

2.2 Insurance

Think about car insurance for a second and forget about any laws that may force you to carry at least some insurance. Why would you buy it when you probably think you are better than the average driver? (90% people think that way by the way, which is clearly impossible)

The answer is simple: Risk management. There may be very little chance you get into an accident, but if you do, you are out a couple grand if you're lucky. You may go into serious debt if it was a not-so-trivial accident. Is there a better way to deal with this? Can you buy peace of mind if you don't mind paying a little bit?

Of course – and it's called insurance. It is pretty clear insurance is just a tool to manage an unwanted risk. By buying insurance from the insurance company, I am transferring the risk to the insurance company. Note that the insurance contract does not decrease the probability that I may have an accident. In fact it may even increase it because I may tend to slack off and become less careful. Therefore, the risk that is transferred is not that of having an accident. *Instead, you are transferring the risk of incurring a big expense if you have an accident.* Having good brakes makes your car safer; having insurance makes your pockets safer.

Why is someone else willing to take the risk? The answer is that all risks are not created equal. Structured right, the same risk could mean a lot to you but almost nothing to someone else. For example, a \$20,000 loss could be devastating to you. To your standard insurance company, however, it is pocket change. The insurance company aggregates all these individual transactions from many drivers like you. Moreover, the number of accidents on an aggregate basis, in all likelihood, is pretty stable over time and the insurance company has good data on historical patterns. This enables the insurance company to model out expected claims and sell policies with desired pricing. We have a wonderful business model here where you are happy because you managed a big risk, and the insurance company is happy, because by being able to diversify and charge accordingly, the company made money.

There are traditional insurance policies on cars and homes. There is health insurance of course. There are some secondary policies, such as home appliance insurance. We have catastrophe insurance against hurricanes and such. Sometimes, the insurers are not comfortable with the risks they end up with, so they go out and buy insurance themselves – this is called reinsurance.

In addition to all of the above, there are some really exotic ones. Ugly Betty's smile, Bruce Springsteen's voice, and Abraham Lincoln's hair are insured. Hair is valuable in the sports world, too - Troy Polamalu's hair is also insured. Yet another sports example, which we discussed before. You can buy insurance for Adrian Peterson, if you have him on your fantasy team – hey, losing him for the entire season is probably a risk you don't want to take.

The idea is always the same though. There is a risk you are not comfortable with, for one reason or the other. Is there somebody, an insurer, out there who takes some off the risk off your back along with some of your money: Generally, there is one.