

Corporate Insurance

- Why do corporations buy insurance?
- Corporations want to maximize profits

$$\max \Pi = p \cdot q - \text{Cost}(q)$$

Insurance Demand

- Consumers demand insurance b/c they are risk averse
- Firms don't appear to be risk averse

Three potential reasons

- Extra costs associated with large losses
- Insurance companies have special skills
- Tax-induced “risk aversion”—profits are taxed, losses are not
- Employees and managers are risk averse

Extra Costs

- A firm owns a single factory
- Factory faces risk of burning down
- If factory burns down, lose capital in factory
- Probably also need protection from debtors

Bankruptcy

- If expected costs of bankruptcy are larger than price of insurance . . .
- buy insurance.

Small firms vs. Large firms

- Small firms more likely to have catastrophic loss
- More concentrated
- Small firms should be more likely to demand insurance

Key intuition

Firms are not risk averse; still demand insurance.

MGM Grand Fire

- Before fire, had \$30M liability coverage
- After fire, bought another \$170M
- backdated to before fire
- Insurance company agreed to take on claims for the fire.

“Claims only” contracts

Insurance company administers claims; corporation pays them out.

Key intuition

Insurance company has comparative advantage in claims administration.

Monitoring

- Principal-agent problem
- Firm owner faces full cost of factory fire
- Manager does not; wants to maximize output
- Manager will choose a higher level of risk than the owner

Key intuition

Insurance company has comparative advantage in monitoring fire hazards in factory.

Are there tax advantages?

- A loss is a deductible business expense
- Insurance premiums are a deductible business expense
- Insurance benefits reduce deductible loss

If there's a loss

- Pay taxes on difference between insurance received and replacement cost
- I.e., if no replacement, pay taxes on entire claim
- If there's a gain in value from replacement

Could be no tax rationale

However . . .

- Progressive tax rates . . .
- i.e., marginal tax rates go up as income goes up
- Complications from depreciation
- Fines and penalties are less deductible than . . .
- paying for insurance against them.
- California limits such insurance.

Captive Insurers

- Corporation owns a factory and an insurance company
- Hold profits in factory—can be taxed
- “Sell” insurance to factory
- Cost of creating reserves can be tax deductible
- Depends upon jurisdiction

Is government intervention necessary?

- Toy company sells lots of dolls . . .
- makes millions of dollars.
- Dolls contain poison, injuring millions of children . . .
- causing billions of dollars of liability.
- If company can go bankrupt, may not face full cost of poisoning children.
- May lead to more poisonous dolls than is socially efficient.

Who is making the decisions?

- Small firm, owned by two partners
- For each, only income from firm
- May act like consumers, instead of firms, in making insurance decisions.