HMRC - IPT02240 - What Is Insurance? Long Term Practices

In practice, even the simplest of insurance arrangements tends to be more complicated than the example on the previous page. This is because the value of the premises and stock may vary, and the amount of risk may vary (some businesses may use more hazardous processes than others for example). This means that the insurer may need to investigate those seeking to obtain cover. To do this, insurers will ask the person seeking cover to complete a proposal form and often carry out further tests or checks. Thus, people seeking life insurance may have to have medical examinations, while those seeking cover for industrial machines, boilers, lifts etc., will have to have them examined and may have to commit to having them regularly serviced etc.

Insurers will vary the amount they charge, the premium, depending on the amount they might have to pay out, their exposure and on the probability of an event giving rise to a claim, the risk.

While over time, in our example, the number of incidents giving rise to a major claim may average out at one every two years; there is nothing to say that there might be two claims in one year or no claims for three years. It is for these latter reasons that insurers work to build up reserves, or savings of their own, so that if there is an above average run of problems they can afford to meet the costs of more than one major claim.

The existence of these reserves means that an insurer has two opportunities to make a profit. If the cost of claims is less that the premiums received, then they have made a profit from the underwriting side of their business. Where they have built up reserve funds, from which claims have not been paid, then they have had the opportunity of an investment profit as well.

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