By BRIAN BEERS Updated May 16, 2023

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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

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

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.

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.

Types of Insurance Companies

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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.

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 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

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.

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]

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

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.

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