

## INSURANCE--An Overview (21-1)

EO 1. **THE ROLE OF INSURANCE IN RISK MANAGEMENT**--Risk management identifies and treats the loss exposures of an organization or individual.

A **loss exposure** presents the possibility of future loss.

**Basic methods of risk management include** retention, avoidance, loss prevention, loss reduction, **and** loss transfer techniques (such as insurance).

EO 2. **INSURANCE IS A TRANSFER TECHNIQUE** because it

1. **transfers the financial consequences of loss**--The insured shifts the financial impact of possible large losses (his **loss exposure**) to the insurer in return for a small, known loss (his **premium**). Loss is transferred by an **insurance policy** (a contract between the insured and the insurer stating their rights and duties before and after any loss).
2. **shares the costs of losses**--The insurer pools premiums from a group of insureds to pay the group's covered losses.

EO 3. **THE LAW OF LARGE NUMBERS** states that when 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.

Exposure units are **independent** of each other **if** they are **not** subject to the same event.

EO 4. **THE THREE MAJOR TYPES OF LOSS EXPOSURES** faced by businesses and people:

1. **Property losses**--Both
  - a. **real property** (what you'd leave behind if you moved) **and**
  - b. **personal property** (what you'd take if you moved)**may be destroyed, damaged, lost, or stolen.**

A business owner might have a factory building (real property) and inventory (personal property). Damage to property can cause **net income losses** (indirect loss due to decreased revenues and/or increased expenses), since property that is destroyed, damaged, lost, or stolen can **not** be used. **Net income** equals revenues minus expenses for a given time period.
2. **Liability losses**--When a person or business is sued for alleged wrongdoing involving bodily injury, property damage, or **personal injury** (injury other than bodily injury: libel, false arrest, slander), that person or business may face substantial legal fees even if the suit is groundless and results in no adverse judgment.
3. **Personnel losses** (to a business) or **personal losses** (to a family or an individual) involve illness, injury, disability, death, or unemployment.

Personnel and personal losses **both** increase expenses **and** decrease income.

**[The three elements of a loss exposure:**

1. **the item subject to loss**--what can be lost;
2. **the cause of loss (or peril)**--how it can be lost; perils that can cause loss; **and**
3. **the potential financial impact of loss**--how much value can be lost.]

Unasked EO. **THE THREE MAJOR TYPES OF PRIVATE INSURERS:**

1. **Stock insurers**--are owned by stockholders who invested in insurers like Travelers and CNA.
2. **Mutual insurers**--are owned by their policyholders who bought insurance from insurers like State Farm and Liberty.
3. **Reciprocal exchanges**--serve their **subscribers** (members) who have separate accounts and pay their share of expenses and every member's loss, like USAA.

EO 5. **AN IDEALLY INSURABLE LOSS EXPOSURE**

1. involves **pure risk** (the possibility of loss or no loss), rather than **speculative risk** (the possibility gain, loss, or no loss);
2. is accidental (from the insured's standpoint);
3. is definite as to time, place, cause, and amount;
4. has a large number of similar, but independent, exposure units;
5. is not catastrophic to the insurer (but *is* catastrophic to the insured); *and*
6. is economically feasible to insure--not a *very* low severity, very high frequency loss exposure.

*[An insurer can cover an event that is catastrophic to the insured (like windstorm damage) without financial difficulty by making sure only a small number of its insureds for that exposure is exposed to a single event.]*

EO 6. **GOVERNMENT INSURANCE PROGRAMS** exist to ensure that certain types of coverage remain available *[and affordable]*.

**Government insurance programs include**

1. **federal programs** (Social Security, the National Flood Insurance Program, the Federal Crop Insurance Program, federal crime insurance, insurance for depositors through the FDIC and the National Credit Union Administration, and life insurance for members of the armed services) *and*
2. **state programs** (unemployment insurance, workers' compensation insurance, FAIR plans, and auto liability insurance plans).

EO 7. **INSURANCE OPERATIONS:**

1. **Marketing**--Prospect, sell, and deliver insurance products.
2. **Underwriting**--Choose insureds and their coverages.
3. **Claims handling**--Determine if a loss is covered and, if so, the fair settlement owed.
4. **Ratemaking**--Determine the premiums to charge insureds.

EO 8. **STATE INSURANCE DEPARTMENTS REGULATE INSURERS through**

1. **rate regulation** (Rates must be adequate, not excessive, and not unfairly discriminatory.) *and*
2. **solvency surveillance** (Insurers must be financially stable.).

State departments use profitability ratios, **income statements** (revenues and expenses for a year), and **balance sheets** (assets, liabilities, and surplus on a particular date) to check solvency.

**Insurance regulation protects consumers by**

1. licensing insurers and their representatives,
2. approving policy language,
3. monitoring insurer practices, *and*
4. investigating complaints.

EO 9. **THE EIGHT BENEFITS OF INSURANCE:**

1. **Indemnification for loss--To indemnify** is to restore a party who has had a loss to the same financial position that would have existed if no loss had 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 products, owners insolvent, and employees unemployed.  
Insurance, through indemnification, 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.  
Insurance eliminates an insured's uncertainty about the financial consequences of loss by transferring those consequences to the insurer.

3. **Control of losses**--Insurers, to control claims expenses and lower premiums, employ loss control specialists to control their insureds' losses.  
**Insurers also benefit society by** rehabilitating the injured, inventing prosthetic devices, and supporting safety organizations.
4. **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 (buying new cars),
  - b. lets us invest more in our businesses, *and*
  - c. lets us save more for our retirements.
5. **Support for credit**--Lenders take **liens** on personal property and **mortgages** on real property to help guarantee repayment of loans.  
But, if that property were destroyed, they couldn't repossess or foreclose.  
So, lenders require their collateral to be insured.
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).
7. **A source of investment funds**--Insurers use premiums to invest in businesses and social projects.
8. **Reduction of social burdens**--People who suffer losses can become burdens to society if they lack sufficient life, workers' compensation, auto liability, unemployment, or disability insurance.

EO 10. **THE FIVE COSTS OF INSURANCE:**

1. **Premiums**--Insurers collect premiums to pay losses and cover business costs.
2. **Insurers' operating costs**--Insurers pay salaries, commissions, advertising, and overhead expenses.  
The cost of insurance also includes a reasonable profit for the insurers.
3. **Opportunity costs**--Money and labor used in the insurance industry are *not* available to be productive elsewhere.
4. **Increased losses--Insurance can result in**
  - a. **moral hazards--involve active inducement of loss** (as when an insured wants the insurance money more than his car or building or when he knowingly claims more than he is justly entitled to under his policy) *and*
  - b. **morale hazards--involve passive indifference to loss** (which results when people are less worried about whether they will suffer a loss because they're insured).
5. **Increased lawsuits**--The number of liability lawsuits and their average size have grown fantastically in recent decades as juries have awarded money to injured plaintiffs with less and less regard to defendants' negligence.

EO 11. **PROPERTY INSURANCE** covers property and net income loss exposures.

**THE SIX MAJOR TYPES OF PROPERTY INSURANCE:**

1. **Fire and allied lines insurance** covers buildings and contents at fixed places.
2. **Business income insurance** covers lost income and increased expenses.
3. **Crime insurance** covers employee dishonesty and theft losses.
4. **Ocean marine insurance** covers ships and their cargoes.
5. **Inland marine insurance** covers cargoes over land and moveable items.
6. **Auto physical damage insurance** covers the insured's own vehicles.

**LIABILITY INSURANCE** pays a third-party **claimant** (the party suffering loss) on the insured's behalf *if* the insured is legally liable.

**THE FOUR MAJOR TYPES OF LIABILITY INSURANCE:**

1. **Auto liability insurance** covers auto-caused bodily injury and property damage liability.
2. **Commercial general liability insurance** covers BI and PD arising from premises, business operations in progress, products, and completed business operations.
3. **Personal liability insurance** covers BI and PD arising from individual, non-business, non-auto activities--such as dog bites and sports accidents.
4. **Professional liability insurance** covers errors and omissions of professionals.

*[The head of a family might buy property insurance to cover his house for fire damage and liability insurance to cover his liability for medical costs caused by his dog biting someone.]*

EO 12. **LIFE INSURANCE** replaces the income potential of the insured.

**THE THREE MAJOR TYPES OF LIFE INSURANCE:**

1. **Whole life insurance** provides lifetime protection and accumulates cash values.  
Use it when lifetime or long-term protection is needed--to pay estate taxes or to provide for retirement.
2. **Term life insurance** covers a set period of time and has no cash value.  
Use it to maximize current protection at minimum cost.
3. **Universal life insurance** separates the protection, savings, and expense components of the premium and lets the policyholder change the death benefit *and* the amount and timing of premium payments.

**HEALTH INSURANCE** protects against illness and injury losses.

**THE TWO MAJOR TYPES OF HEALTH INSURANCE:**

1. **Medical insurance** covers the *increased expenses* of doctors' and hospitals' bills and related expenses.
2. **Disability insurance** covers the *decreased revenues* of lost income when people are too sick or injured to work.  
Disability insurance pays periodic monthly payments to insureds.

*[The head of a family might buy life insurance to pay estate taxes and health insurance to cover his family's hospital bills.]*