Choices and Risks

All choices involve risk—some more than others, of course. What about driving a car? Everyone knows that when you drive a car you risk having an accident. You could cause an accident yourself or another driver could cause an accident that involves you. How can you reduce the risk associated with having an automobile accident?

First, you could choose to stop driving—ride the bus, ride a bike, ride with a friend, or walk. But for most people, the no-driving alternative may seem extreme and inconvenient.

Second, you could become a safer driver. You could take a course in defensive driving; study the state's road-safety manual; pay attention in driver's education class; avoid driving during rush hour, on dangerous roads, and late at night. You could also avoid distractions like using your cell phone, eating while driving, driving under the influence, or driving with little or no sleep.

And, third, you could purchase auto insurance. Auto insurance helps protect you from potential financial loss to pay for car repairs, medical care, or lawsuits that result from an accident. With insurance, you might still have a wreck, but the financial consequences would not be as bad as they would without it.

Your choices about driving are similar to many others you make because you can take steps to reduce the risk involved. For example, you can lock your doors to prevent theft and walk/run in well-lit areas to reduce the potential for personal attacks.

Other types of insurance can also help you manage potential loss from other risks. While you may be able to avoid specific health issues by eating healthy or getting plenty of exercise, you may want health insurance to reduce the financial risk if you get sick or need medical care. Buying homeowner's or renter's insurance provides an important way to reduce the risk of financial loss from theft, fire, or other disasters.

While everything you do involves risk, you can reduce the potential problems it may cause.

Insurance works by spreading risks out over many people. That way, the cost for risk is shared by others—not just one person.

Suppose there are 1,000 students in your high school and the student council decides to sell "locker insurance" to cover potential theft of personal items from your locker. It is determined that students at your school have an average of $50 worth of personal possessions in their lockers and that an average of 10 lockers per year are broken into.

In a typical year, students in the school lose a total of $500 ($50 of stuff x 10 locker break-ins) to locker theft. If all 1,000 students bought locker insurance, the cost would be $.50 each ($500 total loss divided by 1,000 students equals 50 cents each.)

If every student bought $.50 worth of locker insurance, all of them would be covered against losses they might incur from locker break-ins. This is what it means to pool or spread risk and is how insurance companies work. Insurance companies charge a fee (a premium) paid by customers to provide protection against certain types of loss. The fee or premium covers the losses and also the costs of operating the business and earning a profit.

Questions

a. What is meant by "risk"?

b. Why do people buy insurance?

c. What is the purpose of pooling risk?

d. What is a premium?