How Does an Insurance Company Operate?

Insurance companies are like all other businesses in that their primary objective is to make a profit. Any business makes a profit when revenues exceed expenditures. In the case of an insurance company, this means when premiums are greater than the combined cost of paying claims and the cost of doing business, the company makes a profit.

Let's look at the earlier example of a $1,000 premium for $200,000 of property coverage in a homeowner's policy. It may seem impossible for the insurance company to make money. If there is a total loss of the home within a 200-year span. The insurance company loses money. That is why insurance companies write a lot of different homes in different areas.

The operation of an insurance company is based on two basic concepts:

* the concept of independent losses, and
* the concept of spreading risk

Under the concept of independent losses, an insurance company looks for one loss that is not likely to affect a large number of different policyholders. An example of this is robbery/burglary. One policyholder may suffer a large burglary loss, but this affects only the one policyholder. So the cost of this one loss spread among a large group of policyholders. Under the concept of spreading risk, the insurance company tries to "spread" the risk among a large number of policyholders so that one type of loss won't affect the entire group of policyholders. This is why an insurance company does not write all of their homeowner's coverages in a coastal area. Otherwise, one hurricane could destroy all of their policyholder's homes, resulting in huge payouts for the insurance company. Again, the losses experienced by a few policyholders will be paid for by the majority of policyholders who do not experience any losses. These two concepts are closely related. By successfully achieving both of these on a large scale, premiums can be kept low, and the insurance company can make a profit.

It is important to understand how insurance companies operate so that you can better understand the reasons behind why they do what they do. An insurance policy is a type of contact. And in this contract both parties are expected to act in "good faith." This means that the policyholders should not file false or fraudulent claims and the insurance company should pay claims promptly and accurately. In order for any insurance company, or the entire insurance industry, to be profitable, all parties must act in good faith. **Insurance is, above all, a contract of good faith.**

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