

## RISK AND INSURANCE (33-1)

EO 1. **RISK** refers to uncertainty about outcomes, whether positive or negative. The evaluation of risk distinguishes between **possibility** (the chance that an event *could* happen) and **probability** (the mathematical likelihood that the event *will* happen). Possibility indicates the existence of risk, but is *not* measurable. Probability *is* measurable. [Possibility either exists or does not exist. There *is* a possibility that I could win a million dollars. There is *no* possibility that I will grow wings and fly.]

### Two types of risk:

1. **Hazard risk** [aka *pure risk*]-is the risk of accidental loss. Hazard risk presents the possibility of loss or no loss, with *no* possibility of gain. *Example:* The risk of earthquake damage to your home is a hazard risk.
2. **Business risk** [aka *speculative risk*]-is the risk inherent in undertaking a for-profit venture. Business risk presents the possibility of loss, no loss, *or* gain. *Example:* The introduction of a new product line creates a business risk because the company might lose money, might break even, *or* might earn a profit.

**RISK MANAGEMENT (RM)** is the systematic, problem-solving process used to identify and treat the pure loss exposures of an organization or of an individual.

**Risk management techniques seek to eliminate, control, or finance loss exposures.**

1. **Risk control techniques**--reduce the estimated frequency and/or severity of accidental losses.  
**The six risk control techniques:**
  - a. **Avoidance**--reduces the chance of loss to zero as a *potential* loss exposure is avoided or an *existing* loss exposure is eliminated. *Examples:* Do not skydive. Do not give property away. Discontinue production of any hazardous product.
  - b. **Loss prevention**--reduces loss frequency. *Examples:* Wear a backup parachute. Lock money in a safe. Install circuit breakers.
  - c. **Loss reduction**--reduces loss severity. *Examples:* Install a sprinkler system. Deposit receipts more often. Wear seatbelts.
  - d. **Separation**--reduces potential loss severity, *but* increases loss frequency, by dividing exposure units. *Example:* Manufacturer uses three small warehouses instead of one large warehouse.
  - e. **Duplication**--reduces effective loss frequency or severity by creating back-ups of critical records, machinery, and/or data. *Example:* An extra production machine may mean no lost production time.
  - f. **Diversification**--reduces loss severity for speculative risks by spreading loss exposures over different categories of risks in the hopes that losses from one investment will be offset by gains from another investment. *Example:* Investors use diversification when they allocate their portfolios among a mix of stocks and bonds from companies in different industries.
2. **Risk financing techniques**--produce the funds to pay for losses.  
**The three risk financing techniques:**
  - a. **Insurance**--transfers the financial impact of loss for specified exposures to a professional risk bearer in return for the premium.
  - b. **Noninsurance transfer**--shifts the financial impact of loss to a non-insurer. *Example:* Some lease agreements transfer the risk of certain types of losses from the landlord to the tenants.
  - c. **Retention**--allows or forces the entity to keep or bear the financial consequences of its loss exposures.

EO 2. **INSURANCE** is the system in which a person or organization (**the insured**) transfers the risk of financial loss to an insurance company (**the insurer**) in exchange for payment of the premium.

1. **The law of large numbers**--lets insurers predict the group's losses and charge adequate premiums to cover those losses.  
**The law of large numbers** states that if the number of similar, independent, exposure units (cars, lives, homes) increases, the relative accuracy of loss predictions also increases.
2. **The principle of indemnity**--states that no insured should profit from a covered loss. The insured is compensated **only** for the amount of his financial loss.
3. **Insurable interest** is financial interest in the continued existence of the thing insured. An **insurable interest** exists in property if a person would suffer financial loss from its damage or destruction. A person may insure something **only** to the extent of his insurable interest. Insuring beyond insurable interest violates the principle of indemnity and increases moral and morale hazards.  
An applicant **may** buy insurance **only if** he has an insurable interest in the insured property, but he **still** must meet the insurer's underwriting guidelines before he **can** buy insurance.

**THE PARTIES TO THE INSURANCE CONTRACT**--The insurance contract (policy) involves two parties: the insured (**the first party**) and the insurer (**the second party**).

A **first-party claim** refers to a claim made by an insured against his insurer.

A **third-party claim** is made against the insured alleging legal liability for injury to another.

#### **THE NINE BENEFITS OF INSURANCE--Insurance**

1. **provides loss payments**--that let insureds continue producing and consuming goods.
2. **reduces financial uncertainty**--and creates confidence for businesses and individuals.
3. **provides credit support**--that encourages banks to loan money.
4. **creates funds for loans and investments**--from the policyholders' premiums.
5. **uses loss control**--to reduce and to eliminate risks.
6. **allocates resources**--and lets insureds use more funds for consumer goods and business growth.
7. **reduces social burdens**--by providing life, workers' compensation, auto liability, unemployment, and/or disability benefits that keep people who suffer losses from becoming burdens to society.
8. **satisfies legal and business requirements**--of workers' compensation, automobile financial responsibility, and mortgage protection.
9. **provides employment and tax revenues**--because insurers both pay taxes and employ more than 2.2 million people who pay taxes. [*This is actually a cost, not a benefit, of insurance.*]

#### **THE FIVE COSTS OF INSURANCE:**

1. **Premiums**--The direct costs of insurance include acquisition costs, overhead expenses, loss adjustment expenses, **and** insurer profit.
2. **Opportunity costs--Opportunity cost** represents income not earned because an income-producing opportunity was not pursued. Premium dollars could have been used for other purposes.
3. **Increased litigation**--Many people view insurance as a source of 'free money'. That attitude encourages people to sue more often and encourages juries to award larger verdicts.
4. **Moral hazard--(active inducement of loss)**--involves intentional loss caused by the insured in order to profit. The principle of indemnity prevents an insured from profiting from insurance by collecting more than his loss but there may be claims where the loss payment is greater than the property value or where the insured can exaggerate personal injury.
5. **Morale hazard aka attitudinal hazard--(passive indifference to loss)**--refers to losses that occur because the insured is careless because he knows insurance will cover any loss.  
**Examples:** poor housekeeping, failure to secure property.

EO 3. **CLAIM DEPARTMENT STRUCTURE** varies among insurers, *but* most claim departments include a senior claim officer and at least one claim office.  
Each claim office typically includes a claim manager, claim supervisors, *and* claim representatives.

**FIVE TYPES OF CLAIM REPRESENTATIVES:**

1. A **staff claim representative** is employed by an insurer.
2. An **independent adjuster** works for the insurance industry and handles insurers' claims on a case-by-case basis.  
Independent adjusters are paid fees for their work.
3. A **third-party (claim) administrator (TPA)** (outside service provider) adjusts claims for large businesses that **self-insure** (absorb losses themselves).
4. A **producer** may adjust claims for his insurer(s).  
Most insurers give their producers **draft authority**, which lets the producers settle small property claims by issuing **drafts** (similar to checks, on the insurer's account).
5. A **public adjuster** represents insureds and claimants in exchange for a percentage of their claim settlements.

**CLAIM PERSONNEL PERFORMANCE MEASURES:**

1. **Profitability measures**--measure underwriting profitability.
  - a. **The loss ratio**--equals (incurred losses + loss adjustment expenses) divided by earned premium.  
**Incurred losses** include amounts paid for losses, the loss adjustment expenses, *and* **loss reserves** (funds set aside to pay claims).
  - b. **The combined ratio**--equals the **sum** of the insurer's **loss ratio plus its expense ratio**.  
**The expense ratio**--equals expenses divided by earned premium.  
**An underwriting profit** occurs when an insurer's combined ratio is less than 100 percent.  
**An underwriting loss** occurs when an insurer's combined ratio is greater than 100 percent.
2. **Quality measures**--evaluate the performance of the claim department.
  - a. **Best practices**--refers to a set of identified internal practices that are often based on legal requirements.  
Best practices may specify preferred time periods to acknowledge claims, make initial contact, respond to communications, file documentation, and/or pay or deny claims.
  - b. **Claim audits**--involve review of open and closed claim files to evaluate best practices and to gather statistical information about claims.
  - c. **Customer satisfaction**--is evaluated by reviewing customer complaints.

EO 4. **EIGHT INSURANCE COMPANY FUNCTIONS:**

1. **The marketing and sales function**--brings business to the insurer.  
**Marketing usually involves** delivering goods and services to the customer.  
**Sales usually involve** contacting customers and delivering applications to the insurer.
2. **The underwriting function**--receives the insurance application and decides if the applicant meets the insurer's guidelines.  
Underwriting involves risk selection, pricing, *and* determining coverage terms and conditions.
3. **The loss control function**--inspects and evaluates insured property and suggests ways to reduce loss frequency and loss severity.
4. **The reinsurance function**--creates reinsurance programs, sets guidelines for reinsurance procedures, *and* negotiates the terms of reinsurance contracts with **reinsurers** (insurers that assume all or part of the primary insurer's risk exposures).
5. **The actuarial function**--calculates rates, develops rating plans, *and* estimates loss reserves.

6. **The finance and accounting function**--invests premiums, prepares financial statements, *and* monitors daily cash operations.
7. **The information technology function**--creates the technological infrastructure that supports communications and collects and stores data.
8. **Miscellaneous functions**--include premium audit, human resources, training, *and* legal services.

EO 4. **THE HISTORY OF INSURANCE REGULATION**--Our industry is regulated by the states, *not* by the federal government.

The US Constitution grants the US Congress the power to regulate “commerce among the States”.

**In 1869**, the US Supreme Court decision in **Paul vs. Virginia** held that the states (but *not* the federal government) could regulate insurance because the business of insurance is *not* “commerce among the States”.

**In 1944**, the Court decided **United States vs. South-Eastern Underwriters Association (SEUA)**, in which the Court reversed **Paul vs. Virginia** and held that insurance *was* “interstate commerce” [*Notice the change from the actual wording, “commerce among the States”. A reasonable person might not think your insurer or your insured is a “State”.*] and hence was subject to federal antitrust laws!

### **THREE MAJOR FEDERAL STATUTES THAT REGULATE INSURANCE:**

1. **The McCarran-Ferguson Act**--was passed in 1945 in response to the SEUA case because Congress was *not* prepared to regulate insurance.  
That act exempts insurance from federal laws *if* the individual states maintain a comprehensive regulatory system, which they do.
2. **The Insurance Fraud Protection Act**--is part of a federal anti-crime bill passed in 1994.  
That Act defines the crime of **insurance fraud** to include filing false statements, falsifying insurer records, embezzlement, *and* obstructing insurance regulatory proceedings.  
That act prohibits anyone convicted of a felony involving honesty from working in the insurance industry.
3. **The Gramm-Leach-Bliley (GLB) Act of 1999 (aka Financial Services Modernization Act)**--states that each segment of the financial services is regulated separately and clarifies that states have primary regulatory authority for insurance activities.  
That act also requires banks to disclose their privacy policies.

**THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS (NAIC)** is the group of all state insurance commissioners that coordinates insurer financial audits and designs insurance regulatory laws. The NAIC has *no* direct regulatory authority over its members, *but* the NAIC model laws and regulations *do* strongly influence state regulation.

### **THE THREE PURPOSES OF INSURANCE REGULATION:**

1. **to protect consumers against fraud and unethical practices by providing systems to**
  - a. review insurance policy forms for fairness,
  - b. respond to complaints about unfair practices,
  - c. ensure that insurance is available, *and*
  - d. educate consumers about insurance.
2. **to monitor the financial solvency of insurers, and**
3. **to prevent destructive competition.**

### **INSURANCE REGULATORS**

1. approve policy forms;
2. hold rate hearings and review rate filings;
3. license insurers, producers, adjusters, and claim representatives;
4. investigate consumer complaints;

5. oversee insolvent insurers;
6. issue cease-and-desist orders;
7. conduct claim audits and underwriting audits;
8. review solvency information;
9. perform market conduct examinations; *and*
10. educate consumers about insurance.

**THE FOUR TYPES OF INSURANCE REGULATION:**

1. **Rate regulation--Regulators ensure that**
  - a. rates are adequate to pay losses, but are *not* excessive or unfairly discriminatory *and*
  - b. rates reflect the exposure to loss [*which is contained in adequate but not excessive rates*].
2. **Solvency surveillance--Regulators**
  - a. identify and monitor insurers with financial troubles,
  - b. enforce rules regarding the liquidation of insolvent insurers, *and*
  - c. create **insurance guaranty funds** to pay the claims of insolvent insurers licensed in the state.
3. **Insurance policy regulation--Regulators**
  - a. ensure that policies are clear, fair, and readable *and*
  - b. may dictate specific policy language.
4. **Consumer protection--Regulators**
  - a. set licensing requirements,
  - b. approve policy forms, *and*
  - c. monitor conduct.

**UNFAIR TRADE PRACTICES**--Every state has a statute or regulation (usually based on the **NAIC Model Unfair Trade Practices Act**) that defines and prohibits unfair trade practices.

**Under the NAIC model law, it is an unfair trade practice to**

1. misrepresent or falsely advertise insurance policies;
2. give false information in advertisements, announcements, or statements;
3. defame an insurer (by giving out *in*accurate information);
4. enter an agreement to boycott, coerce, or intimidate;
5. make a false statement or entry about an insurer's financial condition;
6. induce buying through promises of stock, dividends, or profit sharing;
7. unfairly discriminate against different individuals in the same class;
8. fail to maintain marketing and performance records;
9. fail to maintain and follow complaint-handling procedures;
10. allow misrepresentations on insurance applications; *and/or*
11. fail to provide claims history.

**STATE UNFAIR CLAIM PRACTICES ACTS** define and prohibit unethical and illegal claim practices. Most states have adopted the NAIC model law on unfair claim settlement practices.

**It is an unfair claim settlement practice to**

1. knowingly misrepresent relevant facts or policy provisions,
2. fail to respond promptly to claim communications,
3. fail to use standards that ensure prompt investigation and prompt settlement,
4. fail to attempt good faith settlement of claims with clear liability,
5. 'lowball' insureds to force them to file suit,
6. refuse to pay a claim without a reasonable investigation,

7. fail to affirm or deny coverage after investigation,
8. try to settle a claim for less than a reasonable amount,
9. try to settle a claim based on an altered application,
10. make claim payments without indicating the applicable coverage,
11. unreasonably delay investigation or settlement of a claim,
12. fail to promptly explain denial of coverage,
13. fail to provide claim forms within a reasonable time, *and/or*
14. fail to adopt standards to assure workman-like repairs.

Some courts have held that improper claim handling constitutes *both* breach of contract *and* the tort of **bad faith** (breach of the duty of good faith and fair dealing). [*See Assignment 5.*]