Are Insurance Companies Greedy?

April 2019 Newsletter | By: Ian Sachs

How many times have you heard someone say, "Insurance companies are greedy"? Have you ever felt this way?

For this month's newsletter, I want to refute or at least address this sentiment. Let's start by looking at what costs are associated with a policyholder's premium. Though many of the following concepts and characteristics apply to a variety of insurance products, they are specifically tailored towards life insurance.

The Costs of Insurance

- **Benefits** paid out each year make up a majority of the premium.
- **Operating Costs** account for approximately 25% of each dollar that the insurer takes in. This includes administrative expenses, loss adjustment expenses, commissions, and taxes. Opportunity costs are also taken into account.
- **Profits** are necessary to increase the insurance company's surplus positions and to reward investors. The profit margins are small, only accounting for about 5% of the total premium cost. If profits didn't exist, insurers would be unable to attract necessary operating capital.
- **Adverse Selection** is the tendency for people who know that they may be vulnerable to loss from a specific risk to be enticed to acquire and retain insurance. Think of a home owner in California who lives near a fault line or a 16-year-old who has little driving experience and just got their license.
- **Increased Losses** are a natural byproduct of insurance. Though rare and difficult to measure precisely, the existence of insurance can stimulate attitudinal and moral hazards resulting in greater carelessness and even fraud.

How Insurance Companies Make Money

Insurance companies (carriers) need to collect more money in premiums than they pay out in benefits. That's obvious, but how do they do it? Let's look at life insurance specifically.

The carrier doesn't know exactly which insured clients are going to pass away each year, so they have to predict how many policyholders (who are typically the insureds) will die. This is done by analyzing the entire pool of policy holders and assessing their mortality.

Actuaries, the experts who utilize statistical models and mortality tables, are able to

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calculate projected death benefits and additional expenses. Underwriters look at specific traits in each applicant to price the policy so that it correlates with their level of financial risk using, among other traits, age, gender, tobacco consumption, blood pressure, lifestyle, etc.

Arithmetically, the carrier also needs to determine how many clients will continue paying their premiums for the length of the policy or until death. Some policyholders let their policies lapse (stop paying premium) or surrender them for cash value. In these scenarios, the carrier will receive premium revenue without paying a death benefit. This is known as the "lapse ratio" which is another important factor that they take into consideration.

The Nature of an Insurance Contract

An insurance contract is a **unilateral contract** meaning that only one party to the contract (the carrier) makes a binding promise. If the promise is broken, the carrier will be in breach of contract and may be found legally liable.

An insurance contract is also a **contract of adhesion**, meaning that it is prepared by one party and the terms are not negotiated between two parties. The applicant either accepts the policy as prepared or declines it. For this reason, if there is any ambiguity or obscurity, the construction that is most favorable to the policy owner generally prevails.

Policy Privileges and Provisions

Most term life insurance policies provide what is called a **conversion privilege**. If the insured wishes to increase the length of their coverage by converting their term policy to a permanent policy which could last indefinitely, they have the right to do so without proving insurability. In other words, the insured may be in poor health or completely uninsurable years after the policy is issued and the carrier will still need to honor the contract by converting it should the insured wish to exercise their privilege.

State law differs slightly from state to state, but all life insurance policies include a provision called the **incontestable clause**. This prohibits the carrier from contesting or disputing the validity of the policy once it has been enforced for a certain period of time (maximum of 2 years).

The clause exists because of the belief that the policy's beneficiaries should not suffer for those mistakes that may have been made by the applicant. As long as the policyholder continues to pay their premiums, the carrier cannot have the policy declared invalid or refuse benefits unless any of the three following exceptions occur:

1. The applicant did not possess insurable interest at policy inception.

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2. The policy was purchased with the intention of murdering the insured.
3. The insured was fraudulently impersonated by another person (e.g. someone else took the medical exam for the insured).

Most people wonder what circumstance would cause an insurance policy to not pay out the benefit. Unless the previously mentioned scenarios exist (or suicide occurs), a benefit will be paid. A **suicide provision** is included in life insurance policies stating that after the first two years of the policy, benefits will still be paid even if the insured commits suicide.

Conclusion

Are insurance companies truly greedy? In my opinion and as I've hopefully been able to summarize, insurance companies are not greedy. They do their best to conduct an adequate level of due diligence, offer a contract, and have to stick to their part of the agreement. The law is very strict and regulations take great strides to protect the consumer and their best interest. Insurance provides an extremely important component to financial planning at all levels and without it, we wouldn't be able to efficiently mitigate our risk in most areas of our lives.

Remember, the insurance companies are **locked into us** – the policyholders. We are **not locked into them**. We can walk away from our insurance policies at any time and unless we fail to make our required premium payments, the carrier can't break the contract (unless one of the previously mentioned exceptions occurs).

If you are insurable now, make sure that you have adequate coverage in place and that it's cost effective. Insurance companies aren't greedy, but each company does specialize in a different area and will charge more or less depending on where their strengths lie. Risk Resource is here to help. As the saying goes, make hay while the sun shines.

About Risk Resource

Risk Resource insures life's risks by providing a single-source solution for a wide range of financial services that protect our clients and their families. With four decades of experience in insurance planning, we partner with our clients to navigate the full spectrum of financial tools by exploring all options and customizing plans that meets their unique needs.

We specialize in Life Insurance, Disability, Long-Term Care, Annuities, and Tax-Free Wealth Accumulation, and understand that every need is different which is why we represent over 100 insurance carriers. This gives us the flexibility and freedom to find the right solutions for each of our clients.

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