1.7.3. Other Elements of Insurable Risks

There are additional rules that govern what risks are considered suitable subjects for insurance. Risks that do not meet these criteria are probably better handled using an alternate method of risk management.

- The risk of loss must be definite as to time and place and difficult to counterfeit or falsify. Death is probably the best example of a definite loss.
- The risk must be unexpected. In fact, as we mentioned earlier, if the results are expected, it does not qualify as a risk. The risk of a train wreck could be insured, whereas the risk that your suitcase will eventually wear out is not really a risk at all and, therefore, is not insurable.
- The risk must be large enough to create a financial hardship for the individual involved. A financially insignificant risk, such as the chance that you might lose a pair of inexpensive sunglasses, is not insurable.
- The loss must be calculable. In addition to requiring adequately large risks, only risks for which the cost of loss is calculable may be insured. Risks that involve loss that can't be assigned a financial value are uninsurable.
- The cost of the insurance must be affordable to the insured. If the risk is so severe that it requires the insurance company to charge prohibitively high premiums to accumulate enough money to pay losses, it is not an insurable risk. Even if the person purchasing the insurance could afford to pay it, the cost should be only a fraction of the value of the item itself.
- There must be a large number of persons with a similar potential loss available for the insurance so that overall, losses become predictable. The law of large numbers applies here. To accumulate adequate funds to pay losses, the insurance company must be able to predict losses. Accurate predictions are possible only when there are sufficient numbers of potential insureds with a similar chance of loss.
- The loss must not happen to a large number of insureds at the same time. Although insurance companies do want to insure a large number of persons, if a great number of these insureds were to suffer a loss at the same time, it would be catastrophic for the insurance company.

For instance, suppose an insurance company were to insure every home in a single town. A rapidly spreading fire could destroy the entire town. So instead of insuring every person in a single town, a company will want to insure several people in many towns. This is known as **spread of risk.** The greater the spread of risk, the less likely that there will be a catastrophic loss for the insurance company.