance businesses can provide a number of benefits. Insurance firms receive money from the premiums that policyholders pay. Investors may benefit from the dependability and stability this steady source of income can offer, as this cash flow stream is often fixed and potentially locked into long-term agreements.

As their clientele and portfolio of insurance products grow, insurance businesses may see long-term growth. The demand for insurance protection often rises as populations and economies expand while becoming more complex. Plus, compared to other industries, the insurance sector is typically less vulnerable to recessions. People and organizations frequently place a high priority on keeping their insurance coverage in place to guard against potential risks and losses, even in difficult economic circumstances.

The practice of distributing dividends to shareholders is common among insurance businesses. Insurance stocks appeal to income-oriented investors since dividends can offer a continuous revenue stream to investors. In addition, insurance firms can change the cost of their premiums to reflect inflation, helping safeguard the value of investments against inflation.

Last, there are legal ramifications that may be favorable. Mergers and acquisitions are a common method of industry consolidation in the insurance sector. As businesses join forces and realize possible synergies, this may result in higher shareholder value. The industry is also somewhat safer in regards to potentially more robust regulations in place to safeguard policyholders, companies, and investors.

Cons of Equity Ownership in Insurance Company

Despite its strengths, the insurance sector does have some downsides in regards to holding an equity position. Insurance companies face the risk of significant losses due to natural disasters, large-scale accidents, or widespread claims. Such events can negatively impact their financial performance, especially when unpredictable or black swan events occur.

Because insurance companies operate in a highly regulated industry, changes in regulations, compliance failures, or legal issues can result in financial penalties. It may also cause reputational damage. One such example may be insurance regulators imposing capital requirements to ensure solvency and stability. An insurance company may be forced to slash dividends to ensure sufficient cash is kept on hand to meet such a requirement.

Insurance companies generate income by investing the premiums they receive. Fluctuations in interest rates or poor investment performance can affect their profitability resources on hand. Alternatively, insurance companies may be negatively impacted by unfavorable economic conditions. Consider how companies that go out of business will no longer need coverage and may cancel their premium.

Pros

- May provide stable and predictable earnings due to long-term, fixed contracts
- May be resilient to many market cycle stages
- May result in dividend income
- May protect against inflation
- Often protects investors more heavily due to higher regulatory oversight

Cons

- May be vulnerable to unpredictable, catastrophic events
- May face headwinds regarding regulatory and compliance risks
- May experience losses due to investment portfolio or fluctuations in interest rates
- May lose contracts due to economic downturns if businesses shutter

Insurance Sector Regulation

A crucial component of ensuring consumer safety, financial stability, and ethical practices in the insurance sector is regulation. Insurance firms are required to abide by the laws and regulations that are set forth by regulatory and governmental bodies. Here is a summary of the laws governing the insurance sector.

- Insurance firms are frequently obliged to **seek a license or registration** from the regulatory body in the country where they conduct business. This makes sure that only reputable and solidly-capitalized businesses may provide insurance goods.
- Insurance regulators often **set financial solvency criteria** to make sure that businesses have enough cash and reserves to cover any claims. Depending on the jurisdiction and the type of insurance, these regulations change. To ensure adherence to solvency norms, routine financial reporting and auditing are carried out.
- Regulations often require the insurance sector to **provide plain and understandable disclosures** of policy terms, conditions, and exclusions. Regulations may also forbid unfair acts like deceptive advertising, biased underwriting, or unfair claims handling.
- To avoid unjust discrimination and advance affordability, regulators may keep an eye on insurance companies' pricing and underwriting procedures. They might demand actuarial support for premium rates and keep a close eye on pricing procedures to make sure they **adhere to reliable statistical principles** and are sufficiently and quantifiably supported.
- Regulations frequently **establish rules for quick and equitable claims management**. The appropriate handling of claims, prompt contact with policyholders, and fair settlement processes are all requirements for insurance firms. In situations where claims are denied or processed slowly, regulatory agencies may step in. For instance, the state of Washington requires notice of receipt of a claim within 15 working days of receipt of a claim.2
- To prevent anti-competitive activity and maintain fair competition, insurance regulators **keep an eye on insurance businesses conduct** in the market. They may look into complaints, carry out market research, and enforce laws pertaining to advertising, sales tactics, and conduct of agents and brokers. The National Association of Insurance Commissioners encourages those who are dissatisfied with the actions of their insurance provider to file a complaint with your state's department of insurance.3

Insurance and Selling Financial Products

How Many Sectors Are There in Insurance?

The insurance sector is sometime broken into three smaller sectors. The first focuses on property/casualty insurance such as auto, home, and commercial insurance. The second focuses on life and annuity insurance. The third is public and/or private health insurance.

What Is the Primary Function of the Insurance Sector?

The insurance sector is intended to provide protection against future risks, accidents, and uncertainty. It provides opportunities for those who wish to hedge against the unknown by entering into contracts to share in the risk of unfavorable outcomes. From the perspective of the insurance sector, the function of the business is to assess premiums to generate income that exceed claim payouts.

What Is the Difference Between Insurance and Assurance?

Insurance often refers to the general process of compensating a party for a loss. It involves the umbrella term for entering into a policy to share risk with another party. The term assurance is often used within the insurance sector, and it is a statement that guarantees certain benefits will be distributed at certain times. For example, a policyholder often receives assurance that their life insurance compensation will be distributed upon death.

What Does the Future of the Insurance Sector Look Like?

Very broadly speaking, some believe emerging technology sometimes increases risk. For example, the introduction of the Internet brought about entirely new commercial markets to insurance as cybercrime, identify theft, and new forms of risk and loss emerged. As the world continues to evolve and become even more interconnected, some argue the centralization of information and speed at which data is transmit increases general business and personal risk. As researched by McKinsey, the way insurance is calculated, purchased, issued, and paid out may dramatically change over the next decade.4

The Bottom Line

By providing both individuals and businesses with a variety of insurance products, the insurance industry offers financial protection against potential risks and losses. Insurance companies evaluate risks, gather premiums, and draft policies that specify the details of coverage. Policyholders may submit claims for compensation when they suffer covered losses. The industry is governed to guarantee consumer safety, monetary stability, ethical business practices, and adherence to solvency criteria.