What Is Insurance?

by Sophia

WHAT'S COVERED

In this lesson, you will explore the importance of health management and general insurance. You will better understand how skills like problem solving and technology can help you invest in your well-being. Specifically, this lesson will cover:

1. Human Capital and Health

Human capital encompasses your ability and willingness to work, learn, earn, and make wise decisions about how to save and invest money. As such, human capital represents one of the most valuable assets that you possess. Keep in mind the following points as you begin to develop strategies to safeguard your human capital.

- As you continue to progress in your formal education, gain valuable experience, and receive additional training in your career, your human capital will increase.
- Increased human capital usually results in higher yearly earned income.
- Higher annual income creates the financial capacity necessary to reach your goals.

However, just like there is uncertainty associated with investments, there are also risks to your human capital. Perhaps the single greatest risk to anyone's human capital is the deterioration of personal health.

- If your health declines, it is more challenging to make and save money. Although you may still be employed, you might end up spending more on healthcare expenditures.
- If your health becomes worse, you may no longer be able to work.

Hardly anyone plans to stop working due to sickness or disability. Rather, it is the unexpected that tends to throw people off their planned life journey. Without preparation, a single negative health event can destroy years of human capital development. If this should happen to you, your financial goals, as well as the financial goals of those who depend on you, can quickly move out of reach. Although this discussion may seem disheartening, don't worry. As long as you act while you are healthy, you can protect yourself from most unexpected events.

BIG IDEA

Life's financial journey gets more complicated for those with health issues. A healthy person who loses her or his job can recover by learning new skills, obtaining additional training, relocating to find a different job, or starting a business.

Problem Solving: Why Employers Care

One of the most significant investments you can make is in yourself. By pairing skills like problem solving with the knowledge you’re exploring in this course, you’re not only improving your financial well-being, but you're also maximizing your potential in any career or task that you choose to pursue.

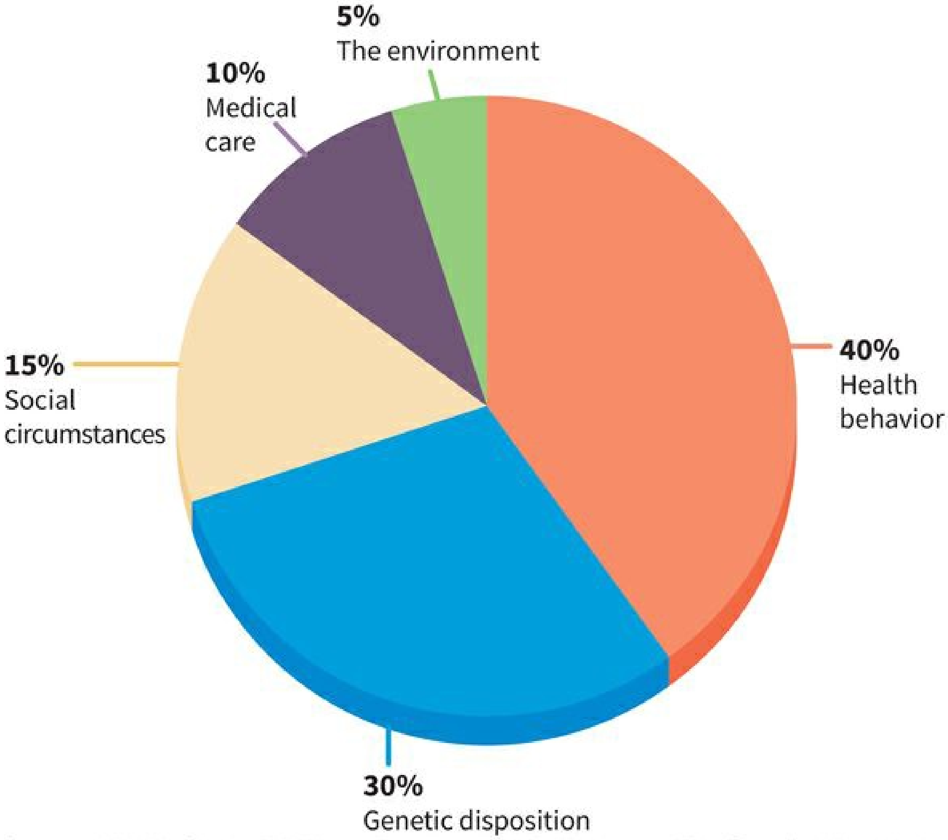
2. Protecting Your Health

Poor health can be debilitating and completely derail your lifetime financial journey. Unfortunately, sometimes avoiding health risks is just not possible. As a result, you also need to learn how to manage health risks through two strategies: behavior modification and health insurance.

2a. Behavior Modification

There are numerous events and triggers that influence your health. The pie chart below shows the major factors that determine how healthy you are today and will be in the future. Note that your behavioral choices are the best indicators of your current and future health status. These choices relate to your daily activities, including:

- Diet and exercise
- Safety practices (e.g., wearing seat belts)
- Stress management
- Avoidance of substance abuse and addictions



Source: J. M. McGinnis, P. Williams-Russo, and J. R. Knickman, "The Case for More Active Policy Attention to Health Promotion," *Health Affairs* (*21*(2), 2002), pp. 78–93. DOI: 10.1377/hlthaff.21.2.78.

It turns out that how you approach these activities has a greater determinant on your health than your genetics, where you live, or your social background! This means that your health is significantly under your control.

HINT

Numerous negative health outcomes can be avoided through healthy living and never giving a genetic vulnerability an opportunity to express itself.

Technology: Skill Tip

There are lots of apps out there that can help you manage your stress levels. Some popular ones are Calm and Headspace. You can use your technology skill to check these out or search for others that may work better for you.

2b. Health Insurance

Nearly all people buy health insurance coverage (1) in the private marketplace, (2) through their employer, (3) from government agencies, or (4) through the health insurance marketplace. Regardless of where coverage is received, the reason for obtaining coverage is the same: to transfer the risks and costs associated with health-related events to an insurance company.

We discuss health insurance in more detail later in this unit. First, it is helpful to have an understanding of how insurance companies operate.

3. Overview of Insurance Companies

Insurance is the primary way people transfer risk of a loss to another party, like an insurance company. To take on your risk, an insurance company will likely charge you the following three amounts:

1. A **premium**, which is the cost of the insurance.
2. A **deductible**, which is the amount that you must pay on a claim before insurance comes into play.
3. A **copayment**, which is a cost-sharing amount with the insurance company.

HINT

Health insurance policies often include a coinsurance requirement in addition to or in place of a copayment.

TERMS TO KNOW

Insurance
The primary way people transfer risk of a loss to another party, like an insurance company.

Premium
The cost of the insurance.

Deductible
The amount that you must pay on a claim before insurance comes into play.

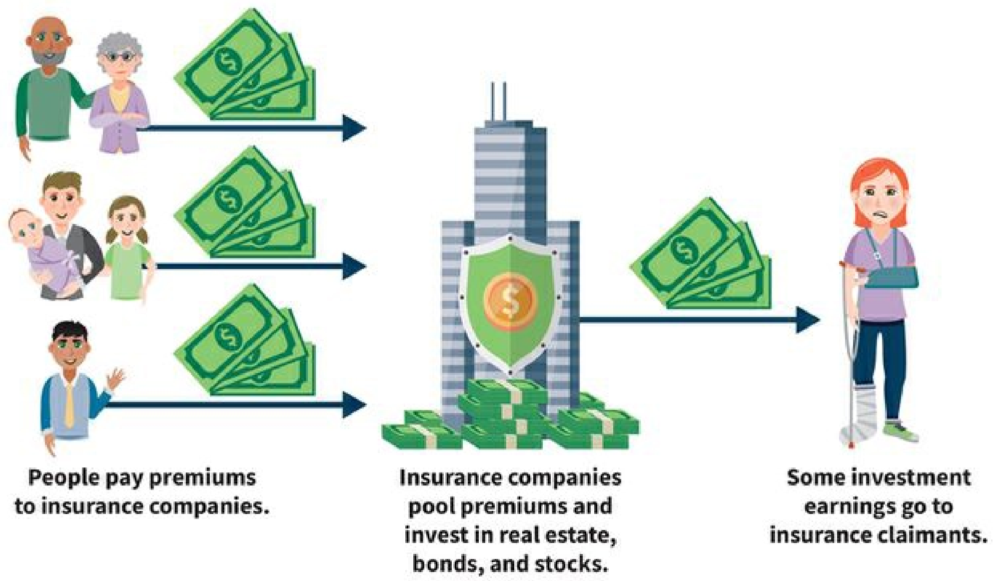
Copayment
A cost-sharing amount with the insurance company.

3a. How Insurance Companies Operate

Nearly all insurance companies, regardless of whether they specialize in health, home, auto, or life insurance, operate under similar guidelines and procedures.

- Insurance companies want to minimize their risks, so they prefer to provide protection when the frequency of a loss is relatively low and the severity of loss is modest.
- Insurance companies build large portfolios of assets by pooling premiums – the cost a consumer pays for insurance – from thousands, if not millions, of individuals. This helps spread out the severity associated with a few high-cost events.
- If the severity and frequency of a risk increase, then so will the premiums insurance companies charge.

Insurance premiums tend to increase dramatically as the frequency and severity of an event increases. This is true whether the risk is related to your health or property. For example, let's look at the market for flood insurance.



- In today's insurance marketplace, homeowners can no longer purchase flood insurance directly from private insurers. Because the frequency of significant flooding is high and the severity of losses tends to be catastrophic, private insurance companies pulled out of the market.

HINT

Private insurers have historically been unable to pool enough people together to purchase flood insurance in a way that makes the product profitable.

- Once the largest insurance firms stopped issuing flood insurance, homeowners living in flood-prone areas faced large potential losses. As a result, the federal government stepped in to provide subsidized flood insurance to those living in areas with a history of flooding. Homeowners can now purchase flood insurance from the Federal Emergency Management Agency (FEMA).

3b. How Insurance Companies Make a Profit

Insurance companies invest the premiums received from those they insure in real estate, bonds, stocks, and other investment assets. Insurance companies then use the earnings from these investments to pay claims for those who are affected by an event. This process is shown in the previous illustration.

You should always remember that insurance companies are in business to make money.

- Insurance companies make money by offering insurance on low-frequency events that do not generally result in extremely high losses.
- Over time, insurance companies may decide to cancel policies or stop issuing new policies. This can occur when insurance companies conclude that the frequency of an event is greater than expected or the cost of paying claims is too high.
- Insurance companies are also on the lookout to make sure that people do not profit from a claim (see Hint below). Insurance is designed to compensate individuals (the policy owners) only up to the value of their loss. This is known as the principle of **indemnity**.

HINT

If an insurance company believes that one person or a group of people are making claims primarily to profit from a loss, the company can dispute the claim(s) or cancel policies.

TERM TO KNOW

Indemnity
An insurance provision that states that individuals (the policy owners) can only be compensated up to the value of their loss.

SUMMARY

In this lesson, you reviewed the definition of **human capital** in terms of your **health**. There are two primary ways you can maintain and **protect your health**. One way is through **behavior modification**, such as eating healthier and paying attention while driving. A second way is by obtaining **health insurance**. Strong problem-solving and technology skills can help you focus on your well-being.

In this lesson, you also went through an **overview of insurance companies**. You learned **how insurance companies operate**. Like any business, insurers aim to control their risk while providing you a financial service. Insurance companies generally charge you higher premiums (costs) when the frequency and the severity of risk to insure you is high. **Insurance companies make a profit** by investing premiums into investment assets. They also monitor their claims and make policy adjustments when needed.

REFERENCES

McGinnis, J. M., Williams-Russo, P., and Knickman, J. R. "The Case for More Active Policy Attention to Health Promotion." *Health Affairs*, (21)2. doi: 10.1377/hlthaff.21.2.78
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TERMS TO KNOW

Copayment
A cost-sharing amount with the insurance company.

Deductible
The amount that you must pay on a claim before insurance comes into play.

Indemnity
An insurance provision that states that individuals (the policy owners) can only be compensated up to the value of their loss.

Insurance
The primary way people transfer risk of a loss to another party, like an insurance company.

Premium

The cost of the insurance.