HMRC - IPT02220 - What Is Insurance? Spreading The Risk

Insurance, in effect, is a mechanism for spreading risk.

A simple example will demonstrate how this works:

There are 100 people engaged in furniture repair businesses.

Each of them has things they want to insure, premises, tools, equipment and furniture under repair, valued at £10,000.

Experience suggests that, on average, every two years one business will suffer a major fire, and will lose everything.

These businesses have clubbed together to insure themselves (in technical terms they form a mutual insurer), which costs £500 a year to run.

Every two years the ‘furniture mutual’ will have to pay out £10,000 against claims, and with their running costs (£500 x 2) this means a total cost of £11,000, or £5,500 a year.

The cost is paid by the 100 businesses - that is to say, each pays a 1% share of £5,500 or £55 each. This means that instead of running a risk of being wiped out by a fire, and having to safe- guard the future of the business by building up big cash savings, each business pays a relatively small premium confident in the knowledge that if disaster strikes there will be a pay- out, which will enable it to start again.

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