INS – 21

FUNDAMENTALS OF INSURANCE

SEGMENT A: FUNDAMENTALS OF INSURANCE
CHAPTER 1: Insurance: What is it?

Insurance can be described as follows:

- A *transfer system*, in which one party – the **insured** – transfers the chance of financial loss to another party – the insurance company or the insurer.

  An **insured** is a person, a business, or an organization whose property, life, or legal liability is covered by an insurance policy.

  An **insurer** is an insurance company.

- A *business*, which includes various operations that must be conducted in a way that generates sufficient income to pay claims and provide a reasonable profit for its owners.

- A *contract* between the insured and the insurer that states what potential costs of loss the insured is transferring to the insurer and expresses the insurer's promise to pay for those costs of loss in exchange for a stated payment by the insured.

Insurance as a Transfer System

Insurance is a system that enables a person, family, or business to **transfer the costs of losses to an insurance company**. The insurance company, in turn, pays for **covered loses** and, in effect, distributes the costs of losses among all insureds (that is, all insureds share the cost of a loss).

Thus, insurance is a system of both *transferring* and *sharing* the costs of losses.

Transferring the Costs of Losses

By transferring the costs of their losses to insurance companies, insureds exchange the possibility of a large loss; insureds exchange the possibility of a large loss for the certainty of a much smaller, periodic payment (the premium that the insured pays for insurance coverage).

This transfer is accomplished through insurance policies.

An insurance policy is a contract that states the rights and duties of both the insured and the insurer regarding the transfer of the costs of losses.

A **loss exposure,** or simply an **exposure,** is any condition or situation that presents the possibility of a loss.

It is not necessary for a loss to occur for a loss exposure; simply there should be a possibility of a loss.

Sharing the Costs of Loses

As a system of sharing, insurance involves the "pooling" by the insurance company of the premiums paid by the Insureds and payment of claims from such pool.

Insurance Companies estimate future losses and expenses to determine how much they must collect from insureds in premiums.

One popular method that Insurance Companies use for predicting future losses is the mathematical principle The **Law of Large Numbers.**

The law of large numbers is a mathematical principle stating that as the **number of similar but independent exposure units increases, the relative accuracy of predictions about future outcomes (losses) based on these exposure units also increases**.

An **Exposure Unit** is a measure of loss potential and is used in pricing insurance.

Types of Loss Exposures

Potential losses can be categorized as under:

- **Property loss exposures**
- **Liability loss exposures**
- **Human and personnel loss exposures**

Property Loss Exposures

A **property loss exposure** is any condition or situation that presents the possibility that a property loss will happen.

The term property is further categorized into **Real Property** and **Personal Property**.

Real property means immobile fixed assets such as land, building and other structures attached to the land or embedded in it.

Personal Property consists of all tangible or intangible property that is not real property such as furniture, fixtures, fittings, plant and machinery, money, so on and so forth.

Net income also forms part of Personal Property. Net income refers to the income or revenue minus expenses during a given period.

Liability Loss Exposures

A **Liability Loss Exposure** presents the possibility of a claim alleging legal responsibility of a person or business for injury or damage suffered by another party.

A liability loss is a claim for monetary damages because of injury to another party or damage to another party's property.

Liability claims might result from bodily injury, property damage, libel, slander, humiliation, defamation, invasion of privacy and similar occurrences.

Human and Personnel Loss Exposures

A **Human loss exposure,** also called a **personal loss exposure,** can be defined as any condition or situation that presents the possibility of a financial loss to an individual or a family by such causes as death, sickness, injury or un-employment.

In a broader sense, the term personal loss exposure can also be used to include all loss exposures faced by individuals and families, including property and liability loss exposures.

Personnel loss exposures, on the other hand, affect businesses.

A **personnel loss exposure** is the possibility of a financial loss to a business because of the death, disability, retirement or resignation of key employees.

Ideally Insurable Loss Exposures

- **Large number of similar exposure units**
- **Losses that are accidental**
- **Losses that are definite and measurable**
- **Losses that are not catastrophic**
- **Losses that are economically feasible to insure**

Large number of similar exposure units

The method adopted by insurance companies to quote premium is the Law of Large numbers, which clearly states that larger the number of similar exposure units larger shall be the accuracy of future loss predictions.

An ideally insurable loss exposure must be common enough that the insurer can pool a large number of homogeneous, or similar, exposure units. This characteristic is important because it enables the insurer to predict losses accurately and to determine appropriate premiums.

Losses that are accidental

In order to have an exposure insurable the losses need to be accidental from the standpoint of the Insured. If an exposure is certain to result in loss or damage then insurance companies are sure to pay the claim. In such a case, the core principle of insurance is defeated in total.

Losses That Are Definite and Measurable

To be insurable, a loss should have a definite time and place of occurrence and the amount of loss must be measurable in pecuniary terms.

If the time and location of a loss cannot be definitely determined and the amount of loss cannot be measured, writing an insurance policy that defines what claims to pay and how much to pay in the event of a loss is highly impossible. Also losses are impossible to predict if they cannot be measured.

Losses That Are Not Catastrophic

Under this topic, the crux is that Insurance business should have a reasonable Geographical Spread.

Effective pooling of exposure units assumes that the exposure units are independent. Independence means that a loss suffered by one insured does not affect any other insured or group of insureds. If exposure units are not independent, a single catastrophe could cause losses to sizable proportions of Insureds at the same time.

This tendency of insurers not to insure catastrophic losses does not mean that they are not interested in covering catastrophic perils like flood, inundation, storm, typhoon, tempest, hurricane, tornado, etc.,

This lay emphasis that there should be a reasonable geographical spread.

Losses That Are Economically Feasible To Insure

Insurance companies seek to cover only loss exposures that are economically feasible to insure.

Because of this constraint, loss exposures involving small losses as well as those involving a high probability of loss are generally considered uninsurable.

Writing insurance to cover small losses does not make sense when the expense of providing the insurance probably exceeds the amount of potential losses.

It also does not make sense to write insurance to cover losses that are almost certain to occur.

Insurance as a Business

This section provides a brief overview of the business of insurance in regard to the following:

- **Types of insurers**
- **Insurance operations**
- **Financial performance of insurers**
- **State insurance regulation**
- **Benefits and costs of insurance**

Types of insurers

- **Private Insurers**
- **Federal Government Insurance Programs**
- **State Government Insurance Programs**

Private Insurers

The three major types of private insurers are as follows :

- Stock Insurance Companies, which are corporations owned by stockholders
- Mutual insurance companies, which are corporations owned by their policy holders
- Reciprocal insurance exchanges (also known as inter insurance exchanges), which are unincorporated associations that provide insurance services to their members, often called subscribers.

Other private providers of insurance include Lloyd's of London, captive insurance companies and reinsurance companies.

Federal Government Insurance Programs

Some federal government insurance programs exist because of the huge amount of financial resources needed to provide certain types of coverage and because the government has the authority to require mandatory coverage.

Social Security is the best example of such a program. Generally, the number of Social Security beneficiaries and the range of coverages are beyond the scope of private insurers.

Additionally, the federal government provides coverage that only certain segments of the population need.

The National Flood Insurance Program provides insurance for owners of property located in flood-prone areas and for others concerned about the exposure of flooding.

The Federal Crop Insurance Program insures farmers against damage to their crops by drought, insects, hail and other causes.

The federal government also insures depositors against loss resulting from the failure or insolvency of banks (through the Federal Deposit Insurance Corporation) and credit unions (through the National Credit Union Administration).

State Government Insurance Programs

State Governments also offer insurance programs to assure the availability of certain types of coverage considered necessary to protect the public.

All states require that employers be able to meet the financial obligations based on workers compensation laws.

Some states sell workers compensation insurance to employers.

In addition, state governments operate unemployment insurance plans, which ensure at least a minimum level of protection for eligible workers who are unemployed.

Fair Access to Insurance Requirements (FAIR) plans have been implemented in many states to provide basic property insurance to property owners who cannot otherwise obtain needed coverage.

Through automobile insurance plans and other programs, states make auto insurance available to drivers who have difficulty obtaining such insurance from private insurers.

Insurance Operations

The main operations of the insurance companies are

- Marketing
- Underwriting
- Claim handling
- Ratemaking

Marketing is the process of identifying customers and selling and delivering a product or service. Insurance marketing enables insurers to reach potential customers and retain current ones.

Underwriting is the process by which insurance companies decide which potential customers to insure and what coverage to offer them.

Claim handling enables insurance companies to determine whether a covered loss has occurred and if so the amount to be paid for the loss.

Ratemaking, another important insurance operation, is the process by which insurers determine the rates to charges the thousand (or millions) of similar but independent insureds. Insurers need appropriate rates to have enough money to pay for losses, cover operating expenses and earn a reasonable profit.

Financial Performance of Insurers

The primary sources of income for insurance companies are **premiums** and **investments**. Insurance Companies have investments because they receive premiums before they pay for losses and expenses.

Insurers need to generate enough revenues from premiums and investments to pay for losses, meet other expenses and earn a reasonable profit. In addition to loss payments, insurance companies incur several other types of expenses such claim settling expenses, viz., surveyors' and investigators' fees, marketing expenses such as providers' commission and advertisement expenses, payment of taxes, viz., income tax, service tax and other expenses such as salaries and other overheads.

State Insurance Regulation

A major concern of insurance regulators is that insurers be able to meet their obligations to insureds. A financially weak insurer may not have the resources necessary to meet its obligations.

Therefore, insurance regulators closely monitor the financial condition of insurance companies and take actions necessary to prevent insurer insolvency.

Every state has an insurance department that regulates the insurers doing business in the state. Almost all aspects of the insurance business are regulated to some degree, but most insurance regulation deals with rates, insurer solvency, and consumer protection.

State insurance departments regulate insurance rates to protect consumers from excessive rating and thereby avoid discriminations.

Through solvency surveillance, insurance regulators monitor the financial condition of insurance companies. Such surveillance enables regulators to work with insurers who have financial difficulties to keep the insurers in business and maintain their ability to meet obligations to insureds.

Insurance regulation protects consumers in several ways. Insurance companies must be licensed to write insurance policies in a given state, and licensing requires an insurer to meet tests of financial strength. In addition to licensing insurance companies, states require that certain representatives of insurance companies also be licensed. Such licensing requirements apply to insurance producers as well and may also apply to claim representatives and others.

Most states require that insurance companies file their policy forms with the insurance department so that the department can approve policy language.

States also monitor specific insurance company practices concerning marketing, underwriting and claims. In addition, state insurance departments investigate complaints against insurance companies and their representatives and enforce standards regarding their conduct.

Benefits of Insurance

The very many benefits provided by insurance include :

- **Payment for the costs of covered losses**
- **Reduction of the insured's financial uncertainty**
- **Loss control activities of insurance companies**
- **Efficient use of resources**
- **Support for credit**
- **Satisfaction of legal requirements**
- **Satisfaction of business requirements**
- **Source of investment funds**
- **Reduction of social burdens**

Payment for Losses

The primary role of insurance is to **indemnify** individuals, families and businesses that incur losses. When an insurance company pays an insured for a loss, the company has indemnified the insured.

To **indemnify** means after a loss to restore the insured in the same financial position as he had enjoyed immediately before the loss.

Reduction of Uncertainty

Because insurance provides financial compensation when covered losses occur, it greatly reduces the uncertainty created by many loss exposures.

A family's major financial concerns, for instance, would probably center around the possibility of a breadwinner's death or the destruction of a home. When such an uncertainty is transferred to an insurer, the family practically eliminates these concerns.

Insurance companies have greater certainty than individuals about losses, because the law of large numbers enables them to predict the number of losses that are likely to occur and the financial effects of those losses.

Loss Control Activities

Insurance companies often recommend loss control practices that people and business can implement.

Loss control means taking measures to prevent some losses from occurring or to reduce the financial consequences of losses that do occur.

Individuals, families, and businesses can use measures such as burglar alarms, smoke alarms, and deadbolt locks to prevent or reduce losses.

Loss control generally reduces the amount of money insurers must pay in claims.

Efficient Use of Resources

It is a common practice that individuals and business organizations set aside a certain amount from their income to face future uncertainties. By transferring such uncertainties to the insurers they can use such reserves for further development by individuals and business organizations, in exchange for a relatively small premium.

Support for Credit

Before advancing a loan for purchase of any property, lender wants assurance that the money will be repaid. Insurance makes loans to individuals and businesses possible by guaranteeing that the lender will be paid if the collateral for the loan (such as house or a commercial building) is destroyed or damaged by an insured event, thereby reducing the lender’s uncertainty.

Satisfaction of Legal Requirements

Insurance is often used or required to satisfy legal requirements. In many states, for example, automobile owners must prove they have auto liability insurance before they can register their autos. All states have laws that require employers to pay for the job related injuries or illnesses of their employees and employers generally purchase workers compensation insurance to meet this financial obligation.

Satisfaction of Business Requirements

Certain business relationships require proof of insurance. For example, building contractors are usually required to provide evidence of liability insurance before a construction contract is granted.

In fact, almost any one who provides a service to the public, from an architect to a tree trimmer might need to prove that he or she has liability insurance before being awarded a contract for services.

Source of Investment Funds

One of the greatest benefits of insurance is that it provides funds for investment. When insurers collect premiums, they do not usually need funds immediately to pay losses and expenses. Insurance Companies use some of these funds to provide loans and make other investments, which is helpful for economic growth and job creation. Moreover additional income generated by the insurers helps to keep insurance premium at reasonable levels.

Reduction of Social Burdens

Uncompensated accident victims can be a serious burden to society. Insurance helps to reduce this burden by providing compensation to such injured persons. Examples of such insurances are auto insurance, workmen's compensation insurance, etc.,

Without insurance, victims of job-related or auto accidents might become a burden to society and need some form of state welfare.

Costs of Insurance

The benefits of insurance are not cost-free. Among the costs of insurance are both direct and indirect costs including the following: -

- **Premiums paid by insureds**
- **Operating costs of insurers**
- **Opportunity costs**
- **Increased losses**
- **Increased lawsuits**

Premiums paid by Insureds

Insurers must charge premiums in order to have the funds necessary to make loss payments. In fact, an Insurance company must collect a total amount of premiums that exceeds the amount needed to pay for losses in order to cover its costs of doing business. Usually premium rating shall be structured in such a manner that a portion of premium is used for other expenses of the insurers.

Operating Costs of Insurers

Like any business, an insurance company has operating costs that must be paid to run the day-to-day operations of the company. Those costs include salaries, agent commissions, marketing expenses, licensing fees, taxes, reserves for future losses and growth, an element of profit, etc.,

Opportunity Costs

If capital and labor were not being used in the business of insurance, they could be used elsewhere and could be making other productive contributions to society. Therefore, whatever resources the insurance industry uses in its operations represent lost opportunities in other areas – in other words, opportunity costs. These opportunity costs represent one of the costs of insurance.

Increased Losses

Increased Losses can be categorized as follows: -

Fraudulent Claims
Exaggerated / inflated claims
Claims on account of careless on the part of the insured

Because of insurance, a person might intentionally cause a loss or exaggerate a loss that has occurred. Many cases of arson or suspected arson involve insurance; some property owners would rather have the insurance money than the property.

Inflated claims of loss are more common than deliberate losses. For example, an insured might claim that four items were lost rather than the actual three or that the items were worth more than their actual value. In liability claims, claimants might exaggerate the severity of their bodily injury or property damage. In some cases, other parties such as physicians, lawyers, garage owners, repairers, etc., encourage exaggerated claims.

Some losses might not be deliberately caused, but they might result from carelessness on the part of the insured.

Increased Lawsuits

Liability insurance is intended to protect people who might be responsible for injury to someone else or damage to someone's property. The number of liability lawsuits has increased steadily in recent years. One reason for this increase is that liability insurers often pay large sums of money to persons who have been injured. The increase in lawsuits in the United States is an unfortunate cost of insurance in our society.

INSURANCE AS A CONTRACT

Insurance is a contract entered into between two parties wherein one party viz., the insurer promises to pay the other viz., insured for a loss which is indemnifiable as per the policy terms conditions and exceptions for a return of a consideration viz., premium.

The four basic types of insurance (property, liability, life and health) are generally divided into two broad categories:

- **Property / Liability Insurance**
- **Life / health Insurance**

Property Insurance

Property insurance covers the costs of accidental losses to an insured's property.

Many types of insurance are classified as property insurance such as the following: -

- Fire and allied lines
- Business income
- Crime
- Ocean and inland marine
- Auto physical damage

Fire and allied lines: - Fire and allied lines insurance covers direct damage to or loss of insured property. The term "allied lines' refers to insurance against causes of loss usually written with (allied to) fire insurance, such as windstorm, hail, smoke, explosion, vandalism, and others. Examples of such policies are a dwelling policy and commercial property policy.

Business income insurance: - Business income insurance covers the loss of net income or additional expenses incurred by a business as the result of a covered loss to its property. For example, when a business has a serious fire, it might have to close until repairs to the building are made and personal property is replaced because of which there shall be loss of net income. This insurance pays the insured for such loss of income or additional expenses that the insured incurs.

Crime Insurance: - Crime Insurance protects the insured against loss to covered property from various causes of loss such as burglary, robbery, theft and employee dishonesty. Coverage is provided for money, securities, merchandise and other property under this insurance. Individuals can avail this cover under Homeowner's policy and business organizations have to go in for separate insurance.

Ocean marine insurance: - This includes hull insurance (which covers ships) and cargo insurance (which covers the goods transported by ships).
Inland marine insurance covers miscellaneous types of property, such as movable property, goods in domestic transit, and property used in transportation and communication.

Auto physical damage insurance: - covers loss or damage to specified vehicles owned by the insured and sometimes covers vehicles borrowed or rented by the insured. Auto physical damage is generally considered to mean loss or damage to specified vehicles from collision, fire, theft, or other causes.

Liability Insurance

An insurance policy is a contract between the insured and the insurance company, and these two are usually the only parties involved in a property loss. Liability insurance, however, is sometimes called "third-party insurance" because three parties are involved in a liability loss; the insured, the insurance company, and the party who is injured or whose property is damaged by the insured.

Examples of Liability Insurance include the following:

- **Auto Liability**
- **Commercial general Liability**
- **Personal Liability**
- **Professional Liability**

Auto Liability Insurance covers an insured's liability for bodily injury to others and damage to the property of others resulting from automobile accidents.

Commercial general liability insurance covers businesses for their liability for bodily injury and property damage. It can also include liability coverage for various other offenses that might give rise to claims, such as libel, slander, false arrest, and advertising injury.

Personal liability insurance provides liability coverage to individuals and families for bodily injury and property damage arising from the insured's personal premises or activities.

Professional liability insurance protects physicians, accountants, architects, engineers, attorneys, insurance agents and brokers, and other professionals against liability arising out of their professional acts or omissions.

LIFE INSURANCE

One of the most severe causes of financial loss to a family is the premature death of a family member, especially the primary wage earner. Life insurance can greatly reduce the adverse financial consequences of such premature death.

Although there are many variations of life insurance, the three basic types are: -

- **Whole life insurance**
- **Term Insurance**

- **Universal life insurance**

Whole life insurance provides lifetime protection (to age 100). Whole life insurance policies accrue cash value and have premiums that remain unchanged during insured's lifetime.

Cash Value is a savings fund that accumulates in a whole life insurance policy and that the policy holder can access in several ways, including borrowing, purchasing paid-up life insurance, and surrendering the policy in exchange for the cash value.

Term Insurance is a type of life insurance that provides temporary protection (for a certain period) with no cash value.

Universal life insurance combines life insurance protection with savings. A universal life insurance policy is a flexible premium policy that separates the protection, savings and expense components.

HEALTH INSURANCE

The two types of Health Insurance cover are a) Medical Insurance and b) disability income insurance.

Medical Insurance covers the cost of medical care, including doctors' bill, hospital charges (including room and board), laboratory charges, and related expenses.

Disability income insurance is a type of health insurance that provides periodic income payments to an insured who is unable to work because of sickness or injury.

CHAPTER 2: Who Provides Insurance and How Is It Regulated?

This chapter deals with various types of insurers to start with, and also details out how and why insurance is regulated by various states.

Types of Insurers

Private Insurers

Numerous kinds of private insurers provide property and liability coverages for individuals, families, and business.

This section discusses various types of private insurers, primarily in terms of:

- The purpose for which they were formed
- Their legal form of organization
- Their ownership
- Their method of operation

To start with, the following shows the differences amount major types of private insurer (and Lloyd's of London)

Type	Purpose for which formed	Legal form	Ownership	Method of Operation
Stock Insurer	To earn profit for its stockholders	Corporation	Stockholders	The board of directors, elected by stockholders, appoints officers to manage the company.
Mutual Insurer	To provide insurance for its owners (policyholders)	Corporation	Policyholders	The board of directors, elected by policyholders, appoints officers to manage the company.
Reciprocal insurance exchange (interinsurance exchange)	To provide reciprocity for subscribers (to cover each other's losses)	Unincorporated association	Subscribers (members)	Subscribers choose an attorney-in-fact to operate the reciprocal.

Lloyd's of London	To earn profit for its individual investors and its corporate investors	Unincorporated association	Investors	The Committee of Lloyd's is the governing body and must approve all investors for membership.

Stock Insurance Companies

A **Stock Insurance Company** is an insurer that is owned by its stockholders and formed as a corporation for the purpose of earning a profit for these stockholders.

Insurance formed for the purpose of making a profit for their owners are typically organized as for – profit (stock) corporations. By purchasing stock in a for-profit insurer, stockholders supply the capital the insurer needs when it is formed or the additional capital needed by the insurer to expand its operations. Therefore, one of the primary objectives of a stock insurance company is returning a profit to its stockholders. The stock form of ownership also provides financial flexibility for the insurer. For instance, stock insurance companies can sell additional stocks for its expansions, etc.,

Mutual Insurance Companies

A **Mutual Insurance Company** is an insurer that is owned by its policyholders and formed as a corporation for the purpose of providing insurance to its policyholder-owners.

The corporation of a traditional mutual insurer issues no common stock, so it has no stockholders. Mutual insurance companies are also slowly changing their objective towards profit making akin to that of Stock Insurance Company.

One traditional difference among mutual insurers involves the insurer's right to charge its insureds an assessment, or additional premium, after the policy has gone into effect. Known as an assessment mutual insurance company, this type of mutual insurer is less common today than in the past.

Demutalization is the process by which a mutual insurer, which is owned by its policyholders, becomes a stock company, which then owned by its stockholders.

Reciprocal Insurance Exchanges

A **reciprocal insurance exchange (**or an **interinsurance exchange)** is an unincorporated association formed to provide insurance coverage to its members. One of the distinguishing features of a reciprocal is that the subscribers empower an attorney-in-fact to manage it.

Subscribers (also known as members) are the policyholders of a reciprocal insurance exchange who agree to insure each other.

The **attorney-in-fact** of a reciprocal insurance exchange is the contractually authorized manager of the reciprocal who administers its affairs and carries out its insurance transactions.

A **reciprocal insurance exchange** (or an **interinsurance exchange**) consists of a series of private contracts among the **subscribers,** or members, of the group, with subscribers agreeing to insure each other. Each member of the reciprocal is both an insured and an insurer.

Lloyds Association

Two types of Lloyd's associations exist – Lloyds of London and American Lloyds.
Lloyds of London

Although not technically an insurance company, Lloyd's of London is an association that provides the physical and procedural facilities for its members to write insurance. In other words, it is a marketplace, similar to a stock exchange, wherein members who are investors, work to earn a profit from the insurance operations at Lloyds.

Each individual investor of Lloyd's belong one or more groups called syndicates, which conducts insurance operations and analyzes insurance applications for insurance coverage.

The insurance written by each individual Name is backed by his or her entire personal fortune and assumes liability only for the insurance he or she agrees to write. Lloyd's of London has earned a reputation for accepting applications for very unusual types of insurance, such as insuring legs of a famous football player against injury. But most of the insurance written through Lloyds is commercial property and liability insurance.

American Lloyds Associations

American Lloyds associations are much smaller than the Lloyd's of London, and most are domiciled in Texas, with a few in other states. The liability of American Lloyds is limited to their investment in the Lloyds association. State laws require a minimum number of underwriters (ten in Texas) for each Lloyds association. American Lloyds are usually small and operate as a single syndicate under the management of an attorney – in – fact.

Other Private Insurers

Captive Insurance Companies

A **Captive Insurance Company** (or simply a **Captive**) is an insurer that is formed as a subsidiary of its parent company, organization, or group, for the purpose of writing all or part of the insurance on the parent company or companies.

Three factors have contributed to the growth of captives in recent years viz., low insurance cost, insurance availability, and improved cash flow.

Reinsurance Companies

Reinsurance is a type of insurance in which one insurer transfers some or all of the loss exposures from policies written for its insureds to another insurer.

In reinsurance, the **primary insurer** is the insurance company that transfers its loss exposures to another insurer in a contractual arrangement.

A **reinsurer** is the insurance company that accepts the loss exposures of the primary insurer.

Government Insurance Programs

Both the federal government and state governments have developed certain insurance programs to meet specific insurance needs of the public.

Federal Government Insurance Programs

Some federal government insurance programs serve the public in a manner that only the government can.

One federal government insurance programs that requires mandatory participation is the Social Security program.

The Social Security Program

The social security Program formally known as Old Age Survivor's Disability and Health Insurance Program (OASDHI) is a comprehensive program that provides benefit to millions of Americans, though certain private insurers have similar coverages, they cannot match the scope of Social Security Program.

The Social Security Administration, a federal government agency, operates the program and provides four types of benefits: -

- Retirement benefits to the elderly.

- Survivor ship benefits for dependents of deceased workers.
- Disability payments for disabled workers.
- Medical benefits for the elderly.

Other Federal Insurance Programs

Losses, which are highly concentrated and are also catastrophic nature, are not preferred risks by private insurers. Hence, federal government have come out with certain plans like National Flood Insurance Program and Federal Crop Insurance Program.

State Government Insurance Programs

Among the most common insurance programs provided or operated by state government insurance programs are: -

- Workers Compensation insurance funds
- Unemployment insurance programs
- Automobile insurance plans
- FAIR Plans
- Beachfront and windstorm pools.

In addition, all states have some type of insurance guaranty fund designed to pay for covered loses in the event that an insurer is financially unable to meet its obligations to its insureds.

State Workers Compensation Insurance Funds

A **Monopolistic Fund** is a State workers compensation insurance plan that is the only source of workers compensation insurance allowed in that state.

A **Competitive State Fund** is a state workers insurance plan that competes with private insurers to provide worker's compensation insurance.

A **residual market plan** (or **shared market plan)** is a plan that makes insurance available to those who cannot obtain coverage because private insurance will not voluntarily provide coverage such coverage for various reasons.

Other State Insurance Programs

- Unemployment insurance protections to ensure that eligible workers have some unemployment insurance protection.
- Compulsory Auto liability insurance before registering an automobile to those insureds who cannot avail the same from private insurers due to various reasons such as poor driving record, etc., As a result, all the fifty states and District of Columbia have implemented automobile insurance plans through a residual

market system to make auto liability insurance available to nearly every licensed driver.

- Fair Access to Insurance Requirements (FAIR) - These plans make property insurance more readily available to property owners who have exposure to loss over which they have no control. Therefore, eligible property includes property in urban areas as well as property exposed to bush fires, for example.

Insurance Guaranty Fund

A **Guaranty Fund** is a state fund that provides a system to pay the claims of insolvent insurers. Generally, the money in guarantee funds comes from assessments collected from all insurers licensed in the state.

INSURANCE REGULATION

The possibility that an insurance company might not be able to pay legitimate claims to or for its policyholders is the primary concern of the insurance regulators who monitor the financial condition and operations of the insurance companies.

- **NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS (NAIC)** Was established to encourage coordination and cooperation among state insurance departments. NAIC consists of Commissioners of Insurance Departments of each state, the District of Columbia and US territories and possessions. The NAIC coordinates insurance regulation activities among the various insurance departments.

  A **Model Law** is a document drafted by NAIC in a style similar to the state statute, that reflects NAIC proposed solutions to the given problem and provides a common basis to the states for drafting laws that affect the insurance industry.

  Despite the difference among the state regulations, the primary objectives of insurance regulations are

  - Rate Regulation
  - Solvency Surveillance
  - Consumer Protection

  ### Rate Regulation

  Because insurers develop insurance rates that affects most people, the laws of nearly all states give the state insurance commissioner the power to enforce regulation of insurance rates

Ratemaking is the process insurer use to calculate the rates that determine the premium for insurance coverage.

A **Rate** is the price of insurance for each unit of exposure. The rate is multiplied by number of exposure units to arrive at the premium.

A **Premium** is the periodic payment by an insured to an insurance company in exchange for insurance coverage.

An **Actuary** analyzes data on past losses and expenses associated with losses and combining this with other information develops insurance rates. In other words, an actuary is a person who uses complex mathematical methods and technology to analyze loss data and other statistics to develop system for determining insurance rates.

Objectives of Rate Regulation

Rate regulation serves three general objectives: -

- To ensure that rates are adequate
- To ensure that rates are not excessive
- To ensure that rates are not unfairly discriminatory.

Ensuring that Rates are adequate

When rates are adequate, the prices charged for a given type of insurance coverage should be high enough to meet all anticipated losses and expenses associated with that coverage while generating a reasonable profit for the insurer.

It is virtually impossible to guarantee that premium paid by the insured will be adequate to cover insured losses. Even when a large group of similar exposure unit is covered, unexpected events, such as a natural disaster, might lead to losses significantly higher than those predicted when rates were originally set.

Ensuring that rates are not Excessive

To protect consumers, states also require that insurance rate not be excessive. Excessive rates could cause insurers to earn unreasonable profits. Determining whether rates are either excessive or inadequate is difficult, especially since insurers must price insurance policies long before the results of the pricing decision are known.

Ensuring that rates are not unfairly discriminatory

Since insurance is a system of sharing the costs of losses, each insured should pay a fair share of the insurer's losses and expenses. Some disagreement exists as to how this fair share should be determined.

Actuarial equity is a ratemaking concept through which actuaries base rates on actuarially calculated loss experience and place insureds with similar characteristics in the same rating class.

Social equity is a rating concept that considers rates to be unfairly discriminatory if they penalize an insured for characteristics (such as age or gender) that are beyond the insured's control.

Unfair discrimination would involve applying different standards or methods of treatment insureds who have the same characteristics and loss potential. This would include charging higher-than-normal rates for an auto insurance applicant based solely on the applicant's race, religion, or ethnic background.

Insurance Rating Laws

In attempts to balance conflicting objectives, states have developed a variety of laws to regulate insurance rates.

- Prior approval law – Rate must be approved by the state insurance department (commissioner) before they can be used. The commissioner has certain period typically 30 to 90 days to approve or reject the filing. Some states have deemer provision (delayed effect clause) that causes the rates to be deemed approved if the commissioner does not respond to the rate filing within the specified time period.
- Flex Rating Law – Prior approval is required if the new rates are specified percentage and above or below previously filed rates.
- File and use Law – Rates must be filed but do not have to be approved before use.
- Use and File Law – Rates must be filed within a specified period after they are first used in the state.
- Open Competition (No File Law) – Rates do not have to be filed with the state regulatory authorities. This approach is called open competition, because it permits insurers to compete with one another by quickly changing rates without review by the state regulators. Market forces determine rates under this approach.
- State Mandated Rates – This system requires all insurers to adhere rates established by the state insurance department for particular type of insurance.

Solvency Surveillance

Solvency is the ability of insurance company to meet its financial obligations as they become due even those resulting from insured losses that might be claimed several years in the future.

Solvency surveillance is the process conducted by state insurance regulators of verifying the solvency of insurance companies and determining whether the financial condition of insurers enables them to meet their obligations and to remain in business in the long term.

Two major aspects of Solvency Surveillance are Insurance Company Examinations and Insurance Regulatory Information Systems (IRIS).

Insurance Company Examinations consists of thorough analysis of insurance company operations and financial conditions. During Examination, a team of state examiners reviews a wide range of activities including claim, underwriting, marketing and accounting and financial records.

The **Insurance Regulatory Information Systems (IRIS)** is designed by NAIC to help regulators identify insurance companies with potential financial problems. In other words, it is an Early Warning System to monitor overall financial conditions of an insurance company in an analytical way.

Consumer Protection

The Insurance Regulators undertake the following activities to protect insurance consumers: -

- Licensing Insurers
- Licensing Insurance Company Representatives
- Approving Policy Forms
- Examining Market Conduct
- Investigating Consumer Complaints

Licensing Insuring

Most insurance companies must be licensed by the state insurance department before they are authorized to write insurance policies in that State.

- Licensed Insurer (admitted insurer) is one who is authorized by the state insurance department to sell insurance in that state.
- Domestic Insurer is an insurance company that is incorporated in the same state in which it is writing insurance.
- Foreign Insurer is an insurance company licensed to operate in that state but is incorporated under the laws of another state.

- Alien Insurer is an insurance company licensed to undertake business in a State but incorporated in another country.

Licensing Insurance Company Representatives

All the states have licensing requirement for certain representatives of the insurance companies like agents, brokers and claim representatives to transact insurance business in the State. A license is usually granted only after the applicant passes an examination on insurance laws and practices.

Approving Policy Forms

Most state requires insurance companies to file their policy forms with the state insurance departments in a manner similar to method used for rate filing.

For example, when an insurer wants to change language of a particular policy, it must submit the new form for approval.

Examining Market Conduct

It consists of state laws that regulate the practices of insurers in regard to the four areas of operations, i.e., Sales and Advertising, Underwriting, Rate Making and Claim Handling. If there be any unfair trade practices, the license of the particular insurance company involved will be revoked or suspended by the authorities.

Investigating Consumer Complaints

Every State Insurance Department has a consumer complaints division to enforce the consumer protection objectives of the state insurance department and to help insureds deal with problems that they have encountered with insurance companies and their representatives.

Excess and Surplus Line Insurance (E & S)

This consists of insurance coverages usually unavailable in the standard market, that are written by unlicensed insurers.

The **Standard Market** collectively refers to insurers who voluntarily offer insurance coverage at rates designed for customers with average or better than average loss exposures. Such insurers write the majority of commercial property, liability insurance in the United States.

Changes in the business practices, arrival of a new technology, might create new loss exposures not contemplated in traditional insurance policies. These types of exposures are often covered under Excess and Surplus Line Insurance by non-traditional insurance markets.

Unlicensed Insurers are those who are not licensed in many states in which they operate and who exclusive write only Excess and Surplus lines of business.

Classes of E&S Business

The following of classes of business are often insured in E & S Line Market: -

- Unusual or unique exposures
- Non Standard Business
- Insured needing high limits
- Insured needing usually broad coverage
- Exposures that require new forms

Unusual or unique exposures

One of the requirements of the Commercial Insurable loss exposure is that large number of similar exposure units should exist. If the exposure does not meet with this requirement standard insurers are often unwilling to provide this coverage. This type of insurance known as non-appearance insurance is written by E & S Insurers. For example, singer not showing up for a performance, in which sponsors suffer a financial loss because of his non-performance.

Non Standard Business

Sometimes loss exposures do not meet the underwriting requirements of the standard insurance market. This might be evidence of poor loss experience that cannot be adequately controlled and the premiums of the standard insurers normally charged are not adequate to cover these exposures. An E & S insurer might be willing to write these types of coverages with a premium substantially higher than the standard insurers would charge.

Insureds needing high limit

Some businesses demand very high limits of coverage especially for liability insurance. A standard insurance company might not be willing to offer limits as high as insured needs. The E & S market often provides the needed limits in excess of limits written by standard insurers.

Insureds needing usually broad coverage

The traditional insurance market uses standard coverage forms developed through advisory organizations like insurance services office and American association of insurance service. When broader coverages are necessary often insureds seek such coverage from E & S market.

Excess & Surplus Line Regulation

E & S insurance is usually written by non admitted (un licensed) insurers. These insurers are not required to file their rates and policy forms with state insurance departments, which gives them more flexibility than standard insurers. Although, non-admitted insurers are generally exempted from laws and regulations applicable to licensed insurers, the E & S market is subject to regulation. More states have surplus lines laws that require that all E & S business be placed to Excess & Surplus Line broker. The E & S broker is licensed by the state to transact insurance business through non-admitted insurers. When an insurance producer seeks insurance with non-admitted insurers he or she must arrange an E & S broker to handle the transaction.

Chapter 3 – How Is the Financial Performance of Insurers Measured?

Insurer Profitability

Like any other business, an insurance company must manage its income and expenses to produce an overall gain from its operations and to ensure the profitability on which its survival depends.

Sources of Income for Property and Liability Insurance Companies

Income

An insurance company receives income from two major sources: -

- Sale of Insurance
- Investment of Funds

Premium Income is the money an insurer receives from its policyholders in return for the insurance coverage it provides. When measuring its total premium income for the year, an insurance company must determine what portion of its written premiums is considered as earned premium and unearned premium incomes.

Written Premiums are premiums on policies put into affect or written during a given period.

Earned Premium represents the portion of the written premium that is recognized as income only as time passes and as the insurance company provides the protection promised under the insurance policies.

Un Earned Premium is the portion of written premium that applies to the part of the policy period that has not occurred.

Investment Income An insurance company collects premiums from its policyholders and pays claim for its policyholders, the insurer handles large amount of money. Insurers invest available funds to generate additional income particularly during periods of high interest rates and high returns in the stock market, the income generated by these investments are Investment Income.

The reasons for investments of its funds are as follows: -

- Insurers are legally required to maintain a certain amount of funds called policyholder surplus so it can meet its obligation even after catastrophic losses.
- Insurance company has funds available for investments are that it usually receives premium before it pays claims on the corresponding policies.

Types of Expenses that property and liability insurance companies incur

Expenses The major expenses incurred by insurance company are claim payments for insured who has suffered losses and costs incurred in handling these losses.

The insurers also incur operating expenses in providing and servicing its insurance products. For an insurer to be profitable its combined premium and investment income must exceed its total loss payments and other expenses.

Losses and Underwriting Expenses

Losses The major expense category for most insurance company is payment for losses arising from claims. Claims are not settled immediately after a loss occurs. This is due to lengthy and at times legal proceedings or sometimes loss may be occurred in one year but are settled in the later year or loss may be occurred in one year and may be reported in the succeeding years. In any given year, an insurance company knows only the amount of losses it has paid so far, but not the definite amount it will ultimately have to pay. To compare income and expenses however an insurer must calculate not only its paid losses but also incurred losses for the period.

Paid Losses All claim payments that an insurer has made in a given period.

Incurred Losses For a particular period equal to sum of paid up losses and changes in losses reserves (loss reserves at the end of the period minus loss reserves at the beginning of the period).

Loss Reserves these are the amounts designated by insurance companies to pay claims for losses that have already occurred but not yet settled. A loss reserve for a particular claim is the insurer's best estimate of the total amount that will pay in the future for the losses that has already occurred.

Incurred But Not Reported Losses The Losses that are incurred in a particular period but not reported to the insurance company in the given period.

Loss Expenses Expenses necessitated by the process of investigating insurance claims in settling term according to the term specified in the insurance policy.

Other Underwriting Expenses In addition to the losses and loss expenses the cost of providing insurance includes other significant underwriting expenses. The major category of insurers' underwriting expenses is

- Acquisition Expenses
- General Expenses
- Taxes and fees

Acquisition Expenses The expenses associated with acquiring new business are significant such as payment of commission, brokerage, bonus paid on the sales, profit and other measures of productivity, etc., Advertising expenses can be significant component of acquisition expenses for most of the insurers, regardless of whether the advertising is directed towards the general public or specifically towards insurance producers.

General Expenses The General Expenses include expenses associated with staffing and maintaining insurance departments such as accounting, legal, research, product development, customer service, electronic data processing and building maintenance. In addition insurers must provide office space, telephones and other utility services for smooth running of the organization.

Taxes and Fees All the insurance companies in the fifty states levy premium taxes usually between 2 to 4 percent on all premiums generated by the insurers in a particular state. Fees component include such things as expenditure involved for licensing and participating in various insurance programs such as Guarantee Funds and Automobile insurance plans.

Investment Expenses An insurer's investment department includes staff of professional investment managers who oversee the company investment program. Investment expenses include the salaries and all other expenses related to the activities of the investment department. On their financial statement, insurance companies deduct these expenses related to the activities of the investment department to show net income.

Gain or Loss from Operations An insurers net underwriting gain or loss is its earned premium minus its losses and underwriting expenses for the specific period. When an insurer adds its net investment gain or loss results to its net underwriting gain or loss, the resulting figure is the overall gain or loss from the operations.

Net Income before tax is its total earned premium and investment income minus its total losses and other expenses in the corresponding period.

Income Taxes Like other businesses insurance company pay income taxes on the taxable income.

Net operating income or loss After an insurance company has paid losses and reserved money to pay additional expenses, losses and income taxes the reminder is net operating income, which belongs to the owners of the company.

Insurer's Solvency

The ability to pay claims in the event of occurrence of losses depends upon financial condition of the insurer. So an insurance company must remain financially sound to pay losses. Its assets, liabilities and policyholder surplus measure the financial position of the insurance company at any particular time.

Assets These are property both tangible and intangible in nature, owned by an entity, in this case an insurance company. These include money, stocks and bonds, buildings, office furniture equipment and accounts receivable from agents, brokers and reinsurers.

Admitted Assets are types of property such cash and stocks, that regulators allow insurers to show as assets on their financial statements. Such assets are easily convertible to cash at or near property's market value.

Non Admitted Assets are types of property such as office furniture and equipment, that insurance regulators do not allow insurers to show assets on financial statements because these assets cannot readily be converted to cash at or near their market value.

Major types of liabilities found on the financial statements of the insurers

Liabilities are financial obligations or debts owned by a company to other entity, usually the policy holder in the case of an insurance company. There are two major type of liabilities found on an insurer's financial statement: -

- Loss Reserve
- Unearned Premium Reserve

Loss Reserve is a financial obligation owned by the insurer to estimate final settlement amount on all claims that have occurred but have not yet been settled.

Unearned Premium Reserve It is a major liability found on the financial statement of the P & C insurers. It is liability because it represents the insurance premiums prepaid by insured for services that the insurers have not yet rendered. For example, if insurance company decides to wind up its operations midway, the unearned premium on the policies needs to be refunded.

Policyholder Surplus of an insurance company is equal to its total admitted assets minus its total liabilities. In other words, policyholder surplus measures the difference between what the company owns and what it owes.

Monitoring the financial performance of insurers

The objective of most insurers include being profitable and remaining in business in the long term, insurance companies must carefully monitor their financial performance. Insurers must record and report financial information in a consistent manner using various financial statements which include: -

- Balance Sheet
- Income statements

Balance Sheet is a type of financial statement that shows the company's financial position at a particular point of time and includes the company's admitted assets, liabilities and policyholder surplus.

Income Statements is a type of financial statement that shows the company's revenues, expenses and net income for a particular period, usually one year.

Financial Statement Analysis

Analyzing the relationship of different items that appear on the insurer financial statements helps determine how well insurance companies are performing. Comparing two items produces a ratio that highlights a particular aspect of financial performance. Several such ratios are widely used in the insurance business. These ratios are broadly known as Profitability Ratio.

Profitability Ratio

Several ratios measure the profitability of an insurance company. These profitability ratios are as follows: -

- Loss Ratio
- Expense Ratio
- Combined Ratio
- Investment Income Ratio
- Overall operating Ratio

Loss Ratio is calculated by dividing an insurer's incurred losses (including loss expenses) for a given period of time by its earned premium for the same period.

Expense Ratio is calculated by dividing an insurer's incurred underwriting expenses for a given period by its written premiums for the same period.

Combined Ratio is the sum of loss ratio and expense ratio.

Investment Income Ratio is calculated by dividing net investment income by earned premiums for a particular period.

Overall Operating Ratio is calculated by subtracting the invest income ratio from the combined ratio.

Capacity Ratio or Premium to Surplus Ratio is calculated by dividing its written premiums by its policyholder surplus.

SEGMENT B – INSURANCE OPERATIONS
CHAPTER 4 – MARKETING

Marketing enables an insurance company to determine which products meets customer needs and then to sell and deliver those products to its customers. It is a process of identifying customers and their needs and then creating, pricing, promoting, selling and distributing products or services to meet those needs.

A Producer is any person who sells insurance products for an insurance company. However, agent, broker, sales representative and other titles are also used to denote special category of producer.

The Legal Role of an Insurance Agent

Agency is a legal relationship that is formed when one party, the principal, authorizes another party, the agent to act as a legal representative of the principal. In the agency relationship, the principal is the party that authorizes the agent to act on its behalf. In agency relationship, the agent is the party that is authorized by the principal to act on principal's behalf.

Creation of Agency Relationship

An agency relationship is usually created by written contract between principal and the agent. In insurance, the insurance company is the principal that appoints insurance agents to serve as its representatives; a written agency contract specifying the scope of the authority given to an agent formalizes this relationship.

An Agency Contract or Agency Agreement is a written agreement between the insurance company and the agent that specifies, among other things, the scope of the agent's authority to conduct business for the insurer.

Insurance Agents are legal representatives of the insurance company for which they have contractual agreement to sell insurance.

Responsibilities of an Agent and the Principal

The agency relationship, which is based on the mutual trust and confidence, empowers the agent to act on behalf of the principal and imposes significant responsibilities on both the parties.

Responsibilities of the Agent to the Principal

In an agency relationship, the agent's fundamental responsibility is to act on benefit of the principal. The laws of agency impose five specific duties on all agents: -

- Loyalty
- Obedience
- Reasonable Care
- Accounting
- Relaying Information

Responsibilities of the Principal to the Agent

The Principal's primary duty is to pay the agent for the services performed. The principal also has a duty to indemnify the agents for any losses or damages suffered without the agent's fault but arising out of agent's acts on behalf of the principal. An important factor involved in this duty is exposure of insurance agents to errors and omissions claims, which might arise from agent's negligent action.

Errors and Omissions are negligent acts committed by a person in the conduct of insurance business that give rise to legal liability for damages. E & O Claims can also arise from the failure to act that creates a legal liability.

Responsibilities of an Agent and the Principal to Third Parties

An agency relationship also creates responsibilities to the Third Parties. The agent's authorized acts on behalf of the principal legally obligate the principal to Third Parties in the same way as if the principal acted alone.

Thus from insured point of view, little distinction exists between insurance agent and insurance company. The Law presumes that knowledge acquired by the agent is the knowledge acquired by the insurance company. According to the agency law, the fact that the agent knew about the exposure means that the insurer is presumed to know about it.

Authority of Agents

Insurance agents generally have three types of authorities to transact business on behalf of the insurers: -

- Express Authority
- Implied Authority
- Apparent Authority

Express Authority is the authority that the principal specifically grants to the agent to sell the insurance company's product or that the agent has the authority to bind coverage upto a specified limit. Binding authority is generally granted to the agent in the agency contract and thus is a form of express authority.

Binding Authority is a power to make insurance coverage effective on behalf of the insurer; binding coverage is usually accomplished by issuing binders.

A **Binder,** which can be either written or oral**,** is a temporary contract between the insurance company and the insured that makes insurance coverage effective.

Implied Authority is the authority that arises from actions of the agent that are in accord with the accepted custom and that are considered to be within the scope of authority granted by the principal, eventhough such authority is not expressly granted orally or in agency contract.

Apparent Authority is the authority based on the Third Party's reasonable belief that an agent has authority to act on behalf of the Principal.

Insurance Marketing Systems

Most Insurers use one or more of the following traditional marketing systems: -

- Independent Agency System
- Exclusive Agency System
- Direct writing System
- Direct Response System

Independent Agency System An independent agency is an independent firm that sells insurance usually as a representative of several unrelated insurance companies. As an exception to the foregoing, some independent agents agree to place all or most of their business with one insurance company.

Independent Agent is a producer who works for an independent agency.

One of the main distinguished features between independent agency system and other marketing systems ownership of the agency expiration list which is the record of present policy holders, the dates that policies expire (owning the expiration means, the agency expiration list of an independent agency belongs to the agency and gives the agency the right to solicit those policy holder for insurance).

Brokers An insurance broker is an independent business owner or firm that represents customers rather than insurers. Brokers shop among insurance companies to find the best coverage or value for their clients. The Brokers are not legal representatives of the Insurer, or not likely to have authority to commit the insurer by binding coverages unlike agents who generally have binding authority.

Managing General Agencies (MGAs)

A Managing General Agency is an independent business organization that appoints and supervises independent agents for insurance companies that use the independent agency system. The MGA functions almost as a branch office for one or more insurance companies. They receive managerial commission often referred as override, which is the percentage of premium or the profits on policies, sold by producers placing business with the insurance company through the MGA.

Exclusive Agency System

An Exclusive agent is an agent that has a contract to sell insurance exclusively for one insurance company or a group of related companies. Usually, the agency contract entered into between the Insurer and the agent contains an agreement that, upon termination of agency contract the insurance company will by the expiration list from the exclusive agent. But in certain cases, an exclusive agent owns the list and has a right to sell it to another party also.

Direct Writing System

The direct writing system of an insurance marketing uses sales representatives who are employees of the insurance company.

A direct writer is an insurer that uses the direct writing system to market insurance. Such sales representatives are paid commission as well as office expenses. In this system, expiration does not belong to the sales representative and is exactly owned by the insurance company only.

Direct Response System

A direct response system includes any insurance marketing system that does not depend primarily on individual producers to locate customers and sell insurance but relays primarily on mail, phone and internet sales.

Mixed Marketing System

This is a system which refers to the use by the insurer of more than one marketing system.

Differences Among Traditional Insurance Marketing System

Type of marketing	**What company or companies do the producer represent**	**Does the insurer employ the producers?**	**How are producers usually Compensated?**	**Does the Agency or Agent own the Expiration List?**	**What methods of sales are usually used?**
Independent Agency System	Usually more than one insurer	No. The producers are employed by the agency	Sales commissions and contingent commissions	Usually Yes.	Personal Contact, Phone or internet.
Exclusive Agency System	Usually one insurer or group of related insurers	Usually No. However some producers begin as employees.	Sales Commissions and Bonus	Usually No. But the agency contract might provide for the agent's right to sell the list to the insurer.	Personal contact, Phone or internet
Direct Writing System	Only the producer's employer	Yes.	Salary, bonus, commissions or combinations	No.	Personal contact, Phone or internet
Direct Response System	Only the producer's employer	Yes.	Salary	No.	Mail, Phone or internet

Compensation of Producers

While some producers receive a salary, commissions provide the primary form of compensation for producers. Two types of commissions that producers typically earn are sales commissions and contingent commissions.

Sales Commission (or simply a commission) is a percentage of the premium that insurer pays to the agency or producer for the new policies sold or existing policies renewed.

The commission compensates the agency not only for making the sale but also for providing service before and after the sale. Service provided before the sale includes locating and screening the insurance prospects, conducting a successful sales solicitation, getting the necessary information to complete an application, preparing a submission to the insurance company and presenting a proposal to the prospect. To make a sale, an agent must also evaluate the prospects' needs and recommend appropriate coverage for the client to sell it. After the sale, the agent often handles the paper work that accompanies policy changes, billing and claim handling among other things. While the policy is getting to be renewed, the agency must again analyze the coverage needs and consider any changes in the insurance coverage.

Contingent Commissions

In addition to the commissions based on a percentage of premiums, many agencies receive a contingent commission referred to as profit sharing. It is a commission that an insurer pays usually annually to an independent agency that is based on the premium volume and profitability level of the agency business with that insurer.

Marketing Management

An important function of marketing management is monitoring agency sales and underwriting sales to ensure that both the company's and agency's sales and profit objectives are met.

Producer Supervision

As insurance selling is a one to one activity that often occurs in the producer's office and insurance companies do supervise their producers by using independent agents typically known as **marketing representatives** who visit the independent agents representing the company. They are employees of the insurer whose role is to visit agents representing the insurer, to develop and maintain sound marketing relationships with those agents, and to motivate the agents to produce a satisfactory volume of profitable business to the insurer.

Production Underwriters are insurance company's employees who work in an insurer's office in an underwriting position but also travel to visit and maintain rapport with agents and sometimes clients.

Producer Motivation

Insurance companies need to motivate their producers to sell the types of insurance the companies wants to sell. Motivation comes from the programs developed in the home office by way of financial incentives that producers receive for selling of insurance products. Different ways of motivation is payment of contingent commissions, Sales contest, awards, remunerations, holiday trips, etc.,

Product Management and Development

Insurance Production is most successful when producers have a desirable product to sell at a competitive price. Usually, Insurance Company's marketing department strives to give producers the products and the pricing they need. As the producers are involved in the sales are often first to identify a need that could be addressed by either a new policy or modifications of an existing policy as they are actually aware of the competition in the market they recommend to the marketing department regarding the product management and development.

Regulation of Insurance Producers

Licensing Laws

To function legally as an insurance agent, a producer must be licensed by state or states in which he or she wishes to sell insurance. These laws vary by state and change periodically. Some states have several different licenses including license for agents, brokers and solicitors.

Some states such as California, has separate license for solicitors who work for and are representatives of agents or brokers, often has office employees, and who have more limited authority than agents. Generally, solicitors can solicit prospects but cannot bind insurance coverage. In other states, the solicitors are often called customer service representatives or customer service agents who must secure an agent's license.

Licensed producers are required to adhere to all laws regulating insurance sales in the state or states in which they conduct insurance business.

Unfair Trade Practices Laws

These are State Laws that specify certain prohibited business practices. These laws typically prohibit various unfair trade practices such as

- Misrepresentation and false advertising
- Tie-in-Sales
- Rebating
- Other deceptive practices

Misrepresentation and false advertising

It is an unfair trade practice for insurance agents to make issue or circulate information that does any of the following: -

- Misrepresents the benefits, advantages, conditions or terms of any insurance policy.
- Misrepresents the dividends to be received on any insurance policy.

- Makes false or misleading statements about dividends previously paid on any insurance policy.
- Uses a name or title of insurance policies that misrepresents the true nature of policies.

Tie – In – Sales

It is unfair trade practice for a producer to require that the purchase of insurance be tied to some other sale or financial arrangement, i.e., a practice referred to as tie – in – sales.

Rebating

Rebating is offering anything other than the insurance itself to an applicant as an inducement to buy or maintain insurance.

Other deceptive practices

Other than above, unfair trade practices laws prohibit other practices of insurers that are deceptive or unfair to applicants and insureds like prohibiting an insurer and its agents from making a false statement about the financial condition of another insurer.

It is also an unfair trade practice, to put false information on an insurance application to earn a commission from an insurance sale.

CHAPTER 5 : UNDERWRITING

Underwriting is the process of insureds, pricing coverage, determining insurance policy terms and conditions, and then monitoring the underwriting decisions made.

An **Underwriter** is an insurance company employee who evaluates applicants for insurance, selects those that are acceptable to the insurer, prices coverage and determines policy terms and conditions.

Underwriting Activities

Underwriting includes the following activities: -

- Selecting insureds
- Pricing Coverage
- Determining Policy terms and conditions
- Monitoring Underwriting Decisions

Selecting Insureds

Insurers must carefully screen applicants to determine which one is desirable to insure. If insurers do not properly select policyholders and price coverages, some insureds might be able to purchase insurance at prices that do not adequately reflect their loss exposures. The underwriting selection process is not limited to the underwriters but also include producers and underwriting managers. Insurance company receives applications, but not all applications result in issuance of policies. An insurance company cannot accept all applicants for two basic reasons: -

- The insurer can succeed only if he selects applicants who are as a group present loss exposure that are proportionate to the premiums that will be collected. In other words, insurers try to avoid adverse selection.
- An insurer’s ability to provide insurance is limited by its capacity to write new policies.

Adverse Selection Considerations

Adverse Selection is a situation that occurs because people with greatest possibility of losses are the ones most likely to purchase insurance. Adverse Selection normally occurs if the premium is low related to the loss exposure.

Capacity Considerations

Capacity refers to the amount of business an insurer is able to write usually based on the comparison of the insurer’s written premium to the size of the policyholder’s surplus. An insurer must have adequate policyholder surplus to be able to increase in the volume of insurance it writes.

Insurers attempt to protect their available capacity in three primary ways: -

- Maintaining a spread of risk
- Optimizing the use of available resources
- Arranging Re-insurance

Maintaining a spread of risk

Since every insurer has limited capacity insurance companies must allocate their available capacity. By spreading their risk among various type of insurance and different geographical areas, insurance companies reduce the chances that overall underwriting results will be adversely affected by large number of losses in one type of insurance or one territory.

Insurance companies allocate capacity by setting limitations on the amount of insurance they write for any one insured.

Optimizing use of available resources

Various resources of an insurance company shall include financial resources, physical resources such as building, office equipment and human resources which include underwriters, claim representatives, producers and service personnel.

Optimizing use of available resources means that an insurance company shall use all its resources to make a profit from the line of business which it specializes. For instance, an insurance company will not generally write farm business from applicants who have little or nil experience in the same because of non availability of expertise towards intricacies of the business.

Arranging Reinsurance

Reinsurance is a contractual agreement whereby one insurer, the primary insurer, transfers some or all of the loss exposures from policies written for its insureds to another insurer, the reinsurer.

If the reinsurance is readily available, insurance company can increase the number of new policies they write by transferring some of the premiums and loss exposures to the reinsurers. Thus the availability of reinsurance can affect an insurance company's to write business.

Pricing Coverage

The Underwriting pricing objective is to charge a premium that is commensurate with the exposure. Commensurate means showing an appropriate relationship. A premium is commensurate with the exposure when the appropriate relationship exist between the size of the premium and exposure assumed by the insurer.

Premium Determination

Rate is a price of insurance charged per exposure unit, and an exposure unit is a measure of loss potential used in rating insurance. The premium is determined by multiplying the rate by number of exposure units.

Type of Rates

In determining the appropriate premium to charge for coverage, insurers use either class rates or individual rates.

Class Rates

They are also called manual rates or rates that apply to all insureds in the same rating category or rating class. Insureds with similar loss exposure are grouped into similar rating classes.

Class Rates have traditionally been published in rating manuals – books used by underwriters, raters and producers in pricing individual policies. Many insureds within a rating class have loss characteristics that might not be fully reflected in Class Rate.

Merit Rating Plans modify class rates to reflect these characteristics. Merit Rating serves two purposes: -

- It enables the insurer to fine tune the class rate to reflect certain identifiable characteristic of a given insured.
- It encourages loss control activity by rewarding safety conscious insureds with lower premium or rate than those who do not participate in loss control.

Individual Rates

Individual Rates are also called Specific rates are used for commercial property insurance on unique structures. The rate is developed only after detailed inspection of the structure and its contents. Each Individual Rates reflects characteristics such as building construction, its occupancy, public and private fire protection and external exposure.

Judgment Rates

It is a type of individual rate is used to develop a premium for a unique exposure for which there is no established rate. With judgment rating, the underwriter relies heavily on his or her experience.

Determining Policy Terms and Conditions

Selection and Pricing are intertwined with the third underwriting activity – determining policy terms and conditions. The insurer must decide what type of coverage it will provide to each applicant and then charge a premium appropriate to that coverage. Insurance Advisory Organizations develop policy forms using standard insurance wording. These policy forms are referred as standard forms that contains standardized policy wordings. Some insurers develop their own standard forms that they use in policies for their insureds.

Monitoring Underwriting Decisions

Underwriters periodically monitor the hazards, loss experience, and other conditions of specific insureds to determine whether any significant changes have occurred. Since underwriting decisions involve an assessment of loss potential, hazards and other conditions must be reviewed periodically.

Monitoring also applies to underwriting decisions on entire book of business. A book of business also called as portfolio can refer to all policies in a particular territory or to all policies providing a particular type of insurance business. A book of business can also refer to all policies of an insurance company or agency or as a whole.

Underwriting Management

The role of insurance company's underwriting management involves various responsibilities: -

- Participating in the overall management of the insurance company
- Arranging Reinsurance
- Delegating underwriting authority
- Making and enforcing underwriting guidelines
- Monitoring the results of the underwriting guidelines

Participating in Insurance Company Management

The head of insurance underwriting department participates with other members of the insurance top management team in making broad business decisions regarding the company's objectives and how it plans to meet those objectives. Given a top management consensus on the insurer's broad goals and how its capacity should be allocated, underwriting management must decide how underwriting activities can contribute to these goals.

Arranging Reinsurance

Another aspect of Underwriting Management is arranging reinsurance. There are two broad categories of reinsurance i.e., Treaty Reinsurance and Facultative Reinsurance.

Treaty Reinsurance

It is an arrangement whereby an reinsurer agrees to reinsure automatically a portion of all the eligible insurance of the primary insurer. There is no individual selection of policies. Treaty requires that primary insurer is required to reinsure and reinsurer must accept all the business covered by the treaty.

Facultative Reinsurance

This involves a separate transaction for each reinsurance policy and it is not an automatic binding between the primary insurer and the reinsurer that is the reinsurer evaluates individually each policy that is asked to reinsure.

Delegating Underwriting Authority

An underwriting authority is the limit on decisions that an underwriter can make without receiving approval from someone at a higher level. The amount of authority given to each underwriter usually reflects the underwriter's experience, the job title and responsibilities, and type of insurance handled. With some insurers underwriting authority is highly decentralized i.e., Underwriting Management delegates extensive underwriting authority to the personnel in the field offices. Other insurers are highly centralized with many or all final underwriting decisions are being made in the home office.

Many insurance companies also grant some underwriting authority to the agents who represent the company called frontline underwriters, these agents make the initial decisions regarding applications and then forward to the company underwriter those applications that meet underwriting guidelines.

Making and enforcing Underwriting Guidelines

Underwriting Management develops the guidelines that line underwriter's views in underwriting process. Underwriting guidelines and bulletins explain how underwriter should approach each application. The guidelines list the factors that should be considered by the underwriter for each type of insurance, desirable and undesirable characteristics of applicants relative to those factors, the insurance company's overall attitude towards the applicants that exhibit those characteristics.

Monitoring the results of underwriting guidelines

Monitoring the results of Underwriting Guidelines includes taking steps to ensure that the underwriters are following guidelines in that underwriting objectives are being met. If the guidelines are not followed there is no evidence as to whether they will work. An underwriting audit attempts to determine whether underwriters are following the guidelines. If the guidelines are being followed it is necessary to determine whether they are having the desired results.

The Underwriting Process

An underwriting decision must be made on every new insurance application as well as on the renewal policies. The Underwriting process comprises the following steps: -

- Gathering the necessary information
- Making the Underwriting Decision
- Implementing the Decision
- Monitoring the decision

Gathering Underwriting information

Underwriting Information forms parts of the important element based on which underwriters make decisions. Underwriters derive information from several sources: -

- Producers – may supply additional information such as a personal evaluation of the applicant.
- Consumer investigation reports – Several independent reporting services investigate and provide background information on prospective insureds.
- Government records – such as Motor Vehicle Records, court records and public information also provide underwriting information.
- Financial rating services – There are firms involved in Credit rating business and provide such relevant information.
- Inspection reports – Loss control representatives of insurance company inspect the premises and operations of insurance applicants.
- Field marketing personnel – Field personnel often provide additional insights to the underwriters based on their personal observation.
- Claim files – Claim files maintained by insurance companies also provides valuable information in forming decisions as to renewal of insurance.
- Production records – The record of the producer who brings in business also gives information, which affects decision making.
- Premium audit reports – A premium auditor provides such information as whether the premium charged is adequate, etc., after examining insured's book of records.
- Applicant's or insured's records – Valuable information can also be sought from insured's records, appraisals, bills of sale, balance sheet and income statement.

Making the Underwriting Decision

To make an underwriting decision, the underwriter should gather and analyze information to determine what hazards the applicant presents.

Hazards are condition that increase the chance of a loss occurring.

Analyzing Hazards

An underwriter must evaluate four categories of hazards:

- Physical hazards
- Moral hazards
- Morale (attitudinal) hazards
- Legal hazards

Physical Hazards are tangible characteristics of property, persons, or operations that tend to increase the probable frequency or severity of loss.

Moral Hazards are dishonest tendencies in the character of the insured (or applicant) that increase the probability of a loss occurring.

Morale Hazards (also known as **attitudinal hazards**) involve carelessness about, or indifference to potential loss on the part of an insured or an applicant.

Legal Hazards are characteristics of the legal or regulatory environment that affect an insurer's ability to collect a premium commensurate with the exposure to loss.
Hazards in a legal environment might include court decisions that interpret policy language in a way unfavorable to insurers.

Evaluating Underwriting Options

In evaluating each application, an underwriter faces three options:

- Accept the application without modification
- Reject the application
- Accept the application with modifications.

And finally implementing the Underwriting Decision.

The third option requires the greatest amount of underwriting creativity. This can happen by modification of coverage, rates, terms, conditions of the policy, by arranging adequate reinsurance facility, implementation of loss control measures, etc.,

Monitoring the Underwriting Decision

Monitoring of the Underwriting Decision involves: -

- Reevaluation of decision in relation to claims – The fact that an insured has a serious loss or several losses is not necessarily an indication that the underwriter made a bad decision.
- Recommendation of additional loss control measures.

- Where there is a request for coverage changes underwriter must carefully evaluate each and every change and should make a decision.
- Modifying coverage, rate, terms and conditions as and when need arises.
- Finally cancel or rejection of renewal depending upon the experience on the particular account.

Regulation of Underwriting Activity

Two important examples of the regulation of underwriting activity are:

- Prohibition of unfair discrimination
- Restrictions on cancellation and non renewal

Prohibition of Unfair Discrimination

Unfair discrimination involves applying different standards or methods of treatment to insureds who have the same basic characteristics and loss potential.
According to state insurance laws, unfair discrimination is prohibited as an unfair trade practice.

Restrictions on Cancellation and Non-renewal

Most state requires that insurers notify the insured a specified period (such as thirty days) before a policy is to be cancelled or non-renewed.

This notice is intended to give the insured an opportunity to replace the coverage.

Generally, restrictions of this kind help insurance to serve its purpose of providing protection for policyholders.

However, such restrictions also limit the speed with which an underwriter can stop providing coverage for an insured who has become undesirable.

CHAPTER: 6: CLAIMS

For insurance purposes, a **claim** is a demand by a person or business seeking to recover from an insurance company for a loss that might be covered by an insurance policy.

A **claim representative**, also called an **adjuster**, is a person responsible for investigating, evaluating and settling claims.

A **claimant** is anyone who submits a claim to an insurance company. In some cases, particularly in liability claims, the claimant is a third party that has suffered a loss and seeks to collect for that loss from an insured. In other cases, particularly in property claims, the claimant is the insured (the first party).

The first party to an insurance contract is the insured. (Although the second party is technically the insurer, the term second party I rarely used in insurance).

A third party to an insurance contract is a person or business that is not a party to the contract but who might assert a claim against the insured.

Insurance professionals generally use the term claimant to refer to a third party who submits a claim under an insured's property. This text uses the term claimant to refer to a third-party claimant.

Responsibilities of the Claim Representative

The adjuster or the claim representative has the following responsibilities in the processing of a claim which are as under: -

- To respond promptly to the submitted claim
- To obtain adequate information
- To properly evaluate the claim
- To treat all parties fairly.

Respond Promptly to the Submitted Claim

When a claim is reported, the claim representative need to respond to the claimant and guide him in a manner which shall facilitate claims process. He should empathically, that in the event of a claim, the loss experience might have been painful, frustrating, agonizing, or even embarrassing.

Obtain Adequate Information

Next in the process is to obtain adequate information pertaining to the claim to enable its processing. A claim representative must verify whether the claim is covered under the insured's policy. If a question of coverage exists and insurer wishes to investigate, then a **reservation of rights letter** might be sent to the insured.

A **reservation of rights letter** is a notice sent by the insurer to an insured advising that the insurer is proceeding with investigation of a claim but that the insurer retains its right to deny coverage later.

A reservation of rights letter serves two purposes:

- To inform the insured that a coverage problem might exist
- To protect the insurer so that it can deny coverage later, if necessary.

Properly Evaluate the Claim

Valid and accurate information enables the claim representative to evaluate the claim. This evaluation hinges on two critical elements of the claim handling process:

- Whether the claim is covered according to policy provisions
- If the claim is covered, the dollar amount payable under the policy.

Treat All Parties Fairly

Throughout the claim handling process, the claim representative must remember that a loss often produces strong emotions. Hence, he should ensure that those losses which are covered as per the policy provisions are promptly and quickly paid and vice versa.

Types of Claim Representatives

Several different types of people participate in claim handling, depending on the circumstances. They are: -

- Staff Claim Representatives (inside and outside)
- Independent Adjusters
- Agents
- Public Adjusters

Staff Claim Representatives

A Staff Claim Representative in an insurance company performs some or all of the insurance claim handling activities.

An **inside claim representative** is an employee who handles claims that can be settled, usually by telephone or letter, from inside the insurer's office. They handle claims that are clearly either covered or not covered and that do not involve questions about the circumstances or validity of the claim. If a third party is involved the inside claim representative might use a tape recorder to take statements about the loss from the insured, the claimant and any witness after obtaining their permission to tape their statements.

An **Outside claim representative** (**field claim representative)** is an insurance company employee who handles claims that cannot be handled easily by phone or mail. They spend much of their time visiting the scene of loss, intervene witnesses, investigating damage and meeting with the insureds, claimants, attorneys, and other persons involved in the claim.

Independent Adjusters

They are independent claim representatives who offer claim handling services to insurance companies for a fee. These independent adjusters can be either self employed or work for an independent adjusting firm.

Agents

An agency usually receives the first notification of a claim. Depending upon the size of the office, the agency can have one person, several people or a department responsible for handling claims.
If an agent has a draft authority, he or she might actually settle claims.

Draft Authority is an authority expressly given to an agent by an insurer to settle or pay certain type of claims by writing a claim draft upto a specified limit.

A Draft is similar to a check, but it requires approval from insurance company before the bank will pay it.

Draft Authority is given to agents because insurance companies have found that allowing agents to handle small or routine claims results in both expense saving and increased goodwill. Since agent is a person who gets all the relevant information about the claim the delay and expenses involved in contacting the insurance claim staff are eliminated. This results in reduction in the claim handling expenses both by the agent and the insurer and it contributes to more competitively priced product.

Public Adjusters

A **public adjuster** is a person hired by the insured to represent the insured in handling a claim. Usually insured hires a public adjuster either because of claim is complex in nature or because of loss negotiation are not progressing satisfactorily.

Internal Claim Administration

Many organizations have developed self insurance plans to cover part or all of the loss exposure. This involves handling of the claim through establishing an internal claim department or by hiring third party administrator.

A **Self Insurance Plan** is an arrangement in which an organization pays for its losses with its own resources rather than purchase an insurance. However, organization might choose to purchase insurance for losses that exceed a certain limit.

Internal Claim Departments

If an organization is large enough, it might establish separate claims department who possess skills and experience to handle many different types of claims. However, for certain classes of insurance like Workmen Compensation, Product Liability, etc., such companies will resort to professionals.

Third Party Administrators

The growth of self insurance plans has created a need for third party administrators who agree to provide administrative services to other businesses that have self insurance plan in handling their claims. Large independent adjusting firms sometimes function as TPAs for self insured business in addition to providing independent claims handling services to the insurers.

Claim Handling Process

The claim handling procedures can vary widely depending on the type of claim involved. In case of liability claims it takes years to settle and in case of property claims it might take few months to settle despite the unique challenges and variations in case to case.

There are three steps that are involved in processing most claims: -

- Investigation
- Valuation
- Negotiation and Settlement.

Property Insurance Claims

Step 1: Investigation

When a claim representative receives the initial report of a claim, he or she must investigate to gather further information relevant to the loss. This investigation is necessary to determine the cause of loss, to assess the damage, and to verify the coverage.

Determining the cause of loss and assessing damage

For a property insurance claim investigation involves visiting the site to inspect the damaged property in determining the cause of loss and assessing the damage occurred. Investigation must reveal sufficient information to verify whether the coverage exists under the policy and the physical condition of the property before the loss occurred. Assessing damages involve such activities as valuation of the property damaged by verifying the market value, bills of purchase, other books of records, etc., as required on a case-to-case basis.

Verifying Coverage

In addition to determining the facts surrounding the loss the claim representative must determine the coverage provided by the policy will pay any or all claims submitted.

Following are the checklist of questions which forms part of verifying the coverage: -

- Does insured has an insurable interest in the property?
- Is damaged property covered under the policy?
- Is the cause of loss covered under the policy?
- Do any additional coverages, endorsements or limitations on coverage apply?

Step 2: Valuation

For a claim representative the valuation of loss can be most difficult aspect of settling property insurance claims. In order to indemnify the insured according to the policy provisions, the claim representative must be able to answer two questions: -

- How does the policy specify that the property be valued?
- Based on that specification, what is the value of the damaged property?

How does the policy specify that the property be valued?

All property insurance policies include a valuation provision that specifies how to value covered property at the time of loss. The most common property valuation methods are: -

- Actual Cash Value
- Replacement Cost
- Agreed Value

Actual Cash Value is the replacement cost of the property minus depreciation.

Depreciation is the allowance for physical wear and tear or technological or economic obsolescence.

Replacement Cost is the cost to repair or replace the property using new material or like kind and quality with no deduction for depreciation.

Agreed Value is a method of valuing property in which the insurer and the insured agreed on the value of property at that time of policy is written, and that amount is stated in the policy declarations and is the amount the insurer will pay in the event of total loss to the property.

In commercial lines of insurance, in some policies, the term agreed value has a different meaning and relates to the amount of insurance that the insured must carry to avoid a penalty for underinsurance.

What is the value of the damaged property?

Once the claim representative has verified coverage and identified the valuation method specified in the policy, the valuation process began. He must use some guidelines to determine both replacement cost and actual cash value. Personal property and real property present different valuation problems.

Personal Property

In case of replacement cost method the claim representative will buy the exact style and brand of the damaged property if the property is not obsolete. If the party no longer available, he identifies the closes substitute in style and quality and uses that substitute's value as replacement cost. For actual cash value however depreciation must be estimated.

Real Property

The replacement of the real property can be usually determined by using three factors: -

- Square footage of the property
- Quality of construction
- Construction cost per square foot

In case of partially damaged property, the claim representative usually prepares a repair estimate or obtains repair estimates from one or more contractors. Replacing the property when a partial loss had occurred involves restoring the property to its previous state as closely as possible.

For policies specifying Actual Cash Value method, claim representative estimates depreciation of real property using methods similar to those used for estimating depreciation of personal property. In some claims, payment of ACV takes place immediately, and payment of remaining amount takes place once the actual repair or replacement is completed.

Step 3: Negotiation and Settlement

After the valuation process is complete, the final part is to arrive at a claim amount which shall be mutually negotiated and settled between the parties to the insurance contract.

The two other factors that can affect insurer's cost for property claims: -

- Subrogation
- Salvage rights

Subrogation is an insurer's right to recover payment from a negligent third party. When insurer pays an insured for a loss, the insurer assumes the insured's right to collect damages from a third party responsible for a loss.

Salvage Rights are the rights of the insurer to recover and sell or otherwise dispose of insured's property on which the insurer has paid a total loss or a constructive total loss.

Constructive Total Loss exists when a vehicle (or other property) cannot be repaired for less than its actual cash value minus the anticipated salvage value.

Liability Insurance Claims

Liability Claim handling can be complex for several reasons. In liability claims, the claimant is a third party who has been injured (bodily injury) or whose property has been damaged by the insured. While it is not always easy to determine the amount of loss in the property damage liability claims, the problem becomes even more complex when the loss involves bodily injury or death.

The following points concentrates on the issue of legal responsibility, which lies at the heart of the liability claim handling process: -

Step 1: Investigation

After receiving the first report of injury or damage, the claim representative must gather more detailed information relating to the liability claim. The amount of loss will be relevant only if the loss is covered under the insured's policy, if the insured is legally responsible for the loss. The claim representative's initial emphasis must be on determining how much and why the loss have occurred and whether it appears that the insured is responsible.

- **Determining how the loss has occurred and assessing the situation**
- **Verifying Coverage**

Step 2: Valuation

When bodily injury is involved, determining the amount of damage often depends on the medical reports and the opinions of the attending physicians. Properly evaluating this medical report is critical in determining the amount of damages and is a distinguished factor in settlement of claims. The evaluation aspect of bodily injury claims requires experience and skill.

Damage refer to a monetary award that one party is required to pay to another who has suffered loss or injury for which first party is legally liable.

Legal liability might involve following type of damages: -

- **Compensatory Damage**
- **Punitive Damage**

Compensatory Damage includes both special and general damages that are intended to compensate a victim for harm actually suffered.

Special Damages Specific, out of pocket expenses are known as special damages. In case of bodily injury claims these damages usually include hospital expenses, Doctor and miscellaneous medical expenses, ambulance charges, prescriptions and loss to wages for the time spent away from the job during recovery.

General Damages are compensatory damages awarded for losses such pain and suffering, that do not have a specific economic value.

Punitive Damages are damages awarded by a court to punish wrong doers who, through malicious or outrageous actions, cause injury damage to others.

Step 3 Negotiation and Settlement

While the award for damages might result from court decisions, a very large percentage of liability cases are settled out of court through negotiations between the claim representative and the claimant or the claimant's attorney. If negotiations do not bring about a settlement, the claimant has option of suing for the alleged damages. The court then decides who is responsible and determines the value of the injury or damage.

Unfair Claim Practices Laws

These laws are state laws that specify claim practices that are illegal. The prohibited claims practices usually include

- Misrepresentation of pertinent facts or insurance policy provisions relating to the coverage at issue in a claim.
- Failure to acknowledge and promptly respond to communications with respect to the claims arising out of insurance.
- Actions that compelled an insured to sue to recover amounts due under insurance policies by offering amounts that are substantially lower than the amounts ultimately recovered in legal actions brought by such insureds.
- Refusing to pay claim without first conducting reasonable investigation based on all available information.

Segment C: Insurance Contracts, Loss Exposures and Risk Management.

Chapter 7: Insurance Contracts

Elements of a Contract

Insurance Contract, called a policy, is an agreement between the Insured and the Insurer. An insurance policy must meet the same requirements as a valid contract which is legally enforceable agreement between two or more parties.

The validity of the contract depends upon four essential elements: -

- **Agreement (Offer and Acceptance)**
- **Competent Parties**
- **Legal Purpose**
- **Consideration**

Agreement (Offer and Acceptance)

The One essential element of the contract is that agreement must exist between the parties of the contract. One party must make a legitimate offer and another party must accept the offer. In other word there must be mutual assent.

To be enforceable, the agreement cannot be the result of duress, coercion, fraud or a mistake. If either party to the contract can prove any of these circumstances, a court declare the contract to be void.

Competent Parties

For the contract to be enforceable, all the parties must be legally competent. In other words, each party must have legal capacity to make agreement binding. Individuals are generally considered to be contract and able to enter into legally enforceable contracts unless they are one or more of the following: -

- Insane
- Under the influence of drug or alcohol
- Minors

Another aspect of legal capacity involves the fact that, in most states, an insurer must be licensed to do business in the state.

Legal Purpose

The courts might consider a contract to be illegal if its purpose is against the law or against public policy.

Insurance contracts must involve a legal subject matter. If the property is illegally owned or illegally possessed goods then it is a invalid contract. In addition, no insurance contract will remain valid if the wrongful conduct of the Insured causes the operation of the contract to violate public policy.

Consideration

Consideration is something of value given by each party to a contract. In insurance, consideration given by the insured is the payment of the premium. Consideration on part of the insurer is promise to pay covered losses. Eventhough, someone purchasing insurance receives only a document containing a promise, that promise has a value because it is a legal obligation.

Insurance Contracts

Special Characteristics of Insurance Contracts

- A personal contract
- A conditional contract
- A contract involving the exchange of unequal amounts
- A contract of utmost good faith
- A contract of adhesion
- A contract of indemnity

Personal Contract

The identities of the people insured are extremely relevant to the insurance company, which has a right to select the insureds with whom it is willing to enter into contractual agreement. Most insurance policies contain a provision (called assignment) that states that insurer's written permission is required before an insured can transfer a policy to another party.

Conditional Contract

A conditional contract is a contract in which one more parties must perform only under certain conditions. Coming to insurance contract, for instance, in the event of a loss, insurer shall pay the same only if covered under policy conditions and insured has certain duties as to the loss such as immediate notification, etc.,

Contract Involving the Exchange of Unequal Amounts

Insurance contracts can involve exchange of unequal amounts. For instance, in the event of a claim, it can be such that the claim amount paid is lesser than the premium collected and vice versa.

Contract of Utmost Good Faith

Utmost Good Faith is the obligation to act in complete honesty. Insurance contracts rely exclusively on the information provided by the proposer except in cases where the insurer carries out pre acceptance inspection. Hence it is the duty of the proposer to disclose all facts material to the subject mater. An Insurance company could be released from a contract because of concealment or misrepresentation by the insured.

Concealment

Concealment is an intentional failure to disclose a material fact.

Material Fact

For insurance purposes, a material fact is any information that would affect the insurer's underwriting decision to provide or maintain insurance or that would affect claim settlement.

Courts have held that the insurer must prove two things in order to establish that concealment has occurred.

First, it must establish that the failure to disclose information was intentional.

Second, the insurer must establish that the information withheld was material fact.

Misrepresentation

As used in insurance, misrepresentation is a false statement of the material fact on which insurer relies. Unlike concealment, the insurer does not have to prove misrepresentation to be an intentional one.

Contract of Adhesion

A contract of adhesion is a contract in which one party (insured) must adhere to the agreement as written by the other party (insurer).

If dispute arises between the parties as to words and phrases used in the policy document which results in ambiguity, the court will generally apply the interpretation that favors insured.

Contract of Indemnity

In a contract of indemnity, the insurer agrees, in the event of covered loss, to pay an amount directly related to the amount of the loss. Property insurance policies contain a valuation provision that explains how the value of the insured property is to be established at the time of loss. Liability insurance policies agree to pay on behalf of the insured amounts that the insured becomes legally obligated to pay to others.

The principle of indemnity, states that the insured should not be better off financially after a loss than before. In other words, the insured should not profit from an insurance.

Some insurance contracts are not contracts of indemnity but valued policies.

A **valued policy** is one in which the insurer pays a stated amount in the event of a specified loss regardless of the actual value of the loss.

Content of Insurance Policies

An insurance policy specifically describes the coverage it provides. Since no insurance policy can cover every contingency, the policy must describe its limitations, restrictions, and exclusions as clearly as possible. The best way to determine the coverages provided by a particular policy is to examine its provisions, which are generally included in the following sections of the policy: -

- **Declarations**
- **Definitions**
- **Insuring Agreements**
- **Exclusions**
- **Conditions**
- **Miscellaneous provisions**

Declarations

The declaration page (also simply called declarations or dec) of an insurance policy is an information page that provide specific details about the insured and the subject matter of the insurance, such as

- Name and location of the Insurer
- Name and address of the insured
- Policy Number
- Policy Period
- Description of covered property or locations
- Schedule of coverages and limits
- Deductibles
- Premium(s)
- Policy forms
- List of endorsements, if any
- Agent's name
- Other important details

Definition

Since insurance policy contains technical terms or words that are used for specific purpose. Most policies define these terms that have specific meanings with regard to the coverages provided.

Insuring Agreements

An Insurance agreement in an insurance policy is a statement that the insurer will under certain circumstances, make a payment or provide service.

Exclusions

Exclusions are policy provisions that eliminate coverage for specified exposures.

Reasons for Exclusions

- To avoid covering uninsurable losses.
- To avoid insuring losses that could be prevented.
- To eliminate duplicate coverage.
- To eliminate coverage that most insured do not need.
- To eliminate coverage for exposures that requires special handling by the insurer.
- To keep premium reasonable.

Conditions

Insurance policy contains several conditions relating to the coverage provided. The insured must generally comply with these conditions if coverage is to apply to a loss.

Miscellaneous Provisions

Insurance policies often contain provisions that do not qualify as one of the policy components. These miscellaneous provisions sometimes deal with the relationship between the insured and the insurer, or they might help to establish procedures for carrying on the terms of the contract.

Manuscript Policies and Standard Forms

A Manuscript Policy is an insurance policy that is specifically drafted according to the terms negotiated between a specific insured and the insurer.

Standard Forms are insurance forms that contain standardized policy wordings. Insurance advisory organizations develop standard forms that many insurers use in their insurance policies. Some insurers develop their own standard forms that they use in policies for their insureds.

Structure of Insurance Policies

Self Contained Policies

Self-contained policy is a single document that contains all the agreements between the insurer and the insured that forms a complete policy by itself.

Endorsement

An Endorsement is a document that amends an insurance policy in some way. Endorsements might add or delete coverage, include state specific changes, show a change in the insured's exposures or otherwise modify the policy.

Modular Policies

A Modular Policy consists of several different documents, none of which by itself form a complete contract. Commercial Package Policies are examples of Modular Policy.

In case of personal auto policy, which contains four coverages in one form, a CPP combines different forms depending on the coverages, a particular insured purchases. All CPPs must contain common policy declarations and common policy conditions. The CPP declarations contains information that applies to the entire policy such as name and address of the insured, the policy period and the coverages on which the premium has been paid. The common policy conditions are standard provisions that apply to all CPPs regardless of the coverage included.

For example, if a business owner wanted to purchase property and liability insurance, the CPP would include the following documents: -

- Common policy declarations
- Common policy conditions
- Common property declarations
- One or more commercial property coverage forms
- Commercial property conditions
- One or more cause of loss forms
- Commercial general liability declarations
- Commercial general liability coverage form

Conditions Commonly Found in Property and Liability Insurance Policies

Conditions common to most property and liability insurance policies, both personal and commercial, include:

- **Cancellation**
- **Changes**
- **Duties of the Insured after a loss**
- **Assignment**
- **Subrogation**

Cancellation refers to the termination of a policy, by either the insurer or the insured, during the policy period. The cancellation provision states the procedures that must be followed when cancellation is initiated by the insured or by the insurer. Generally, when the policy is cancelled by the insured he shall be eligible for a premium refund on short period basis and when the insurer cancels a policy; he is eligible for a premium on pro-rata basis.

Changes

Many policies contain a policy changes provision that states changes to the policy are valid if the insurer agrees to change in writing.

A **liberalization clause**, on the contrary, is a policy condition that provides that if a policy form is broadened at no additional premium, the broadened coverage automatically applies to all existing policies of the same type.

Duties of the Insured After a Loss

There are certain duties which the Insured has to follow in the event of a loss. The first and the foremost duty shall involve immediate notification of the claim.
The type of cooperation and the duties required depend on the type of coverage provided. Other duties shall include providing insurer with all the necessary documents such as bills, statement of accounts, etc., and assist insurers in speedy processing of claim.

Assignment

Assignment is the transfer of rights or interest in a policy to another party by the insured. Most policies cannot be assigned without written permission of the insurer.

Chapter 8 Property Loss Exposures and Policy Provisions

Property Loss Exposures

A Property Loss Exposure is any condition or situation that presents the possibility that a property loss will happen.

The three important aspects of Property Loss Exposures are: -

- **Types of property** that might be exposed to loss, damage or destruction.
- **Causes of loss** that might result in property being lost, damaged or destroyed.
- **Financial consequences** that might result from a property loss.

Types of Property

Property is any item with value. One common approach of classifying property is to distinguish between **Real Property** and **Personal Property.**

Real Property consists of land as well as buildings and other structures attached to the land or embedded in it. The term "real estate" is commonly used to refer to real property.

Personal Property consists of all tangible or intangible property that is not real property. Insurance practitioners use categories that relate to the insurance treatment of property, such as: -

- **Buildings**
- **Personal property (contents) contained in buildings**
- **Money and securities**
- **Motor vehicles and trailers**
- **Property in transit**
- **Ships and their cargo**
- **Boilers and machinery**

These categories are listed separately here because they represent types of property for which specific forms of insurance have been developed.

Buildings

Buildings include more than bricks and mortar and other building materials such as plumbing, wiring, heating and air conditioning equipment, some basic portable equipment – fire extinguishers, snow shovels, lawn mowers, elevators, specially designed portable platforms, hoists, tracks for use by window washers, wall to wall carpeting, built in appliances, or paneling, etc.,

Personal Property (Contents) Contained in Buildings

The contents of a typical home include personal property such as furniture, clothing, televisions, jewelry, paintings and other personal possessions.

The contents of Commercial Building might include: -

- Furniture and Fixtures
- Machinery and Equipment
- Stock

Money and Securities

Money means currency, coins and bank notes. Traveler's checks, credit card slips, and money orders held for sale to the public are also considered money in certain cases.

Securities are written instruments representing either money or other property. Stocks and bonds, for example, are securities.
For insurance purposes, money and securities are classified separately from other types of contents because their characteristics present special features / problems.

Motor Vehicles and Trailers

To identify property loss exposures, Motor Vehicles and Trailers are broadly categorized as under: -

- Autos and other high way vehicles
- Mobile equipment
- Recreational Vehicles

In insurance, Auto is a broad term that includes cars, trucks, buses and other motorized vehicles designed for use on public roads.

Mobile Equipment, which is specifically defined in most commercial insurance policies, includes many types of land vehicles – usually designed for use principally off public roads – including equipment attached to them. Examples include bulldozers, farm machinery and forklifts.

Recreational Vehicles are vehicles used for ports and recreational activities. Examples include dune buggies and all-terrain vehicles.

Property in Transit

A great deal of property is transported by truck, but property is also moved in cars, buses, trains, airplanes and ships. These property in transit are exposed to several losses such as breakage, damage, leakage, fire, explosion, etc.,

Ships and Their Cargo

Ships and their cargo are exposed to special perils not encountered in other means of transit. For example, ships that operate along coastal waters can run aground, leaving the cargo stranded. Moreover ocean cargoes fluctuate in their values according to their location.

Boilers and Machinery

Many businesses have objects that can be classified as Boilers and Machinery. Steam Boilers, Domestic Boilers, unfired pressure vessels such as air tanks; refrigerating and air Conditioning equipments; mechanical equipments such as compressors and turbines; production equipment; and electrical equipment, transformers and other electrical apparatus are all examples of boilers and machinery.

Boilers and machinery share two characteristics:

- They are susceptible to explosion or breakdown that can result in serious financial loss.
- They are less likely to have explosions or breakdowns if they are periodically inspected and properly maintained.

Causes of Loss to Property

A cause of loss (or peril) is the actual means by which property is damaged or destroyed. Examples include fire, lighting, windstorm, hail and theft.

Named perils are listed and described in the policy. Only losses caused by those listed perils are covered.

Special form coverage (also called open perils) provides coverage for "risk of direct loss' to property; In other words, coverage is provided for any direct loss to property unless the loss is caused by a peril specifically excluded by the policy.

Hazard is anything that increases the likelihood of a loss or the possible severity of a loss.

An important difference between named perils and special form ("all-risks") coverage involves the burden of proof.

- With a named perils policy, for coverage to apply, the insured must prove that the loss was caused by a covered cause of loss.
- With a special form coverage policy, if a loss to covered property occurs, it is initially assumed that coverage applies. However, coverage may be denied if the insurer can prove that the loss was caused by an excluded cause of loss.

Potential Financial Consequences of Property Losses

The adverse financial effects of a property loss might occur in one or more ways: -

- **Reduction in the value of the property**
- **Loss income**
- **Increased expenses**

Reduction in Value of Property

When a property loss occurs, the property is reduced in value.

If the property can be repaired or restored, the reduction in value can be measured by the cost of the repair or restoration. Property that must be replaced has no remaining worth, unless some salvageable items can be sold as junk. If an item is lost, is stolen, or otherwise disappears, its value to the owner is reduced just as though it had been destroyed and retained no salvage value.

A further reduction in value might occur if repaired property is worth less than it would be if it had never been damaged.

Property might have a few different "values" depending on the method by which the value is determined. The most common valuation measures used in insurance policies are replacement cost and actual cash value and also Agreed Value.

Lost Income

When property is damaged, income might be lost because the income producing capacity of the property is reduced or terminated until the property is repaired, restored or replaced.

Determining the amount of business income that might be lost due to a property loss requires estimating the future level of activity of an organization and doing a "what if" analysis. This analysis involves projections of the organization's revenues and expenses in normal circumstances to determine the amount of income that would be lost in the event of a property loss that disrupts normal operations. The comparison of projected revenues and expenses reveals the potential loss of income.

Rental property also poses a similar situation because rental income would be lost, if the property were damaged and the owner would continue to incur some expenses such as mortgage payments, taxes, etc.

Increased Expenses

When a property is damaged, in addition to the declination in value, the owner or the other user might incur increased expenses in acquiring a temporary substitute or in temporarily maintaining the property in usable condition.

Parties Affected by Property Losses

Parties that might be affected by a property loss include the following:

- **The property owner**
- **Secured lenders of money to the property owner**
- **Users of the property**
- **Other holders of the property**

The Property Owner

When a property of some value is lost, damaged or destroyed, the owner of the property incurs a financial loss because of the cost of repairing or replacing the property.

Secured Lenders

When money is borrowed to finance the purchase of a property, the lender usually acquires some conditional rights to the property, such as the right to repossess the property, if the owner fails to make payments. Such a lender is therefore called a Secured Lender or a Secured Creditor.

When properties are made collateral securities to borrow money, the secured lender is called a mortgagee (or mortgage holder) and the borrower is a mortgagor.

In the event of a mortgage agreement, both the parties are exposed to loss. Property insurance policies generally protect the secured lender's interest in the financed property by naming the lender on the insurance policy and by giving the lender certain rights under the policy.

Users of Property

Some event result in losses to users of the damaged property, eventhough, the users do not own the property. Payment of higher rent for alternate accommodation in the event of damage to the leased building by the user, etc., are all examples.

Other Holders of Property

Some parties are responsible for the safekeeping of property they do not own. Dry cleaners, TV repair shops, common carriers, and many other businesses temporarily hold property belonging to others. Holders of property entrusted to them by others are called Bailees.

Property Insurance Policy provisions

Property Insurance is any type of insurance that indemnifies an insured who suffers a financial loss because property has been lost, stolen, damaged or destroyed.

Property Insurance policies must specify exactly which property loss exposures are covered – that is, the types and locations of property, cause of loss, and financial consequences that are covered. Policies must also state what parties are covered and how the value of insured property will be determined.

Covered Property Locations

An insurance policy must carefully specify the property that is covered and where the property is covered.

Many types of property insurance are designed primarily to cover buildings and personal property. Stating the location of the property covered poses certain challenges. One challenge lies in describing precisely what is and is not covered under an insurance policy that provides building coverage. Another challenge lies in the fact that buildings and personal property do not necessarily remain at a fixed location. Portions of the building might be removed from the premises for repair or storage.

Other types of property insurance policies are designed to cover personal property that often moves from place to place. **Floaters** are policies that are designed to cover property that "floats" or moves fro location to location. Examples of such property are camera, fur, jewelry, etc.,

Dwellings, Buildings and Other Structures

Dwellings and Other Structures

A typical policy on a dwelling covers the "residence premises", which is defined as the location shown in the policy declarations. This shall also usually include structures attached to the dwelling and materials and supplies located next to the building used to construct, alter or repair. The coverage for residence premises does not apply to land. "Structures attached to the dwelling" include an attached garage or carport. A freestanding, detached structure is not part of the dwelling. A separate insuring agreement for "other structures" covers such detached items. The need for separate insurance agreement is that different policy limits (dollar amounts of insurance) apply for dwelling and other structures.

Building and Other Structures

In commercial insurance, a permanent structure with walls and roof is usually called a building. Other outdoor structures, such as carports, antenna towers, and swimming pools, might not be buildings and should insured separately.

In commercial insurance, the term building shall also include: -

- Additions that either completed or under construction as well as materials and supplies used for construction.
- Permanently installed fixtures, machinery and equipment.
- Some items that seem to be personal property such as fire extinguishing equipment, outdoor furniture, wall-to-wall carpeting and refrigerators.

Personal Property

Although buildings and personal property can be insured in the same policy, they are treated as separate coverage items. The reason being that an operation of an insured peril in building can also definitely affect personal property and vice versa.

On the other hand, because personal property can be moved more easily than buildings, it is exposed to additional perils such as theft. In addition, items such as valuable papers, securities, accounts, computer programs, fine arts, stamps, give rise to loss exposures that require special handling.

Dwelling Personal Property

This insurance provides coverage on a worldwide basis. The homeowners insuring agreement for personal property is a very broad statement of coverage, but such broad coverage is restricted by a number of exclusions and limitations.

Exclusions eliminate all coverage for excluded property or causes of loss, limitations place a specific dollar limit on specific property that is covered.

Business Personal Property

Business personal property also includes personal property in the open (or in a vehicle) within 100 feet of the described premises.

Commercial property policies often include an additional coverage (known as a "coverage extension") that provides a certain limit, such as $10,000, of coverage for property off-premises in the specified policy territory.

Property Other Than the Insured's Buildings and Contents

Autos

Autos are generally beyond the scope property insurance policies. Most auto insurance policies do not cover personal while transported in autos, but some provide a minimal amount of coverage for "personal effects".

Non-owned Properties

Homeowners' policies provide coverage for the personal property of others, such as guests or residence employees, while the property is in the insured's home.

Commercial property policies generally extend a limited amount of coverage to the personal effects of officers, partners, and employees as well as to the personal property of others while it is in the care, custody, or control of the insured.

Moveable Property

Dwelling Personal Property insurance provides coverage on a worldwide basis to personal properties that does not remain at a fixed location.

Business personal property also includes personal property in the open (or in a vehicle) within 100 feet of the described premises.

Covered Causes of Loss

The various types of crime losses, such as burglary and robbery, are covered by crime insurance policies as well as by some package policies; special types of policies or endorsements can cover losses from earthquake and flood

Personal and commercial property insurance policies on buildings and personal property are available with three different degrees of coverage:

- **Basic form coverage**
- **Broad form coverage**
- **Special form (open perils) coverage**

Basic Form Coverage

Fire and Lightning

Fire is one of the most serious causes of loss, but not every fire cause loss. A gas fire in a kitchen oven, an oil fire in a furnace, and a wood fire in a fireplace serve a specific purpose and cause no loss-unless they blaze out of control. These are called a **friendly**

fire that stays in its intended place. A **hostile fire** on the contrary is a fire that leaves its intended policy.

Some fires ensue from another peril. Lightning might strike a house and set it on fire. It is standard practice that policies covering fire also cover loss caused by lightning.

These policies also include damage resulting from those conditions accompanying the fire (such as heat and smoke) and those events that can be linked to the fire in an unbroken chain of causation (such as collapse resulting from the fire or water damage caused by fire fighters).

When these conditions occur because of a fire, the fire is considered the proximate cause of the entire loss. The **proximate cause** of a loss is the event that sets in motion an uninterrupted chain of events contributing to the loss.

Windstorm

Windstorm includes hurricanes and tornadoes. Less severe winds can also cause damage.

Water damage due to flood, waves, or spray sometimes accompanies a windstorm. Many insurance policies cover windstorm damage but not water damage, unless wind causes an opening to the structure through which water enters.

Hail

Hail consists of ice particles created by freezing atmosphere conditions. Hailstones the size of marbles, golf balls, or baseballs can cause substantial damages to the insured property. Light hail can cause damage to standing grain, blossoms on fruit trees.

Aircraft

Aircraft damage occurs when all or part of an airplane or satellite strikes property on the ground.

Vehicle Damage

Vehicle Damage is a damage done by a motor vehicle to some other kind of property.

Riot and Civil Commotion

Both terms approximately refer to the same kind of unruly mob behavior.

Explosion

An explosion is a violent expansion or bursting accompanied by noise. Explosions include combustion explosions resulting from the ignition of gases, dust, or other explosive materials, which are usually followed by fire, bursting of pressurized objects, etc.,

Smoke

The sudden or accidental release of large amounts of smoke can result in considerable damage. When the smoke is resultant cause of a fire, fire is usually considered as a proximate cause. All insurance policies covering fire damage also covers smoke.

However, the sudden malfunction of an oil-burning furnace might result in the discharge of clouds of grimy, sooty smoke, which is usually excluded from the scope of insurance.

Vandalism

Vandalism is willful and malicious damage to or destruction of property. These losses are not accidental; they are intentionally caused, usually by an unknown person or persons.

Sprinkler Leakage

Sprinkler leakage is the accidental leakage or discharge of water or other substance from an automatic sprinkler system.

Sinkhole Collapse and Mine Subsidence

Sinkhole collapse is a cause of loss involving damage by the sudden sinking or collapse of land into underground empty spaces created by the action of water or limestone or dolomite.
Mine subsidence is a cause of loss involving the sinking of ground surface when underground open spaces, resulting from the extraction of coal or other minerals, are gradually filled in by rock and earth from above.

Volcanic Action

Volcanic Action is a cause of loss by lava flow, ash, dust, particulate matter, airborne volcanic blast, or airborne shock waves resulting from a volcanic eruption.

Many property insurance policies used to specifically exclude losses caused by volcanic eruption. However, since there were no volcanoes considered active in the continental United States, specific reference to volcanoes began to disappear from insurance policies as they were revised and simplified.

Broad Form Coverage

This coverage additionally includes: -

- Breakage of glass
- Falling objects
- Weight of snow, ice or sleet
- Sudden and accidental water damage.

Collapse

Many property insurance policies provide an additional coverage for loss or damage involving collapse, but only if caused by one or more of the basic or broad causes of losses.

Other covered causes of collapse are hidden decay; hidden damage by insects or vermin; weight of people or contents; weight of rain that collects on a roof; and use of defective material or methods in construction, remodeling, or renovation if the collapse occurs during the construction, remodeling, or renovation.

Crime Perils

Coverage for various crime perils can be included in insurance policies.

- **Burglary** is the taking of property from inside a building by someone who unlawfully enters or exits the building.
- **Robbery** is the taking of property from a person by someone who has caused or threatened to cause the personal harm.
- **Theft** is a broad term that means any act of stealing; theft includes burglary and robbery.

E.g.: - A break-in is a burglary; a purse snatching or a holdup is a robbery; and both are thefts.

Auto Physical Damage

Insurance policies that provide auto physical damage coverage (property coverage for autos) offer the following types of coverage:

- **Collision**
- **Other than collision** (also called **comprehensive**)
- **Specified causes of loss** (used primarily in commercial auto policies)

Collision covers damage to an insured motor vehicle caused by its impact with another vehicle or object or by its upset or overturn.

Other than collision (or **Comprehensive**) is a type of open perils (all-risks) because it covers any “direct and accidental loss” that is not caused by collision and is not specifically excluded such as fire, theft, vandalism, falling objects, flood and various other perils.

Specified causes of loss is a less expensive alternative to comprehensive coverage in commercial auto policies. This coverage is otherwise called named peril coverage.

Causes of Loss Often Excluded

Reasons for Exclusions

- To avoid covering uninsurable losses.
- To avoid insuring losses that could be prevented.
- To eliminate duplicate coverage.
- To eliminate coverage that most insured do not need.
- To eliminate coverage for exposures that requires special handling by the insurer.
- To keep premium reasonable.

Catastrophe Perils

Some perils that affect a great many people at the same time are generally considered to be uninsurable by insurance companies, since the resulting losses would be so widespread that the funds of the entire insurance business might be inadequate to pay all of the claims.

For this reason, almost all property insurance policies exclude coverage for losses from catastrophes such war and allied perils, nuclear reaction and allied perils, Act of God perils like earthquake, flood losses, etc.,

Maintenance Perils

Maintenance Perils that are excluded from most policies include: -

- Wear and tear
- Marring and scratching
- Rust
- Gradual seepage of water
- Damage by insects, birds, rodents, or other animals.

Such losses are generally uninsurable because they either are certain to occur, over time, or are avoidable through regular maintenance and care.

Covered Financial Consequences

Property losses can lead to any or all of the following financial consequences: -

- **Reduction in the value of property**
- **Lost income**
- **Extra expenses**

Reduction in the value of property (Direct Loss)

Direct loss is a reduction in the value of property that results directly and often immediately from damage to that property.

Time Element (Indirect) Loss

These include loss of income or extra expenses resulting from direct loss to property. This type of loss is called “time element” because it takes place over a period of time such as days, weeks, months or even years following a direct loss.

Lost Income

Business income insurance protects a business from income lost because of a covered direct loss to its building or personal property.

Covered business income includes the organization’s net profit (income minus expenses) that would have been earned if the insured property had not been damaged.

It also includes the operating expenses that continue while the business is interrupted.

Extra Expenses

These are expenses that reduce the length of a business interruption or enable a business to continue some operations when the property has been damaged by a covered cause of loss.

Additional Living Expense

This is a coverage in homeowners policies that indemnifies the insured for the additional expenses incurred following a covered property loss so that the household can maintain its normal standard of living while the dwelling is uninhabitable.

Parties Covered by Property Insurance

Depending on the policy terms and conditions, property insurance can protect the insured and sometimes other parties that have an insurable interest in the property and that suffer a financial loss because covered property is lost, damaged or destroyed.

Generally, policies are written to cover these interests as follows: -

- The owner of a building is the named insured on a property insurance policy covering the building.
- A party that owns and occupies a building is the named insured on a property insurance policy covering the tenant’s personal property in that building.

- The tenant of a building is the named insured on a property insurance policy covering the tenant's personal property in that building.
- A secured lender, although usually not a named insured, is listed by name in the declarations (or in an endorsement) as a mortgagee or a loss payee.
- A Bailee, such as Warehouse, is the named insured on a Bailee policy.

Named Insured (s)

The named insured is the policyholder whose name(s) appears on the declarations page of an insurance policy.

In personal insurance, it also generally includes spouse even if not named in the policy. However, coverage for the spouse of a named insured depends on the policy definition of "named insured" and generally requires that the spouse live in the same household as the named insured.

The first named insured is the person or organization whose name appears first as the named insured on a commercial insurance policy and who, depending on the policy conditions, might be the one responsible for paying premiums and the one who has the right to receive any return premiums, to cancel the policy, and to receive the notice of cancellation or renewal.

Secured Lenders

The insurable interest of such lenders is protected when they are listed in the policy.

Mortgagee or Mortgage Holder

Until the loan is paid in full, the lender has an insurable interest in the property because destruction of the property could cause a financial loss to the lender.

The **mortgage clause** (or **mortgage holders clause**) of a property insurance policy protects the insurable interest of the mortgagee by giving it certain rights, such as the right to be named on claim drafts for losses to insured property and the right to be notified in the event of policy cancellation.

The mortgagee has the following rights under the mortgage clause of the building owner's insurance policy: -

- The insurer promises to pay covered claims to both the named insured and the mortgagee as their interests appear (that is to the extent of each party's insurable interest).

- The insurer promises to notify the mortgagee before any policy cancellation or non-renewal. The notice enables the mortgagee to replace the policy with other insurance.

- If the insurer cancels the policy and neglects to inform the mortgagee, the mortgagee's interest is still protected, even if the named insured no longer has coverage.

- So that the policy will remain in effect, the mortgagee has the right to pay the premium to the insurer if the insured fails to pay the premium.

- In case of loss, the mortgagee may file a claim if the insured does not.

- If a claim is denied because the insured did not comply with the terms of the policy, the mortgagee may still collect under the policy.

Loss Payee

A loss payee is a lender, named on an insurance policy, who has loaned money on personal property, such as a car.

A **loss payable clause** provides that a loss will be paid to both the insured and the loss payee as their interests appear and gives the loss payee certain rights. However, a loss payable clause does not extend as many rights to the lender as does a mortgage clause.

Other Parties Whose Property Is Covered

Many property insurance policies provide coverage to parties who are neither named insureds nor secured lenders and following are few examples: -

- A homeowners policy can provide coverage for property owned by relatives and other persons under the age of twenty-one who reside in the named insured's household.
- A homeowners policy can provide coverage for property belonging to guests, residence employees, and others while it is in the named insured's home.
- A commercial property policy providing coverage on the named insured's personal property can also provide limited coverage for (1) the personal effects of officers, partners, or employees and (2) personal property of others in the care, custody, or control of the insured.

- A personal auto policy can provide coverage for collision damage if the named insured borrows a car belonging to somebody else, the car sustains collision damage and the owner of the borrowed car has no insurance.

In the above examples, the other parties do not enter into the insurance contract with the insurer, and they have no specific rights to collect under someone else's policy. However, the named insured can request that the insurer pay claims of this type.

Amounts of Recovery

The amount payable depends on policy provisions in the following categories: -

- **Policy limits**
- **Valuation provisions**
- **Settlement options**
- **Deductibles**
- **Insurance-to-value provisions**
- **“Other insurance” provisions**

Policy limits

When buying property insurance, the applicant usually requests a certain dollar amount of coverage. If the insurer agrees to provide that amount of coverage, the policy limit is established and the same is entered into the policy.

It is the maximum amount of money that can be recovered under a policy. It also enables insured to know whether his property is adequately covered or whether there is any under insurance.

On the other hand, it shows insurer the maximum amount he has to pay in the event of a claim under the policy. This enables insurance companies to keep a track of their operation effectiveness in a given geographical area.

For most property insurance, the premium charged is directly related to the policy limit.

Valuation Provisions

The two most common valuation approaches in property insurance policies are replacement cost and actual cash value. A third approach, used for certain types of property, involves agreed value.

Settlement Options

The insurer generally has the option of:

- Paying the value (as determined by the valuation provision) of the lost or damaged property.
- Paying the cost to repair or replace the property (if repair or replacement is possible)
- Repairing, rebuilding, or replacing the property with other property of like kind and quality.

These options for settling property losses can often reduce the insurer’s cost of settling claims without diminishing the insured’s actual indemnification.

Deductibles

A deductible is a portion of covered loss that is not paid by the insurer. The deductible is subtracted from the amount the insurer would otherwise be obligated to pay the insured.

Deductibles encourage insured to try to prevent losses. Shifting the cost of small claims to the insured also enables the insurer to reduce premiums. Handling claims for small amounts often costs more than the dollar amount of the claim. Thus, deductibles enable people to purchase coverage for serious losses at a reasonable price without unnecessarily involving the insurer in small losses.

Insurance-to-Value Provisions

These are provisions in property insurance policies that encourage insureds to purchase an amount of insurance that is equal to, or close to, the value of the covered property.

Few losses are total. Unless all insureds purchase an amount of insurance close to the full value of their property, some insureds will pay considerably less for what provides, in most cases, the same recovery for a loss.

The traditional approach to encouraging insurance to value is to include a coinsurance provision in the policy. **Coinsurance** is an insurance-to-value provision in many property insurance policies. If the property is underinsured, the coinsurance provision reduces the amount that an insurer will pay for a covered loss.

“Other Insurance” Provisions

In cases, where more than one insurance policy exists covering the same property, “Other Insurance” provision in a policy will prevent insured from profiting out of a claim from all the policies covering the property.

Chapter 9

Liability Loss Exposures and Policy Provisions

A **Liability Loss Exposure** presents the possibility of a claim alleging legal responsibility of a person or business for injury or damage suffered by another party.

A liability loss is a claim for monetary damages because of injury to another party or damage to another party's property.

Liability claims might result from bodily injury, property damage, libel, slander, humiliation, defamation, invasion of privacy and similar occurrences.

Legal Liability

Legal liability means that a person or organization is legally responsible, or liable, for injury or damage suffered by another person or organization.

Sources of Law

The legal system in the United States derives essentially from the following: -

- The Constitution, which is the source of constitutional law
- Legislative bodies, which is the source of statutory law
- Court decisions, which is the source of common law

Constitutional Law

Constitutional law consists of the Constitution itself and all the decisions of the Supreme Court that involve the Constitution.

Statutory Law

Statutory law consists of the formal laws, or statues enacted by federal, state, or local legislative bodies.

Common Law

Common law or case law consists of a body of principles and rules established over time by courts on case-by-case basis.

Criminal Law Versus Civil Law

Criminal law is the category of law that applies to wrongful acts that society deems so harmful to the public welfare that government takes the responsibility for prosecuting and punishing the wrongdoers.
Crimes are punishable by fines, imprisonment, or, in some states, even death.

Civil Law is the category of law that deals with the rights and responsibilities of citizens with respect to one another. Civil law applies to legal matters not governed by criminal law.

Civil law protects personal and property rights. If some invades the privacy or property of another person or harms another's reputation, the insured person may seek amends in court. Thus Civil law contributes to the welfare and safety of society.

Criminal and Civil Consequences of the Same Act

Criminal and civil law do not necessarily deal with entirely different matters. A particular act can often have both criminal and civil law consequences.

Elements of a Liability Loss Exposure

A liability loss exposure involves the possibility of one party becoming legally responsible for injury or harm to another party.

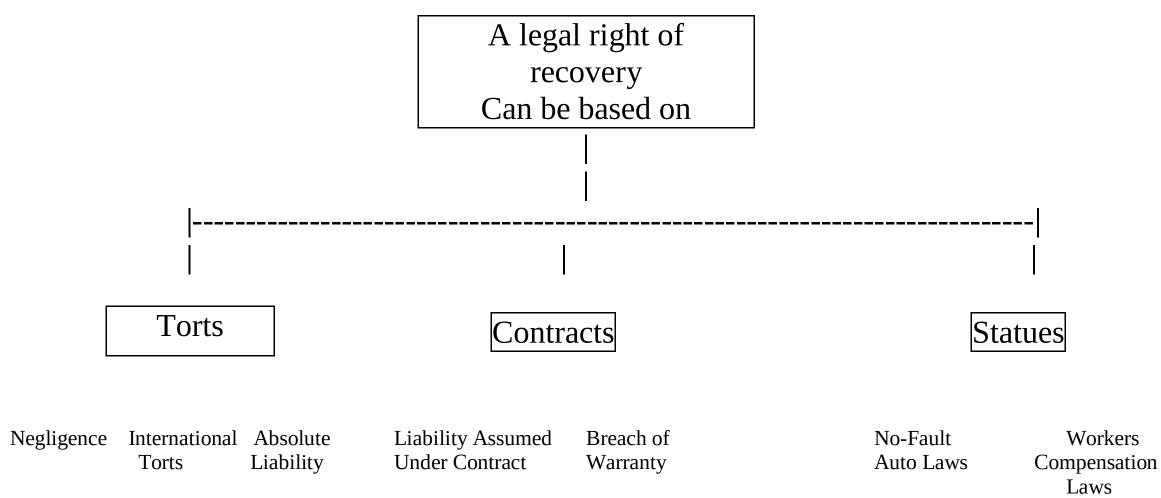
This section examines the following elements of a liability loss exposure: -

- The legal basis of a claim by one party against another for damages
- The financial consequences that might occur from a liability loss

Legal Basis of a Liability Claim

For an injured property to have a right of recovery from another party, some principle of law must create a link between the two parties. This link can appear in tort law, in contract law, or in statutory law. Any law or legal principle that establishes a relationship between the two parties can be the basis for a claim of liability.

Legal Basis of a Liability Claim



Torts

A tort is a wrongful act, other than a crime or breach of contract, committed by one party against another.

Tort law is the branch of civil law that deals with civil wrongs other than breaches of contract. The central concern of tort law is determining responsibility for injury or damage.

Under tort law, an individual or organization can face a claim for legal liability on the basis any of the following: -

- Negligence
- Intentional torts
- Absolute torts

Types of Torts

Negligence (Failure to act in a prudent manner)	Intentional Torts (Deliberate acts that cause harm)	Absolute Liability (Inherently dangerous activities)
Elements: Duty owed to another Breach of that duty Injury or damage Unbroken chain of events from breach of duty to injury or damage	Examples: Assault Battery Libel Slander False arrest Invasion of privacy	Examples: Owning a wild animal Blasting operations

Negligence

Negligence is failure to act in a manner that is reasonably prudent. Negligence occurs when a person or organization fails to exercise the appropriate degree of care under given circumstances.

A liability judgment based on negligence depends on the following four elements: -

- A duty owed to another. The first element of negligence is that a person or organization must have a duty to act (or not to act) that constitutes a responsibility to another party.
- A breach of that duty. In order for a person or an organization to be held negligent, a breach of the duty owed to another party must occur. A breach of duty is failure to exercise a reasonable degree of care expected in a particular situation.

- Injury or damage. The third element of negligence requires that the claimant must suffer definite injury or harm. No recovery can be made unless there is injury or harm.
- Unbroken chain of events between the breach of duty and the injury or damage. A finding of negligence also requires that the breach of duty initiate an unbroken chain of events leading to the injury. The breach of the duty must be the proximate cause of the injury.

A **tortfeasor** is a person, a business, or another party who has committed a tort.

Vicarious liability is legal responsibility that occurs when one party is held liable for the actions of another party. For example, parents might be found vicariously liable for the actions of their minor children.

Intentional Torts

An intentional tort is a deliberate act (other than a breach of contract) that causes harm to another person. Intentional torts include: -

- **Assault** – the intentional threat of bodily harm
- **Battery** – the unlawful physical contact with another person
- **Libel** – a written or printed untrue statement that damages a person's reputation
- **Slander** – an oral untrue statement that damages a person's reputation
- **False arrest** – an unlawful physical restraint of another's freedom
- **Invasion of privacy** – an encroachment on another person's right to be left alone

Absolute Liability

Absolute liability (sometimes called strict liability) is legal liability that arises from inherently dangerous activities or dangerously defective products that result in injury or harm to another, regardless of how much care was used in the activity. Absolute liability does not require proof of negligence. ("Strict liability" is also used to describe the liability imposed by certain statutes, such as workers compensation laws).

For example, Blasting operations present an exposure to liability for business organizations.

Contracts

A contract is a legally enforceable agreement between two or more parties. Contract law enables an injured party to seek recovery because another party has breached a duty voluntarily accepted in a contract. In such a case, it is the specific contract, rather than law in general, that the court interprets.

Two areas of contract law important to insurance are liability assumed under a contract and breach of warranty.

Liability Assumed Under Contract

Parties to a contract sometimes find it convenient for one party to assume the financial consequences of certain types of liability faced by the other. The party assuming liability might be closer to the scene, exercise more control over operations, or have the ability to respond to claims more efficiently.

A **hold harmless agreement** is a contractual provision that obligates one party to assume the legal liability of another party. This provision requires that one party to "hold harmless and indemnify" the other party against liability arising from the activity (or product) that is specified in the contract.

Breach of Warranty

Warranties are promises, either written or implied, such as a promise by a seller to a buyer that a product is fit for a particular purpose.

The law of contracts also governs claims arising from breach of warranty. Contracts for sales of goods include warranties, or promises made by the seller. The law also implies certain warranties. The buyer in such contracts does not have to prove negligence on the part of the seller. The fact that the product does not work shows that the contract was not fulfilled.

Statutes

Statutory liability is legal liability imposed by a specific statute or law. Statutory liability exists because of specific statues. Although common law may cover a particular situation, statutory law may extend, restrict, or clarify the rights of injured parties in that situation or similar ones. One reason for such legislation is the attempt to ensure adequate compensation for injuries without lengthy disputes over who is at fault. Prominent examples of this kind of statutory liability involve no-fault auto laws and workers compensation laws.

No-Fault Auto Laws

In an effort to reduce the number of lawsuits resulting from auto accidents, some states have enacted "no-fault" laws. These laws recognize the inevitability of auto accidents and restrict or eliminate the right to sue the other party in an accident, except serious cases defined by the law. Victims with less serious injuries collect their out-of-pocket expenses from their own insurance companies without the need for expensive legal proceedings.

Workers Compensation Laws

Such a statute eliminates an employee's right to sue the employer for most work-related injuries and also imposes on the employer automatic (strict) liability to pay specified benefits.

In place of the common law principle of negligence, workers compensation laws create a system in which injured employees receive benefits specified in these laws. As long as the injury is work-related, the employer pays the specified benefits regardless of who is at fault.

Potential Financial Consequences of Liability Loss Exposures

A person must sustain some definite harm for a liability loss to result in a valid claim. To those who can show that actual harm or injury was suffered, the court may award damages in addition to the reimbursement of defense costs.

Damage refer to a monetary award that one party is required to pay to another who has suffered loss or injury for which first party is legally liable.

Legal liability might involve following type of damages: -

- **Compensatory Damage**
- **Punitive Damage**

Compensatory Damage includes both special and general damages that are intended to compensate a victim for harm actually suffered.

Special Damages Specific, out of pocket expenses are known as special damages. In case of bodily injury claims these damages usually include hospital expenses, Doctor and miscellaneous medical expenses, ambulance charges, prescriptions and loss to wages for the time spent away from the job during recovery.

General Damages are compensatory damages awarded for losses such pain and suffering, that do not have a specific economic value.

Punitive Damages are damages awarded by a court to punish wrong doers who, through malicious or outrageous actions, cause injury damage to others.

Defense Costs

These costs include not only the fees paid to lawyers but also all the other expenses associated with defending a liability claim. Such expenses can include investigation expenses, expert witness fees, the premiums for necessary bonds, and other expenses incurred to prepare for and conduct a trial.

Activities and Situations Leading to Liability Loss Exposures

Although the following list is far from exhaustive, liability can arise from any of the following exposures: -

- **Automobiles and other conveyances** – Accidents that result in bodily injury, death or property damage of another party.
- **Premises** – Accidental fall of a third party at the residence or business premises.
- **Business operations –** Products of the organization should be defect free and must solve the purpose otherwise leading to liability due to malfunction.
- **Completed operations –** Faulty workman ship can always lead to a liability claim.
- **Products –** Manufacture of hazardous products, usage of hazardous raw materials, hazardous waste arising out of manufacturing process, etc., are typical examples.
- **Advertising –** Proper permission should be sought and procedures need to be followed before releasing an advertisement of a product otherwise it may result in liability claim.
- **Pollution –** Many types of products pollute the environment when they are discarded. In addition, the manufacture of some products creates contaminants that, if not disposed of properly, cause environmental impairment or pollution.
- **Liquor –** Intoxicated persons threaten themselves as well as others. Providers of alcohol can be responsible for customers or guests who become intoxicated and injure someone while drunk.
- **Professional activities –** Attorneys, physicians, architects, engineers and other professionals are considered experts in their field and are expected to perform accordingly. Errors and Omissions (E &O) are negligent acts (errors) or failures to act (omissions) committed by a profession in the conduct of business that give rise to legal liability for damages.

Liability Insurance Policy Provisions

Liability Insurance covers losses resulting from bodily injury to others or damage to the property of others for which the insured is legally liable and to which the coverage applies.

Liability insurance differs from property insurance in several ways: -

- Property insurance claims usually involve only two parties – the insurer and the insured. Liability insurance involve three parties; the insurer, the insured and a third party – the claimant who brings a legal complaint against the insured for injury or damage allegedly caused by the insured. Although the claimant is not a party to the insurance contract, he or she is a party to the claim settlement.
- In property insurance, insurers pay claims to an insured when covered property is damaged by a covered cause of loss during the period. In liability insurance, on

the other hand, insurer pays a third party on behalf of an insured against whom a claim has been made, provided the claim is covered by the policy.

- Property insurance policies must clarify which property and causes of loss the policy covers. In contrast, liability insurance policies must indicate the activities and types of injury or damage that are covered.

In order to clarify the intent of the insuring agreement, the provisions of a liability insurance policy must answer the following questions:

- **What parties are insured?**
- **What activities are covered?**
- **What types of injury or damage are covered?**
- **What costs are covered?**
- **What time period is covered?**
- **What factors affect the amount of claim payments?**

What Parties are Insured?

The extent of liability coverage provided to parties other than the named insured is determined by their relationship to the named insured as well as by circumstances.

For example, the liability coverage of a typical homeowners policy applies to:

- The named insured and the named insured's spouse, if the spouse is a resident in the household.
- Relatives of the named insured or spouse, if the relatives reside in the household
- Children in the care of the named insured or spouse
- Any person or organization legally responsible for animals or watercraft owned by an insured (except in business situations)
- Employees using a covered vehicle, such as a lawn tractor, and other people using a covered vehicle on an insured location with the named insured's consent.

Commercial liability policies, apart from the named insured, also cover: -

- Employees of the named insured
- Real estate managers for the name insured
- Persons responsible for the property of a named insured who has died
- Any person who operates mobile equipment owned by the named insured while on a public highway
- Any organization that is newly acquired or formed by the named insured for up to a certain number of days after it is formed or acquired.

What Activities Are Covered?

Certain policies state the specific activity or source of liability covered.

In contrast, general liability insurance covers all activities or sources of liability that are not specifically excluded. In addition to excluding coverage for losses best handled elsewhere, general liability insurance policies contain exclusions dealing with uninsurable exposures, preventable losses, and exposures that would be too costly to insure.

What Types of Injury or Damage Are Covered?

Bodily Injury

Bodily injury is any physical injury to a person, including sickness, disease and death.

A typical commercial general liability policy defines bodily injury as follows: -

"Bodily injury" means bodily injury, sickness or disease sustained by a person, including death resulting from any of these at any time.

Given the above definition, the commercial general liability policy clarifies that it covers claims for injury, sickness, disease and death.

Property Damage

Property Damage is physical injury to, destruction of, or loss of use of tangible property.

Commercial general liability policy defines property damage as follows: -

"Property damage" means:

a. Physical injury to tangible property, including all resulting loss of use that property; or
b. Loss of use of tangible property that is not physically injured.

Under homeowner's policy, the same is defined as follows: -

"Property damage" means physical injury to, destruction of, or loss of use of tangible property.

Hence the above definitions make it clear that property damage includes both direct losses and time element (or indirect) losses.

Personal Injury

In insurance, the term personal injury is generally used to mean injury, other than bodily injury, arising from intentional torts such as libel, slander, or invasion of privacy.

For insurance purposes, intentional torts are usually considered personal injury offenses and are either excluded from coverage or are specifically covered as a separate coverage.

A few policies define personal injury in a way that includes even bodily injury apart from the offenses listed above.

However, the more common interpretation allows for separate coverage for bodily injury and personal injury, in which case personal injury coverage supplements bodily injury coverage. For example, the commercial general liability policy automatically includes personal injury coverage under a separate insuring agreement. Coverage for personal injury liability can be added by endorsement to a homeowners policy.

Advertising Injury

Advertising injury typically includes the following types of offenses:

- Libel and slander
- Publication of material that constitutes an invasion of privacy
- Misappropriation of advertising ideas or business style
- Infringement of copyright, title, or slogan

The definitions of personal injury offenses and advertising injury offenses overlap somewhat. But this does not result in duplicate coverage. Furthermore, the policy clarifies that personal injury does not include offenses involving advertising activities and that advertising injury refers only to offenses committed in the course of advertising activities.

What Costs Are Covered?

Liability insurance policies typically cover two types of costs:

- The damage that the insured is legally liable to pay
- The cost of defending the insured against the claim

Some policies also cover other costs, such as supplementary payments and medical payments.

Damages

A person who has suffered bodily injury, property damage, or personal injury for which the insured is allegedly responsible might make a claim for damages. The claim is often settled out of court, and the insurer pays the claimant on behalf of the insured.

However, Legal liability might involve following type of damages: -

- **Compensatory Damage**
- **Punitive Damage**

Compensatory Damage includes both special and general damages that are intended to compensate a victim for harm actually suffered.

Special Damages Specific, out of pocket expenses are known as special damages. In case of bodily injury claims these damages usually include hospital expenses, Doctor and miscellaneous medical expenses, ambulance charges, prescriptions and loss to wages for the time spent away from the job during recovery.

General Damages are compensatory damages awarded for losses such pain and suffering, that do not have a specific economic value.

Punitive Damages are damages awarded by a court to punish wrong doers who, through malicious or outrageous actions, cause injury damage to others.

Most liability insurance policies do not specifically state whether punitive damages, intended to punish the insured for some outrageous conduct, are covered. There are certain State Laws that prohibit insurance coverage for punitive damages.

Defense Costs and Expenses

These costs include not only the fees paid to lawyers but also all the other expenses associated with defending a liability claim. Such expenses can include investigation expenses, expert witness fees, the premiums for necessary bonds, and other expenses incurred to prepare for and conduct a trial.

The insurer is obligated to defend an insured only when the claimant alleges that injury or damage caused by a covered activity of the insured.

The expenses incurred for the defense, known, as **Litigation Expenses** are the expenses incurred for legal defense, such as attorneys' fees, expert witness fees, and the cost of legal research.

Supplementary Payments

In liability policies, supplementary payments are amounts the insurer agrees to pay (in addition to the liability limits) for items such as premiums on bail bonds and appeal bonds, loss of the insured's earnings because of attendance at trials, and other reasonable expenses incurred by the insured at the insurer's request.

In other words, these supplementary payments consist of the following: -

- All expenses incurred by the insurer
- The cost (up to a specified limit) of bail bonds or other required bonds
- Expenses incurred by the insured at the insurer's request
- The insured's loss of earnings (up to a specified amount per day) because of attendance at hearing or trials at the insurer's request.

Prejudgment Interest

Prejudgment Interest is interest that might accrue on damages before a judgment has been rendered.

Postjudgment Interest

Postjudgment Interest is interest that might accrue on damages after a judgment has been entered in a court and before the money is paid.

Medical Payments

Medical payments coverage pays necessary medical expenses incurred within a specified period by a claimant (and in certain policies, by an insured) for a covered injury, regardless of whether the insured was at fault.

What Time Period is Covered?

Personal auto insurance is usually written for a six-month term. Other types of liability insurance are usually written for a one-year period, though other policy terms are also possible.

A liability insurance policy states what must happen during the policy period in order to "trigger" coverage. Depending on the type of policy, coverage is usually triggered by either:

- Events that occur during the policy period (in an occurrence basis policy)
- Claims made (submitted) during the policy period (in a claims – made policy)

Occurrence Basis Coverage

Occurrence basis coverage covers liability claims that occur during the policy period, regardless of when the claim is submitted to the insurer.

Occurrence policies do not limit the time period during which a claim can be submitted. As long as the injury or damage occurs during the policy period, coverage applies even to claims made years later.

Claims-Made Coverage

Claims-made coverage liability claims that made (submitted) during the policy period for covered events that occur on or after the retroactive date and before the end of the policy period.

A **retroactive date** in a claims-made policy is the date on or after which injury or damage must occur in order to be recovered.

The situation becomes more complicated in practice, however. Claims due to injuries that occur before that retroactive date are not covered even if the claim is made during the policy period. Occurrence policies also do not cover claims arising from occurrences before the policy's inception date.

Because of period renewals and the possibility that the insured will shift coverage from insurer to another, maintaining continuous coverage without gaps is perhaps the greatest difficulty with claims-made coverage.

What Factors Affect the Amount of Claim Payments?

The extent of the insurer's payment depends on the following types of policy provisions:

- **Policy limits**
- **Defense Cost provisions**
- **"Other insurance" provisions**

Policy limits

Limits are expressed in different ways, as follows:

- An **each person limit** is the maximum amount an insurer will pay for injury to any one person for a covered loss.
- An **each occurrence limit** is the maximum amount an insurer will pay for all covered losses from a single occurrence, regardless of the number of persons injured or the number of parties claiming property damage.
- An **aggregate limit** is the maximum amount an insurer will pay for all covered losses during the covered policy period.

Split Limits and Single Limits

Split limits are separate limits that an insurer will pay for bodily injury and for property damage.

A single limit of liability is the maximum amount an insurer will pay for the insured's liability for both bodily injury and property damage that arise from a single occurrence.

Defense Cost Provisions

Most liability policies do not place any limit as to Defense Cost. The only limitation is that insurer is not obligated to pay once the entire policy limit has been paid in settlement.

On the other hand, defense costs are usually payable in addition to the policy limits and policy limits include only payment for damages.

There are certain policies which states that defense costs should be within the overall policy limit.

"Other Insurance" Provisions

In cases, where more than one insurance policy exists covering the same property, "Other Insurance" provision in a policy will prevent insured from profiting out of a claim from all the policies covering the property.

Chapter 10

Managing Loss Exposures: Risk Management

Risk Management is the process of making and implementing decisions to deal with loss exposures. It involves identifying loss exposures and then applying various techniques to eliminate, control, finance, or transfer those exposures.

Steps involved in Risk Management Process

1. **Identifying and analyzing loss exposures**

Identifying	**Analyzing**
Physical inspection Loss exposure survey Flowchart	Loss frequency Loss severity

2. **Examining risk management techniques**

Avoidance
Loss control:
   Loss prevention
   Loss reduction
Retention
Noninsurance transfer
Insurance

3. **Selecting the most appropriate techniques**

Decisions based on financial criteria
Decisions based on informal guidelines:
  Do not retain more than you can afford to lose.
  Do not retain large exposures to save a little premium.
  Do not spend a lot of money for a little protection.
  Do not consider insurance for a substitute of loss control.

4. **Implementing the chosen techniques**

Decide what should be done. Decide who should be responsible. Communicate risk management information. Allocate costs of the risk management program.

5. **Monitoring and modifying the risk management program**

Continuously monitor the risk management program.
Periodically review the insurance program.
Revise the risk management program as needed.

Step 1: Identifying and Analyzing Loss Exposures

Identifying Loss Exposures

To handle loss exposures, a risk manager must first identify them. Identifying Loss Exposures involves developing a complete list of loss exposures and possible accidental losses that can affect a particular household or organization.

The risk manager can start with a physical inspection of the premises and then use other tools that aid in the identification process, such as loss exposure surveys and flow charts.

Physical Inspection

The most straight forward method of identifying loss exposure is a physical inspection of all locations, operations, maintenance routines, safety practices, work processes and other activities.

Loss Exposure Survey

A loss exposure survey is a risk management tool in the form of a checklist or questionnaire listing potential loss exposures that a household or an organization might face.

A loss exposure survey can be a valuable tool to help the risk manager identify the organization's loss exposures.

The survey's major weakness is that it might omit an important exposure, especially if the organization has unique operations not included on a standard survey form. Hence, the survey must be used as a guide to develop a comprehensive picture of the organization's operations and loss exposures.

Flowchart

A flowchart is a diagram that depicts the flow of a particular operation or set of related operations within an organization.

Risk managers can use a flow chart to identify specific types of loss exposures. A flowchart complements the loss exposure survey by providing a diagram of loss exposures from certain operations. Also it forces the risk manager to examine each and every aspect of the operation in detail.

Analyzing Loss Exposures

Analyzing loss exposures involves determining the financial effect of a potential loss on the household or organization. To determine the financial effect of losses, a risk manager needs to measure both the likely frequency and the severity of the loss.

Loss Frequency

Loss frequency is a term used to indicate how often losses occur or are expected to occur. Loss frequency is used to predict the likelihood of similar losses in the future.

Frequent losses include abrasions and minor lacerations of employees at a manufacturing plant, minor auto accidents with a large fleet of autos, and spoilage of produce at a supermarket. Other losses such as those caused by earthquakes, tornadoes, and hurricanes, occur much less frequently.

Accurate measurement of loss frequency is important because the proper treatment of the loss exposure often depends on how frequently the loss is expected to occur.

Loss Severity

Loss severity is a term that refers to the dollar amount of damages that results or might result from loss exposures. Loss severity is used to predict how costly future losses are likely to be.

Properly estimating loss severity is essential in order to treat the exposure to loss. This also enables on adopting of type of risk management technique.

Most property loss has a finite value and hence it is easy to estimate loss severity of a property loss than a liability loss.

Step 2: Examining Risk Management Techniques

Risk Management Techniques

Technique	**What the Technique Does**	**Example**
Avoidance	Eliminates the chance of a particular type of loss by either disposing of an existing loss exposure or by not assuming a new exposure	A family decides not to purchase a boat and therefore avoids the property and liability loss exposures associated with boat ownership.
Loss Control	Lowers frequency and/or	

	severity of losses	
1. Loss prevention	Lowers loss frequency (number of losses)	A business installs a burglar alarm system in attempt to prevent burglaries.
2. Loss reduction	Lowers loss severity (dollar amount of losses)	A business installs a sprinkler system to reduce the amount of fire damage from potential fires.
Retention	Retains all or part of a loss exposure (intentionally or unintentionally) which means that losses must be paid for with available funds or other assets	A business decides not to purchase collision coverage for its fleet of vehicles and sets aside its own funds to pay for possible collision losses.
Noninsurance transfer	Transfers potential financial consequences of a loss exposure from one party to another party that is not an insurance company	In a lease, a landlord transfers the liability exposures of a rented building to the tenant.
Insurance	Transfers financial consequences of specified losses from one party (the insured) to an insurance company in exchange for a specified fee (premium).	A family purchases homeowners and personal auto policies from an insurance company.

Decisions Based on Financial Criteria

Financial management standards typically call for making those choices that promise to increase profits and/or operating efficiency.

Decisions Based on Informal Guidelines

Do not retain more than you can afford to lose.
Do not retain large exposures to save a little premium.
Do not spend a lot of money for a little protection.
Do not consider insurance for a substitute of loss control.

Step 4: Implementing the Chosen Risk Management Techniques

Implementation of the chosen technique requires that risk manager make decisions concerning:

- **What should be done**
- **Who should be responsible**
- **How to communicate risk management information**
- **How to allocate the costs of the program**

Deciding What Should Be Done

Once the selection of technique is over, the risk manager must workout the details of how to implement them.

Deciding Who Should Be Responsible