

**THE INSURANCE BUSINESS: AN OVERVIEW---SALES; MANAGEMENT; DEFINITIONS; and ORGANIZATION (81-A1)**

AO 1. **THE THREE PARTS OF THE SALES TRILOGY (elements in the sale of any product):**

1. **Product knowledge**--details of the good or service being sold.
2. **Market knowledge**--understanding of homogeneous groups of prospects.
3. **Selling skills**--ability to create consumer demand by converting product features into customer benefits.

*[Marketing finds, sells to, and serves customers.]*

*[A market is a homogenous group of customers or insureds or potential customers or insureds.]*

AO 2. **THE PRINCIPLES OF INSURANCE are discussed below and throughout this assignment.**

**Insurable interest** is financial interest in the continued existence of the thing insured. An insurable interest in a life must exist when the policy is issued. An insurable interest in property-casualty insurance must exist at the time of loss. 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.

**The five steps of risk management:**

1. Identify and analyze loss exposures.
2. Evaluate **the five techniques for dealing with loss exposures**--avoidance, control, insurance transfer, noninsurance transfer, and retention.
3. Choose the best technique or combination of techniques.
4. Implement the chosen technique.
5. Monitor the decision.

**Loss frequency** equals the ratio of the number of losses during a given time period to the number of exposure units. **Loss severity** equals the size of a single loss or, more commonly, the average size of losses during a given period. Loss frequency times loss severity equals total losses.

Use insurance for loss exposures with a low frequency of high severity losses.

**The law of large numbers** states that the greater the number of similar units exposed to a similar loss, the more accurate, in percentage terms, the loss predictions based on those data.

AO 3. **THE TWO CATEGORIES OF RISK (A risk is a chance of financial loss.):**

1. **Fundamental versus particular risk:**

- a. **Fundamental risk** exposes many people to the same loss exposure.  
*Examples:* war, flood, hurricane, and unemployment during a recession.
- b. **Particular risk** exposes just one or a few people to the same loss exposure.  
*Examples:* fire, death, and unemployment due to employee infidelity.

Particular risks are usually insurable, fundamental risks are often not insurable.

2. **Pure versus speculative risk:**

- a. **Pure risk** involves loss or no loss--the chance of financial loss without a chance of financial gain. *Examples:* fire, death, tornado, and auto accident.
- b. **Speculative risk** involves loss, no loss, *or gain*--the chance of financial loss *with* a chance of financial gain. Speculative risk is usually created intentionally.  
*Examples:* stock market investing, creating a business, and gambling.

**Pure risks are insurable because** they are not intentionally created, involve accidental loss, don't increase moral or morale hazard, and offer no chance for financial gain.

**Speculative risks are seldom insurable.**

**CATEGORIES OF HAZARDS** (A **hazard** is a characteristic that increases loss frequency or severity):

1. **Physical hazard** is a tangible characteristic of the person, property, or operation insured.  
*Examples:* ill-health, wood frame construction, and youthful drivers. Physical hazards are generally insurable, subject to loss controls to reduce loss frequency and severity.
2. **Moral hazard** is a subjective characteristic of the insured that increases the loss frequency or severity--*results in active inducement of loss.*  
*Examples:* a reputation for dishonesty, repeated suspicious fires, and dealing with felons. Moral hazards should **not** be insured.
3. **Morale [aka attitudinal] hazard** is an insured's 'What, me worry?' attitude to loss--*results in passive indifference to loss.*  
*Examples:* poor housekeeping, a 'Who cares?' attitude, and unearned wealth. Insureds with morale hazards have more losses than those without moral or morale hazards.
4. **Legal hazard** is the chance of changes in our laws, courts, or juries that increase the frequency and severity of lawsuits.

AO 4. **WHY EXPOSURES MAY BE EITHER UNINSURABLE OR INSURABLE BUT SUBJECT TO LIMITATIONS--The five elements of an ideally insurable loss exposure:**

1. **independent exposures--particular risk**--the probability of loss for each insured is unrelated to the probability of loss for other insureds.
2. **similar exposures--homogeneous exposures**--so the law of large numbers can be applied; homes are like homes and lives are like lives but homes are not like lives.
3. **definiteness--definability**--a loss must be definite in time, place, cause, and amount to determine coverage and to facilitate loss settlement.
4. **calculability--predictability**--loss frequency and severity must be predictable to set premiums.
5. **accidental--unexpected and random**--losses must occur randomly and be neither expected nor intended from the standpoint of the insured.

Exposures that do **not** meet those requirements are often uninsurable.

*Examples:* military personnel's lives in wartime (not independent); foreign credit exposures (not similar); wear and tear (not definite); war and nuclear accidents (not calculable); and arson by the insured (not accidental).

Some non-ideal exposures are commercially insurable with limitations.

*Examples:* flood insurance construction and elevation requirements may qualify some buildings in flood plains and windstorm coverage is universally available.

AO 5. Insurers act as **financial intermediaries** (entities that obtain money from some people--insureds--and redirect it to others--claimants).

*[Banks and stock brokerages are the other two types of financial intermediaries.]*

**THE BENEFITS OF INSURANCE TO SOCIETY:**

1. **Indemnification for losses--To indemnify** is to restore a party who has suffered a loss to the same financial position that would have existed had no loss occurred. Indemnity prevents an insured from profiting from an insured loss through over insurance. Indemnification enables insureds to retain their pre-loss financial positions, employees to keep their jobs, and the economy to remain stable.
2. **Reduction of uncertainty--and anxiety and stress** as we can all better predict our financial losses (ie, regular premiums instead of irregular loss occurrences) and therefore worry less.
3. **Equitable assessment of loss costs**--Businesses incorporate premiums into the costs of their products just as families include their premiums in the costs of home and auto ownership. Losses are dispersed and borne fairly throughout the economy.

4. **A source of funds for long-term investment**--Insurers provide funds to businesses and governments as financial intermediaries by investing unearned premiums.
5. **Reduction of losses**--Insurers sponsor loss control activities that reduce the frequency and severity of losses lowering both uninsured losses and insured losses, hence premiums.
6. **Better use of resources to promote business competition**--We don't need to set aside funds for 'a rainy day' because insurance makes our futures more secure.  
That extra money lets us invest more in our businesses and assume more risk in our investments since we know our other assets will be replaced if they are destroyed.
- [7. **Satisfaction of legal and business requirements**--*Insurance lets people meet auto financial responsibility laws, employers satisfy workers' compensation laws, contractors meet surety requirements, and other professionals (from painters to physicians) meet liability insurance requirements (of owners and hospitals).*
- [8. **Reduction of social burdens**--*People who suffer losses often become burdens to society if they don't have enough life, workers' compensation, auto liability, unemployment, or disability insurance.*
- [9. **Support for credit**--Lenders take **liens** on personal property and **mortgages** on real property to help guarantee repayment of loans. Lenders require their collateral be insured since if it were destroyed, they couldn't repossess or foreclose.]

#### **THE COSTS OF INSURANCE TO SOCIETY:**

1. **Inefficient use of human and material resources**--Insurance consumes forests of trees for policies and armies of people doing work that does not create new, useful things for others.
2. **Moral hazard losses**--occur *because* of insurance, such as murder by beneficiaries and arson.
3. **Morale hazard losses**--occur due to carelessness *because* people expect insurance to make any loss easily affordable by covering above the deductible.
- [4. **Increased dependence on insurance**--*The number and size of liability lawsuits has exploded in recent decades. Also, when insurers must provide coverage at subsidized rates, those with the highest hazards buy more insurance and those with the lowest hazards buy less, thus misallocating our economy's resources.*]

#### AOs 6 + 7. **HOW INSURANCE IS DIFFERENT FROM OTHER BUSINESSES:**

1. **Different accounting cycles**--Manufacturers often get paid before a good is delivered. Insurers do not get full payment until the end of the policy year. At end of the year, insurers don't know the full cost of the losses that occurred during the policy year. Insurers estimate for losses 'reported and adjusted but not paid,' 'reported but not adjusted,' and 'incurred but not reported'. Due to reporting and settlement delays, insurers may not know their true costs for years.
2. **Costs of business**--Manufacturers gain economies of scale. Insurance tends to lose economy with scale--the *more* insureds you accept, the *less* desirable they are. Insurance is labor, not capital, intensive.
3. **Entrepreneurial nature**--Insurance is truly entrepreneurial. Producers have small capital requirements. Their income is limited only by their desire and effectiveness.

#### **HOW INSURANCE IS SIMILAR TO OTHER BUSINESSES:**

1. **Goal**--to earn profit. Producers must be efficient to have revenues exceed expenses.
2. **Competition**--Producers compete both with other producers and with other businesses for consumers' money.
3. **Business standards**--All businesses require integrity, professionalism, and efficiency, ours more than most.

#### AO 8. **INSURER LEGAL ORGANIZATIONAL FORMS:**

1. **Proprietary insurers** (owned and controlled for the purpose of earning profit for their owners)--
  - a. **unincorporated proprietary insurers**--*Example:* Lloyd's of London. Lloyd's is divided

into two organizations--**Lloyd's Corporation** (provides services such as typing, claims statistical work, collections, and disbursements) and the **Lloyd's underwriters** (the actual insurers). **Syndicate managers** accept submissions on behalf of **members or names** (underwriters) who belong to each manager's syndicate.

Each member accepts a percentage of the syndicate's exposures and receives the same percentage of its premium and investment income.

- b. **incorporated proprietary insurers**--capital stock insurers--such as Travelers and CNA, that are owned by their stockholders.
2. **Nonproprietary insurers** (owned and controlled by their policyholders)--
  - a. **Mutual insurers:**
    - 1) **pure assessment mutuals**--assess policyholders for losses and expenses at the end of each year.
    - 2) **assessment mutuals**--charge policyholders advance premiums to cover losses and expenses, but may make further assessments at year-end if actual losses exceeded expected losses.
    - 3) **perpetual mutuals**--charge a single *large* advance premium which earns enough investment income to cover all future losses and expenses.
    - 4) **advance premium mutuals**--issue nonassessable policies and may pay dividends--such as State Farm and Hingham Mutual.
  - b. **Reciprocal exchanges**--unincorporated associations of **members** (insureds) managed by an **attorney-in-fact** (usually a corporation) that manages the association's affairs--such as USAA. Members only insure fellow members (unlike Lloyd's).
  - c. **Miscellaneous cooperatives**--
    - 1) **fraternal benefit societies**--provide life and health insurance for members.
    - 2) **health expense plans:**
      - a) **Blue Cross/Blue Shield**--pre-paid hospital and physician producer cooperatives based on community rating.
      - b) **Health Maintenance Organizations (HMOs)**--groups of physicians who provide total health care.
      - c) **Preferred Provider Organizations (PPOs)**--buying cooperatives of patients that receive discounted fees in return for giving providers more business.
3. **Governmental insurers**--cover commercially uninsurable perils and fundamental risks that fall on the general population. **Examples:** the Federal Deposit Insurance Corporation (FDIC); federal crop, riot, and flood insurance; and social security.

#### AO 9. **THE FIVE INSURANCE DISTRIBUTION SYSTEMS:**

1. **Independent agency system--Independent agents** are independent contractors paid by commission who own their clients' expirations and represent several insurers. They often provide claims and loss control services.
2. **Exclusive agency system--Exclusive agents** are trained by their insurer and then become independent contractors who represent only that insurer. Some exclusive agency agreements contain a '**nonbrokerage rule**' that prohibits agents from placing business with another insurer. **Advantage**--Agents can become expert in their insurer's products. **Disadvantage**--Some insureds prefer to have only one agent and will take all their business elsewhere if the exclusive agent can't place a problem exposure.
3. **Direct writing system--Sales representatives** are company employees who perform only selling activities.
4. **Mail order system**--Insurers eliminate producers and directly target potential, 'above average' insureds.
5. **Mixed system**--Some insurers combine two or more systems. **Example:** Allstate uses only exclusive agents in metropolitan areas and both exclusive and independent agents in rural areas.