

OVERVIEW OF INSURANCE (20-1)

EO 1. **INSURANCE** transfers risk from the **insured** (entity covered by the insurance policy) to the **insurance company (aka insurer)**.

The insured pays an **insurance premium** (a periodic fee) in exchange for the insurer's promise to reimburse the insured for any covered losses. In effect, **insureds share the risks** when they buy insurance because **the insurer pools premiums** and uses them **to pay for losses**.

The insurance policy is the contract that defines the rights and duties of the insured and insurer.

THE THREE ESSENTIAL COMPONENTS OF THE INSURANCE MECHANISM:

1. **Risk**--refers to uncertainty about outcomes, whether positive or negative.
Individuals and families face uncertainty about the possible adverse financial consequences of **loss exposures** (conditions or situations that present the possibility of loss).
2. **Transfer**--is the risk financing technique in which the financial consequences of loss are shifted to another party.
Even though losses may still occur, transfer reduces uncertainty because the insured exchanges the possibility of a large, uncertain loss amount for a known smaller amount (the premium).
Insurance transfer transfers the loss exposure to an insurer.
Noninsurance transfer shifts the loss exposure to a party that is **not** an insurance company.
Examples: A general contractor may require its subcontractors to carry insurance that protects the general contractor.
A landlord might draft a lease agreement stating that tenants are responsible for damages to the landlord's property.
3. **Pooling**--is an arrangement in which the insurer combines all the premiums collected from insureds and uses that fund to pay for any losses that do occur.
Pooling takes the losses of few members and redistributes them over the entire group, thereby subjecting each group member to group average loss rather than his own actual loss.

PROPERTY INSURANCE covers loss resulting from damage to the insured's property.

The insurer reimburses the insured for accidental loss to covered property resulting from a covered cause.

LIABILITY INSURANCE covers the insured's **legal liability** (legal responsibility) to a third party for bodily injury and property damage. The insurer makes payments for covered losses directly to the injured party.

EO 2. **THE LAW OF LARGE NUMBERS** states that as the number of similar, independent, **exposure units** (cars, homes, boats, lives) increases, the relative accuracy of loss predictions also increases.

The law of large numbers allows insurers to predict the group's losses and to charge adequate premiums to cover those losses.

Insurance pools the loss exposures of many insureds, letting insurers predict the group's losses and charge adequate premiums to cover those losses.

An insurer estimates that the loss experience for its insureds will approximate the expected loss experience. However, an individual can **not** use the probability of loss to measure his **own** risk.

Example: Assume the probability of fire loss to a single-family home is 1 in 1,000.

An individual homeowner will have either a loss or no loss--he will not have 1/1,000 of a loss.

The law of large numbers requires grouped loss exposures to be

1. **homogeneous**--All risks are similar. Increase homogeneity by dividing risks into classes.
2. **independent**--One risk's loss does **not** affect another risk's loss.
Exposure units are **independent** of each other **if** they are **not** subject to the same event.
(Fire in one building does **not** increase the chances of fire in another building.)
Risk dependence increases the chance of catastrophic loss.

EO 3. **THE TWO BROAD TYPES OF PROPERTY-CASUALTY INSURANCE POLICIES:**

1. **Personal insurance**--covers the nonbusiness loss exposures of individuals and families.
2. **Commercial insurance**--covers the loss exposures of for-profit businesses and of nonprofit organizations.

FOUR COMMON TYPES OF PERSONAL INSURANCE POLICIES:

1. **Homeowners (HO) policy**--provides both property and liability coverage.
The HO property coverage protects the insured for damage to the home and its contents. Policies usually exclude or limit coverage for certain categories of valuable property, such as jewelry, art, furs, and silverware.
Such property can be insured under a **personal articles policy** that covers more **perils** (causes of loss) than the HO policy *and* that offers higher limits on those items.
The HO personal liability coverage provides coverage for the insured's legal liability arising from bodily injury and/or property damage. Coverage applies to claims made or suits filed against an insured, arising out of bodily injury or property that result from an occurrence to which coverage applies. In other words, the insurer must *defend* the insured against *all* claims and suits, fraudulent/frivolous or not, *and pay* damages (up to the insurance limit) for which the insured is deemed to be legally responsible, *if* the allegations (on their face) state a covered claim.
2. **Personal auto policy (PAP)**--provides liability, medical payments, uninsured motorist, and physical damage coverage for private passenger autos.
3. **Personal watercraft policy**--covers physical damage to watercraft and legal liability for bodily injury and property damage resulting from the ownership, maintenance, or use of watercraft. Both the personal liability coverage in the HO and the auto liability coverage in the PAP exclude or limit coverage for watercraft.
4. **Personal umbrella insurance**--provides higher limits and broader coverages than those available under personal liability or personal auto coverage.

SEVEN COMMON COMMERCIAL INSURANCE POLICIES:

1. **Commercial property policy**--covers damage to buildings and/or contents resulting from a covered cause of loss.
2. **Commercial crime insurance**--covers money, securities, and other contents against theft, robbery, and burglary by outsiders to the business.
3. **Employee dishonesty insurance**--protects businesses against dishonest acts (typically theft) committed by their employees.
4. **Commercial general liability (CGL) insurance**--covers the insured's liability to third parties for bodily injury and property damage arising out of the insured's premises, operations, products, completed operations, and advertising.
5. **Commercial auto policy**--covers business entities for physical damage to automobiles and liability arising from their use.
6. **Workers' compensation policy**--covers employers' statutory liability exposures imposed under workers' compensation laws.
Workers' compensation laws require employers to pay medical costs, lost wages, rehabilitation costs, *and* death benefits for employees' work-related injuries and illnesses.
7. **Commercial umbrella policy**--provides excess coverage over several underlying liability policies and primary coverage for some liability losses not covered by the underlying policies.

A **commercial package policy (CPP)** covers two or more lines of business by containing at least two ISO commercial line coverage parts.

A **businessowners policy (BOP)** covers most of the property, crime, and liability (but *not* auto or workers' compensation) loss exposures of small and medium-sized businesses.

EO 4. **THE SIX BENEFITS OF INSURANCE: [Know these cold!]**

1. **Indemnification for loss--To indemnify** is to restore a party who has had a loss to the same financial position he had before the loss occurred.
Imagine families without insurance, burned out of their homes (or with the breadwinner dead), out on the streets, with no money, clothes, or place to stay.
Imagine businesses without insurance, suddenly bankrupt, producing no goods or services, owners insolvent, and employees unemployed.
Insurance stabilizes society.
2. **Reduction of uncertainty--and anxiety and stress** as we can all better predict our financial losses and therefore worry a lot less.
3. **Better use of resources--**We need to set aside less 'for a rainy day' because insurance makes our futures more secure.
That extra money
 - a. improves our current quality of life (by buying more),
 - b. lets us invest more in our businesses, *and*
 - c. lets us save more for our retirements.
4. **Loss control--**Insurers, to control claims expenses and to lower premiums, employ loss control specialists to control insureds' losses.
Insurers also benefit society by rehabilitating injured insureds, inventing prosthetic devices, *and* supporting safety organizations.
Loss control activities can reduce premiums because
 - a. insurers offer premium discounts to insureds who practice loss control *and*
 - b. loss control reduces the amount insurers pay in claims, thus lowering the costs to all insureds.
5. **Support for credit--Lenders take**
 - a. **liens** on personal property *and*
 - b. **mortgages** on real property**to guarantee repayment of loans.**
But, if that property was destroyed, lenders couldn't repossess or foreclose.
So, lenders require their **collateral** to be insured before making loans.
6. **Satisfaction of legal and business requirements--Insurance allows**
 1. people to meet auto financial responsibility laws,
 2. employers to satisfy workers' compensation laws,
 3. contractors to meet surety requirements, *and*
 4. other service professionals (from painters to physicians) to meet liability insurance requirements (of building owners and hospitals).

EO 5. **AN INSURANCE COMPANY USES PREMIUM DOLLARS**

1. **to pay claims,**
2. **to pay its expenses, and**
3. **for investment--**to generate profits and to build loss reserves and policyholders' surplus.
Policyholders pay premiums at the start of the policy period before losses occur.
Insurers use those premiums as a source of funds for investment.

[Property insurance claims are relatively straightforward and can be settled quickly.

Liability insurance claims often involve lawsuits and are more time-consuming and costly to settle.]