

10.1: Introduction

Life is full of risks. You can try to avoid them or reduce their likelihood and consequences, but you cannot eliminate them. You can, however, pay someone to share them. That is the idea behind insurance.

There are **speculative risks**, that is, risks that offer a chance of loss or gain, such as developing a “killer app” that may or may not sell or investing in a corporate stock that may or may not provide good returns. Such risks can be avoided simply by not participating. They are almost always uninsurable.

There are **pure risks** accidental or unintentional events, such as a car accident or an illness. Pure risks are insurable because their probabilities can be calculated precisely enough for the risk to be quantified, which means it can be priced, bought, and sold.

Risk shifting is the process of selling risk to someone who then assumes the risk and its consequences. Why would someone buy your risk? Because in a large enough market, your risk can be diversified, which minimizes its cost.

Insurance can be purchased for your property and your home, your health, your employment, and your life. In each case, you weigh the cost of the consequence of a risk that may never actually happen against the cost of insuring against it. Deciding what and how to insure is really a process of deciding what the costs of loss would be and how willing you are to pay to get rid of those risks.

The costs of insurance can also be lowered through risk avoidance or reduction strategies. For example, installing an alarm system in your home may reduce homeowners’ insurance premiums because that reduces the risk of theft. Of course, installing an alarm system has a cost too. Risk management is the strategic trade-off of the costs of reducing, assuming, and shifting risks.

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