2.3 Artificial Creation of Risks

Remember the scene from the movie Indecent Proposal where Woody Harrelson and Demi Moore can't decide between red or black at the roulette table? They need money fast, and Vegas is the only place where they can get it. A lot rides on that single bet and the movie makes it clear how important that single bet is after they lose everything they have.

That is somewhat similar to the person without car insurance. It is perhaps less obvious when the bad outcome may hit (roulette kills instantly, accidents can happen anytime) but a lot is at stake in both cases. If this is true, then perhaps the other side on the transaction is not that different either. Consider the insurance company In 2.2 and the casino in 1.5. Any similarities?

Anything can happen in one transaction. A lucky gambler may hit it big, and the casino may lose money as far as that one gambler is concerned. Replace the gambler with a driver, and the insurance company may also lose money by satisfying the claim of the not-so-lucky policy holder. But, does it matter? All they really care about is maximizing the volume, as the risk of losing money *in aggregate* approaches zero very fast. Some people will leave the roulette table with a profit, many more will lose. Some people will have accidents, many won't. Either way, the number of winners and losers are well known and doesn't change much over time. Remember – not all risks are equal. Essentially, your individual risk is blended into many others and once aggregated, it is pretty much a given that *both* the casino and the insurance company will make money (That doesn't clearly take into account operational risks that the casino or the insurance company may have, making payroll, attracting talent, making debt payment etc)

We established that the gambler and driver are similar. So are the casino and the insurance company. The puzzle is this: *Why is insurance a legitimate risk transfer tool and the casino is gambling?* We are not ready to conclusively answer this just yet, but we have a starting point.

What is different is <u>whether the risk already existed</u>. You buy insurance because you want to manage a risk that *already* exists *independent* of your insurance purchase. There is always the chance your house could burn down or you get hit by another car. When you buy insurance, these risks do not go away. It is worth repeating what we said before – it is not the risks that are being transferred but rather the financial responsibility.

Contrast this with the roulette wheel. When you put your chips on red, you created an *artificia*l risk that didn't exist before. Had you not stepped into that casino, you would have absolutely not cared whether the ball lands on 25 or some other number. By inserting yourself into the game, you have deliberately created a risk for yourself. You may be fine this because you view it as entertainment, or perhaps because you are desperate like Woody and Demi. But the key is that you created a risk when there was none before.

Whether the risk is an existing one or artificially created is a very important distinction. Call this your first lego piece – we will collect two more pieces shortly and we will be able to define gambling in Chapter 3.