UNDERSTANDING RISK CLASSIFICATION: HOW RATES ARE DETERMINED FOR INDIVIDUALLY PURCHASED POLICIES

How Individual Life Insurance Products Work

Insurance is based on a relatively simple concept—a group of people can collectively bear costs that would be too great for any one member of the group to handle individually. A life insurance company groups individuals into pools in order to share the financial risks presented by dying prematurely, becoming disabled, or needing long-term care. Grouping people together makes it possible for a company to offer affordable protection against financial loss.

Classifying Risk Allows Companies to Fairly Price Products

The price you pay for insurance is based on many factors, such as your age, your health and whether you smoke among other possible considerations. Insurers gather information about applicants so that they can group together people with similar characteristics and calculate a premium based on that group's level of risk. Those with similar risks pay comparable premiums; for instance, you may pay a lower premium if you don't smoke. On the other hand, if you have a chronic illness, you may be charged a higher premium. This system is known as risk classification. Life insurers typically do not make decisions based on one factor.

If a company is unable to gather accurate information or have access to information known to an applicant, then an applicant masking a higher-than-average risk could purchase a policy at the same price as a person with a lower risk. This is known as "adverse selection." Too many instances of adverse selection are likely to drive up costs for future consumers and could affect the availability and affordability of insurance products.

Put simply, it makes sense for the applicant and insurer to be "on the same page," sharing vital information. If someone knows a risk factor about themselves and are applying for coverage, the insurers should know as well.

The Importance of Risk Classification

Insurers essentially get "one bite at the apple" to use the information gathered to fully evaluate the risk they are being asked to assume. It is a voluntary purchase, with different rules than health insurance and other forms of insurance protection. Once a life, disability income, or long-term care insurance policy is issued, the insurance company cannot cancel it because of changes in the insured's health, or age, for example. The only way policies can be canceled is if the premiums are not paid.

Protecting Policyholders Against Life's Uncertainties

By helping people manage risk, life insurers do what no other industry can: provide millions of Americans with financial protection against the uncertainties of life. It is the process of risk classification that allows the life insurance industry to guarantee its promises—even if that means paying a claim soon after the policy is purchased. This enables Americans to protect their families at every stage of life, no matter what unexpected event might occur.

It is a marketplace that is working for people and families across America.

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