

INTRODUCTION TO RISK---THE CPCU CODE OF ETHICS (510-1)

EO 1. **RISK** refers to uncertainty about outcomes.

THE TWO KEY ELEMENTS OF RISK are

1. **uncertainty**--the lack of a determinate outcome *and*
2. **possibility**--the chance that something could happen.
*[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.]*

PROBABILITY is the likelihood that an event will occur.

Probability equals the proportion of times that an event will occur, in the long run.

Probability is expressed numerically as a number between 0 and 1.

An event with a probability of 0 will *never* happen. An event with a probability of 1 will *always* happen.

EO 2. A **LOSS EXPOSURE** is a situation that presents the possibility of loss, *even if* the exposure is not identified *and* the loss never occurs.

THE THREE ELEMENTS OF A LOSS EXPOSURE:

1. **The item subject to loss**--what can be lost.
2. **The peril or cause of loss**--how the subject can be lost.
3. **The financial impact of loss**--how much value can be lost.
The financial consequences of a loss depend on the type of loss exposure, the cause of the loss, *and* the loss frequency and severity.

EIGHT TYPES OF LOSS EXPOSURES:

1. **Property loss exposure**--is the possibility of financial loss resulting from
 - a. damage to,
 - b. destruction of, *and/or*
 - c. loss of use of**property in which a person or organization has a financial (insurable) interest.**
Tangible property has a physical form and characteristics and can be touched (land, cars, books).
Intangible property has no physical form and can not be seen or touched (patents, copyrights).
Real property consists of land and its attached structures and their fixtures.
Personal property is tangible property other than real property.
2. **Liability loss exposure**--is the possibility that a third party will bring a claim for damages. The exposure emphasizes the possibility of a claim (rather than the possibility of a payment) because even a claim that can be successfully defended will still result in defense costs and adverse publicity.
3. **Personal loss exposure (aka human loss exposure)**--is the possibility that an individual or family will suffer financial loss due to illness/injury, death, disability, or unemployment of a family member.
4. **Personnel loss exposure**--is the possibility that a business will suffer financial loss due to disability, death, retirement, or resignation of a key employee.
5. **Net income loss exposure**--is the possibility of loss caused by a reduction in net income. Net income loss typically involves decrease in revenues or increase in expenses resulting from property loss.
6. **Exposure to loss resulting from failure to perform**--occurs when
 - a. a product fails to perform as promised *or*
 - b. a person fails to honor his obligations.
7. **Missed opportunity**--occurs when a business fails to take advantage of a chance to earn a profit.

8. **Exposure to loss of goodwill**--is the possibility that a business will suffer loss of **goodwill** (the intangible asset that reflects the value a business receives from reputation and patronage).
A business loses goodwill through poor service, mismanagement, *and/or* defective or obsolete products.
 Loss of goodwill reduces the value of a business because customers take their business elsewhere.

A **PERIL** is a cause of a loss. *Examples:* fire, windstorm, explosion, and theft.

A **HAZARD** is a characteristic that increases loss frequency and/or loss severity.

THERE ARE FOUR MAJOR CATEGORIES OF HAZARDS:

1. **Moral hazard**--is a subjective characteristic of the insured that increases loss frequency and/or severity.
Examples: a reputation for dishonesty, repeated suspicious fires, and associating with felons.
[Moral hazard results in active inducement of loss.]
2. **Attitudinal hazard (aka morale hazard)**--is an insured's 'What, me worry?' attitude to loss.
Examples: poor housekeeping, a 'Who cares?' attitude, and unearned wealth.
[Attitudinal hazard results in passive indifference to loss.]
3. **Physical hazard**--is a tangible characteristic of the person, property, or operation insured.
Examples: ill-health, wood frame construction, and youthful and elderly drivers.
4. **Legal hazard**--is a condition of the legal environment or system that increases the frequency or severity of loss.
Examples: the increasing litigiousness of our society, legal trends (such as suits against tobacco manufacturers), the propensity of some jurisdictions to award excessive verdicts, *and* the increasing inability of judges and juries to read, understand, and apply clear policy language.

EO 3. **THE THREE MAJOR WAYS TO CLASSIFY RISK (CLASSIFICATIONS OF RISK):**

1. **Pure risk versus speculative risk--Pure risk** involves loss or no loss--the chance of financial loss *without* the chance of financial gain.
Examples: fire, death, and tornado.
Speculative risk involves loss, no loss, *or gain*--the chance of financial loss *with* the chance of financial gain. Speculative risk is usually created intentionally.
Examples: stock market investing and gambling.
 Insurance is designed to address pure risk, but *not* speculative risk.
2. **Subjective risk versus objective risk--Subjective risk** is the perceived amount of risk, which is based on a person's opinion about risk.
Objective risk refers to the measurable variation in outcomes based on facts and data.
Three reasons subjective risk differs from objective risk:
 - a. **Familiarity**--People tend to underestimate familiar risks and to overestimate dramatic, unfamiliar risks.
 - b. **Control**--People who feel in control tend to underestimate the level of risk.
 - c. **Frequency and severity**--People tend to overestimate low-frequency events and to underestimate high-frequency events.
 Also, some people focus on probability, regardless of severity; while others focus on severity, rather than on probability.
3. **Diversifiable risk versus nondiversifiable risk--Diversifiable risk (aka nonsystematic risk or specific risk)** exposes just one or a few people to the same loss exposure.
Examples: dwelling fire, car theft, and death by auto accident.
Nondiversifiable risk (aka systematic risk or fundamental risk) exposes many people to the same loss exposure. *Examples:* war, terrorism, flood, and earthquake.
 Insurance is designed to address diversifiable risk, but *not* nondiversifiable risk. Nondiversifiable risks are considered the responsibility of society and are often addressed by government.

EO 4. **THE COST OF RISK** represents the extent to which an organization's value has been reduced by its risks.

THREE FINANCIAL CONSEQUENCES OF RISK:

1. **Expected cost of losses**--equals expected loss frequency times expected average loss severity.
2. **Cost of risk management**--includes the costs of loss control, loss financing, and risk reduction.
3. **Cost of residual uncertainty**--includes the effects of uncertainty on the prices of the firm's products and on the price of the firm's stock.

Hidden costs of risk include the costs of

1. time lost by injured employees;
2. time lost by other employees who are distracted by the injuries;
3. time lost by supervisors, managers, and executives in dealing with the risk and the losses;
4. time spent by medical personnel, if *not* paid for by the insurer;
5. damage to machines, tools, and raw materials;
6. incidental costs from lost production, eg lost bonuses and failure to meet contractual obligations;
7. continued wages for the injured employees;
8. lost profit on the injured employees' productivity;
9. decreased morale; *and*
10. overhead costs allocated to the injured employees.

EO 5. **THE PURPOSE OF THE AMERICAN INSTITUTE'S CODE OF PROFESSIONAL ETHICS FOR CPCU CANDIDATES AND FOR CPCUs** is to foster ethical conduct by CPCU candidates and by CPCUs.

Note: The Institute has jurisdiction over *all* CPCUs--*not* just those who choose to be members of the Society of CPCUs.

EO 6. **THE RULES OF PROFESSIONAL CONDUCT ARE BINDING ON**

1. **ALL APPLICANTS** to the CPCU program **upon matriculation** (*Nonmatriculated candidates are not bound by the Rules of Professional Conduct.*),
2. **ALL MATRICULATED CANDIDATES** in the CPCU program, *and*
3. **ALL DESIGNEES (CPCUs)**
 - a. **whose designations were conferred after 6/76 and**
 - b. **whose designations were conferred prior to 6/76, on the later of 7/1/77, or on the day following the filing of their written election to be bound by the Code.**

Other (pre-1976) CPCUs are *not* bound by the Code, but *are* bound by the CPCU Pledge.

[An "applicant" has submitted his CPCU application form.

A "candidate" has had his CPCU matriculation approved.

A "designee" has met all of the requirements for the CPCU designation.

A "CPCU" has received that designation.]

THE EDUCATION REQUIREMENTS FOR COMPLETING THE CPCU:

You meet the CPCU education requirement by passing eight courses (five foundation courses plus three from either the commercial concentration or the personal concentration).

The five CPCU foundation courses:

- CPCU 510--Foundations of Risk Management, Insurance, and Professionalism
- CPCU 520--Insurance Operations, Regulation, and Statutory Accounting
- CPCU 530--The Legal Environment of Insurance
- CPCU 540--Finance for Risk management and Insurance Professionals
- CPCU 560--Financial Services Institutions

The three CPCU commercial concentration courses:

- CPCU 551--Commercial Property Risk Management and Insurance
- CPCU 552--Commercial Liability Risk Management and Insurance
- CPCU 553--Survey of Personal Risk Management, Insurance, and Financial Planning

The three CPCU personal concentration courses:

- CPCU 555--Personal Risk Management and Property-Liability Insurance
- CPCU 556--Personal Financial Planning
- CPCU 557--Survey of Commercial Risk Management and Insurance

THE EXPERIENCE REQUIREMENTS FOR COMPLETING THE CPCU:

You must have worked at least 17½ hours per week for at least 3 of the past 5 years in the field of insurance. Any insurance job qualifies as does a job in any other field of work that relates to the insurance industry.

THE ETHICS REQUIREMENTS FOR COMPLETING THE CPCU were unstated.

However, The Board of Trustees of the AICPCU decides in its sole judgment if you've met the requirements. Expect that you have met the ethics requirements *if* you've honored your signed commitment (on your Matriculation Form) to "**abide by the official Code of Professional Ethics**".

EO 7. **CANONS** (what every CPCU *should* do) are *not* enforceable.

THEIR PURPOSE: to set exemplary ethical standards CPCU candidates and CPCUs should strive to reach.

RULES OF PROFESSIONAL CONDUCT (what every CPCU *must* do) *are* enforceable.

THEIR PURPOSE: to set ethical minimums for CPCU candidates and for CPCUs.

THE PURPOSE OF THE GUIDELINES FOR PROFESSIONAL CONDUCT: Technically not part of the Code, Guidelines assist in understanding, interpreting, *and* applying the Rules of Professional Conduct. Only **Guideline 8.1**, dealing with use of the CPCU designation and CPCU key, is enforceable (because it is incorporated, by reference, in Rule 8.1).

THE GENERAL NATURE or goal OF THE CODE, expressed in Canon 1, is to inspire CPCUs to always endeavor to place public interest above personal interest. **CPCUs AND CPCU CANDIDATES CAN ACHIEVE THAT GOAL BY** adhering to the Rules of Professional Conduct, as ethical minimums, while striving to reach the exemplary ethical standards of the Canons and Guidelines.

HYPOTHETICAL CASE STUDIES (HCSs) present imaginary case situations and resolve the ethical questions and issues involved in those case situations, but are *not* binding as precedent.

ADVISORY OPINIONS provide CPCUs with general and/or individual guidance.

Unpublished advisory opinions are informal opinions guiding the individuals to whom they are issued.

Published advisory opinions are formal opinions guiding all persons subject to the CPCU Code of Ethics.

Advisory opinions can *only* be issued by the **Board of Ethical Inquiry (BEI)**, which also implements ethics policy and imposes penalties for code violations.

EO 8. **THE CODE'S DISCIPLINARY PROCESS:** A complaint may be filed by anyone. It must be signed and submitted, in writing, to the Chairman of the Board of Ethical Inquiry (aka **The Ethics Counsel**). **The Ethics Counsel then investigates and either** dismisses the complaint (if frivolous or lacking in merit) *or* furnishes the respondent with a copy of the charges and initiates a formal hearing before a three-member Hearing Panel of the Board of Ethical Inquiry (**BEI**).

The Hearing Panel then makes a recommendation to the entire BEI.

The BEI recommendation is then submitted to the **Ethics Policy Committee** (a subcommittee of the Board of Trustees of the American Institute that reviews the Institute's ethics activities and policies).

EO 9. **THE DISCIPLINARY PENALTIES THAT MAY BE APPLIED TO CPCU APPLICANTS AND CANDIDATES** who violate the Code's Rules include

1. barred admission to CPCU exams *and/or*
2. withheld conferment of the CPCU designation

both pending proof of complete rehabilitation.

A CPCU candidate may *also* be subject to admonition, reprimand, or censure depending on the severity of his offense.

A CPCU candidate will be immediately suspended from the CPCU program *if* the candidate is convicted of or pleads guilty to any crime that violates the Rules of Professional Conduct.

THE DISCIPLINARY PENALTIES THAT MAY BE APPLIED TO CPCUs who violate the Code's Rules include

1. **private warnings**--to cease and desist,
2. **reprimands**--given limited publication,
3. **censures**--given wide publication, *and*
4. **temporary or permanent suspension or revocation of the privilege to use the CPCU designation**--given whatever publication is deemed appropriate.

A CPCU's designation is immediately suspended *if* the CPCU is convicted of or pleads guilty to any crime that violates the Rules of Professional Conduct.

Unasked EO. **THE AMERICAN INSTITUTE'S CODE OF PROFESSIONAL ETHICS IS PARAPHRASED** in the addendum to this assignment.

[To more fully understand the Canons, Rules, and Guidelines, you should read them in their original version in Chapter 2 of the text.]

[To more fully understand how to apply the Code in 'real life' situations, you should read the Hypothetical Case Studies presented in Chapter 5 of the text.]

To fulfill Canon 1,

1. understand and comply with *all* the Code's Rules *and*
2. never have another do what you are prohibited from doing yourself.

(Rules 1.1 and 1.2)

EO 10. **THE KEY WORDS AND PHRASES** are defined in a separate section of The Burnham System. The key words and phrases are in **bolded, standard type**. Other words and phrases are included in ***bolded italics***.

Note:

Many assignments in this tan book will conclude with my answers to various review questions (ROs) that relate to our Code of Ethics.

Those review questions will be found in your course guide (published by the AICPCU, the Institute).

Treat those review questions as if they were educational objectives (EOs), as if you must learn their answers if you want to pass the national exam.