MacKay ON MONEY

BY FINANCIAL PLANNER CHRIS MACKAY

I HAD A MEETING WITH A NEW CLIENT IN THE OFFICE RECENTLY. SHE TOLD ME HER HUSBAND HAD DIED PREMATURELY A FEW YEARS BACK LEAVING HER AND THEIR YOUNG CHILD BEHIND. IT TRANSPIRED HE HAD A SMALL AMOUNT OF LIFE INSURANCE; ONLY ABOUT $50,000. A WEEK BEFORE HE GOT CROOK WITH WHAT WOULD EVENTUALLY CAUSE HIS DEATH, HE HAD SAID TO HER THAT AS THE "BREADWINNER", HE REALLY NEEDED TO BUY SOME MORE LIFE COVER. IT NEVER HAPPENED.

Another $500k or $1 million would have made a huge difference to his survivors' standard of living. Back then $500,000 in capital would have produced say $30,000 p.a. in net interest. But with current interest rates, you need almost a million to generate a similar return. It sounds a lot of dough – and a lot of insurance – but you know a 45-year-old non-smoking bloke can buy a million dollars of Life cover for less than $25 per week, and a female of the same age, for less than $20 per week.

It is not just Life insurance people forget about. It is fire and general insurance too. Why is it when *the Dominion Post* has a terrible story of someone's house or flat burning down, the poor wretch who has gone through this terrible disaster and lost all their personal treasures, often tells the reporter they have no house or contents insurance in place? Closer to home, I had a mate at school whose father's business premises, filled with inventory to be sold, had been burned to the ground. The story goes he was way underinsured and had to start again, almost from scratch.

What is insurance all about anyway?

Firstly, here is the technical version. Way back in 1930, a chap called Alfred Manes, a German insurance expert defined insurance as "An economic institution resting on the principle of mutuality, established for the purpose of supplying a fund, the need for which arises from a chance occurrence whose probability can be estimated".

A more user friendly definition may be insurance is a promise of reimbursement in the case of a loss.

People buy insurance if they, or people they love or are obligated to, would suffer a financial loss if something terrible happened.

Early traders "insured" their goods by distributing them on a number of boats when travelling down a river. That way, if one boat sunk, they only lost a small amount. Similarly, in the 'old days', if a building was destroyed, the community often worked together to reconstruct it, so the cost was shared among many people.

"Bottomry" – the insurance of merchant ships' "bottoms" (hulls) – was where insurance apparently originated as a branch of commerce.

In 1680 the first fire insurance company was established and in London, in Edward Lloyd's Coffee House, which is thought to have opened in 1688, the specialised marine insurance industry had its roots.

When I first started my career in insurance, I was told merchants would want to insure the value of their vessels and cargoes to and from the colonies. Apparently an insurance contract or the amount of boat and cargo the merchant needed to cover (say £1,500) was put on a blackboard and rich latté drinkers would **write** their names **under** the figure saying they would insure so much of the amount (eg £150). For that they would charge a not very scientifically calculated premium of so many pounds (eg £20) and so would the other caffeine addicts until the £1,500 of cargo was fully insured. This is where the term "underwriter" came from. If the ship went down, the underwriters would cough up the £1,500 and they would have lost on the deal. Over a whole lot of cargoes to and from the rest of the world, they would hopefully charge enough premium to actually make a profit.

According to Niall Ferguson in his excellent book *The Ascent of Money* from whom I have sourced much of this article, these underwriters' (also known as Lloyds' Names) liability evolved in to becoming: unlimited. That is they did not individually guarantee a specific amount but collectively they insured the whole amount in return for the premiums less expenses. And Lloyds' Names did this until just recently. I know a couple of chaps who were Names, and they made a lot of money in the early eighties and lost an awful lot more in the late eighties and nineties. Too many hurricanes reeking havoc and tankers sinking. Pretty much a gamble one would not get a lot of disasters in any one year, and when one did, then out came the big cheque book.

I visited Lloyds in London in the late 80's and recall seeing the famous Lutine Bell which hangs in the Lloyd's building in London. It was very impressive, weighing 106 pounds and measuring 18 inches in diameter. Traditionally it was rung to herald important announcements – one stroke for bad news (when a ship was overdue or sunk or some other disaster happened) and two for good news. The ringing of the Lutine Bell is largely ceremonial now, although exceptions are made. On September 11 2001, the bell rang again. Once only!

Back to the history lesson. Ferguson relates, as time progressed, insurance evolved a more theoretical basis for evaluating risks that were covered. There were six crucial breakthroughs; Probability, Life Expectancy, Certainty, Normal Distribution, Utility and Inference. All too hard to cover here.

Over the years, I have come across the odd misguided fundamentalist religious nutter who tells me they do not need insurance because "God will provide". Presumably these same misguided souls do not keep a spare tyre in the boot, do not have car, house or contents insurance, do not keep a torch or candles in the cupboard, and do not have an earthquake kit or have an umbrella at home. Nor should they lock their doors, wash their hands after going to the loo or say no to eating raw chicken. And with the advent of swine flu, they would be very happy being at the receiving end of a good sneeze!

Luckily these guys are a minority as I have helped heaps of fellow Christians, Hindus, Muslims and also plenty of agnostics and atheists, all of whom actually love their families, buy millions of dollars in insurance cover.

The point of this religious interlude. Well, the first fund based on the theoretical definition of insurance, was the Scottish Ministers' Widows' Fund set up in 1748.

It turns out a Scottish minister Alexander Webster, one of his mates, and a Professor of Mathematics "created the first modern insurance fund, based on correct actuarial and financial principles, rather than mercantile gambling."

Hitherto, if a Church of Scotland minister died, his widow and kids would get a once only payment of half a year's salary. Despite the legendary frugality of the Scots, mum and the bairns were not exactly in clover! Based on the premise history does in fact repeat itself, by working out how many ministers had previously died in any one year and at what ages, these three brilliant men calculated how much premium they would need to levy these clerics in order to give their widows and kids an ongoing annuity which did not last just six months.

Maybe those foolish nuts who do not recognise God does indeed work in mysterious ways, that good people also get crook and can die early and that if it was good enough for all those virtuous Calvinists and Knoxists in the 1700's, then it is good enough for the rest of us!!!

After over 30 years in the insurance business, I can reflect on being instrumental in paying a ton of claims by Fire & General companies and Life and Medical insurers.

As each year comes along, we seem to be having more and more living insurance claims for clients who are very much alive, especially Trauma or Critical Illness payouts. Trauma insurance pays out should one suffer from one of 30 or 40 serious conditions, the big four being stroke, heart attack, cancer and coronary artery bypass surgery.

In the past year or two, we have helped with the successful claims process for heaps of clients including not one but two thyroid cancer victims and a heart attack recipient, these three clients not realising they had Trauma cover in place. One of the claimants even said insurance companies were all crooks and would find a way to not pay out. She ended up with a tax free six figure sum. My experience has been most insurance companies like AXA and Fidelity will try to find reasons for actually paying a claim.

There is nothing more satisfying when a client is having a tough time health wise, than helping them get a Trauma or Income Protection claim paid out.

Those 18th century Scotties would be very pleased and proud of the industry they had such a part in creating.