

Why Do We Buy Insurance?

Have you ever wondered what exactly insurance is and why we buy it? Well, insurance is a way of *transferring risk from you or your company to an insurance company*. Essentially, this means that instead of you keeping (**retaining**) the risk of loss, you pay an insurance company a set amount of money (**premium**) to adept the risk and pay the loss or loss(es).

Insurance is divided into two categories: commercial (**business**) coverage's and personal (Individual/family) coverage's. An example of personal coverage is a homeowner's insurance policy. To illustrate how insurance works, let's say you pay \$1,000 each year for a policy that will rebuild your home, valued at \$200,000, in the event it is destroyed by fire, hurricane, tornado, or some other covered peril. You could choose not to insure your home and take the **risk** that you can afford to rebuild/repair it in the event it is damaged.

By purchasing insurance you transfer this risk of loss to the insurance company. In the event the house was destroyed, the insurance company would pay to rebuild the house instead of you. In this example, if the premiums stayed constant, it would take 200 years of saving the annual premium in order to save enough money to cover the loss. This is why most people prefer to transfer the risk to the insurance company. They believe a catastrophic event will occur within the next 200 years, and they would prefer that the insurance company pay for the loss.

However, insurance should not be viewed as a financial investment tool. Unlike stocks, bonds, certificates of deposits, and other financial instruments, investing \$1,000 each year in an insurance policy will not pay back \$1,000, or more, each year. Remember, this is a *risk transfer tool*, not an investment opportunity. So, paying \$1,000 in annual premiums does not entitle you to receive \$1,000 or more each year in claims.