Property and Liability Insurance Principles

Property and Liability Insurance Principles

Edited by

Mary Ann Cook, CPCU, MBA, AU, AAI

Arthur L. Flitner, CPCU, ARM, AIC

5th Edition • 1st Printing

The Institutes
720 Providence Road, Suite 100
Malvern, Pennsylvania 19355-3433

5th Edition • 1st Printing • September 2011

Library of Congress Control Number: 2011912730

ISBN 978-0-89463-477-2

Foreword

The Institutes are the trusted leader in delivering proven knowledge solutions that drive powerful business results for the risk management and property-casualty insurance industry. For more than 100 years, The Institutes have been meeting the industry's changing professional development needs with customer-driven products and services.

In conjunction with industry experts and members of the academic community, our Knowledge Resources Department develops our course and program content, including Institutes study materials. Practical and technical knowledge gained from Institutes courses enhances qualifications, improves performance, and contributes to professional growth—all of which drive results.

The Institutes' proven knowledge helps individuals and organizations achieve powerful results with a variety of flexible, customer-focused options:

Recognized Credentials—The Institutes offer an unmatched range of widely recognized and industry-respected specialty credentials. The Institutes' Chartered Property Casualty Underwriter (CPCU) professional designation is designed to provide a broad understanding of the property-casualty insurance industry. Depending on professional needs, CPCU students may select either a commercial insurance focus or a personal risk management and insurance focus and may choose from a variety of electives.

In addition, The Institutes offer certificate or designation programs in a variety of disciplines, including these:

- Claims
- Commercial underwriting
- Fidelity and surety bonding
- General insurance
- Insurance accounting and finance
- Insurance information technology
- Insurance production and agency management
- Insurance regulation and compliance
- Management
- Marine insurance
- Personal insurance
- Premium auditing
- Quality insurance services
- Reinsurance
- Risk management
- Surplus lines

Ethics—Ethical behavior is crucial to preserving not only the trust on which insurance transactions are based, but also the public's trust in our industry as a whole. All Institutes designations now have an ethics requirement, which is delivered online and free of charge. The ethics requirement content is designed specifically for insurance practitioners and uses insurance-based case studies to outline an ethical framework. More information is available in the Programs section of our Web site, www.TheInstitutes.org.

Flexible Online Learning—The Institutes have an unmatched variety of technical insurance content covering topics from accounting to underwriting, which we now deliver through hundreds of online courses. These cost-effective self-study courses are a convenient way to fill gaps in technical knowledge in a matter of hours without ever leaving the office.

Continuing Education—A majority of The Institutes' courses are filed for CE credit in most states. We also deliver quality, affordable, online CE courses quickly and conveniently through our newest business unit, CEU.com. Visit www.CEU.com to learn more.

College Credits—Most Institutes courses carry college credit recommendations from the American Council on Education. A variety of courses also qualify for credits toward certain associate, bachelor's, and master's degrees at several prestigious colleges and universities. More information is available in the Student Services section of our Web site, www.TheInstitutes.org.

Custom Applications—The Institutes collaborate with corporate customers to utilize our trusted course content and flexible delivery options in developing customized solutions that help them achieve their unique organizational goals.

Insightful Analysis—Our Insurance Research Council (IRC) division conducts public policy research on important contemporary issues in property-casualty insurance and risk management. Visit www.ircweb.org to learn more or purchase its most recent studies.

The Institutes look forward to serving the risk management and property-casualty insurance industry for another 100 years. We welcome comments from our students and course leaders; your feedback helps us continue to improve the quality of our study materials.

Peter L. Miller, CPCU
President and CEO
The Institutes

Preface

Property and Liability Insurance Principles is the textbook for the first course in The Institutes' Associate in General Insurance (AINS) designation program. Designed for learners who are at the beginning to intermediate level, this course provides the foundation for studying the other courses in the AINS program.

The text is divided into three segments. Segment A explains what insurance is, who provides it, how it is regulated, and how to measure the financial performance of insurers. Segment B describes the functions of marketing, underwriting, ratemaking, and claims, all of which are essential to providing insurance. Segment C examines the risk management process and its purpose, the elements of loss exposures, and the characteristics and provisions of insurance policies.

The Institutes are grateful to the insurance professionals, course leaders, and course sponsors who provided guidance and review during the planning of this text. Their assistance helped ensure the text is accurate and reflects current industry practice.

For more information about The Institutes' programs, please call our Customer Service Department at (800) 644-2101, email us at customerservice@TheInstitutes.org, or visit our Web site at www.TheInstitutes.org.

Arthur L. Flitner

Contributors

The Institutes acknowledge with deep appreciation the contributions made to the content of this text by the following persons:

Richard Berthelsen, JD, CPCU, AIC, ARM, AU, ARe, MBA

Pamela J. Brooks, MBA, CPCU, AAM, AIM, AIS

Doug Froggatt

Contents

Segment A

Assignment 1
Understanding Insurance

Assignment 2
Insurers and How They Are Regulated

Assignment 3
Insurer Financial Performance

Direct Your Learning

1

Understanding Insurance

Educational Objectives

After learning the content of this assignment, you should be able to:

- Explain how insurance functions in each of these roles:
  - As a risk management technique
  - As a transfer system
  - As a business
  - As a contract
- Distinguish among the common types of personal and commercial insurance.
- Describe the characteristics of an ideally insurable loss exposure.
- Explain how insurance benefits individuals, organizations, and society.
- Describe the costs of insurance.

Outline

Understanding Insurance

1

MAJOR ROLES OF INSURANCE

Almost every person, family, and organization needs insurance of some type to protect assets against unforeseen events that could cause financial hardship. Sometimes insurance is required to satisfy a contractual obligation, such as when a homeowner buys insurance on a home to protect the mortgage company's investment in the event the home is damaged or destroyed. Almost everyone needs insurance, but not everyone fully understands it. What exactly is insurance?

One way to define insurance is to examine how it functions in each of these four major roles:

- As a risk management technique that enables a person or an organization to deal with **loss exposures** and their financial consequences
- As a transfer system, in which one party (the insured) transfers the chance of financial loss to another party (the insurer)
- As a business, which includes various operations that must be conducted in a way that generates sufficient revenue to pay claims and provide a reasonable profit for its owners
- As a contract between the insured and the insurer that states the potential costs of loss that 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

Loss exposure
Any condition or situation that presents a possibility of loss, whether or not an actual loss occurs.

Insurance as a Risk Management Technique

Individuals, families, and organizations face loss exposures every day. Many of these loss exposures can have serious financial consequences. For example, a person operating an automobile may cause an accident, leading to thousands of dollars of damage to the property of others and medical expenses for those involved. Businesses face a variety of loss exposures, such as damage to premises, injury to workers, and harm to customers from defective products or workmanship.

A person or an organization can retain some loss exposures. For instance, a flat tire is a nuisance and a minor expense, but it has a relatively minor financial impact. Some loss exposures have the potential to create financial ruin; prudent persons and organizations must find other ways to deal with these exposures. To mitigate the financial consequences of loss exposures, several **risk management** techniques are available.

Risk management

The process of making and implementing decisions that will minimize the adverse effects of accidental losses on an organization.

Loss prevention

A risk control technique that reduces the frequency of a particular loss.

Loss reduction

A risk control technique that reduces the severity of a particular loss.

A person or an organization may choose to avoid a particular type of loss exposure. For example, a city dweller may avoid the loss exposures arising from the ownership, maintenance, and use of an automobile by not owning one and choosing to use public transportation. Loss exposures may also be controlled by **loss prevention** measures (such as the use of safety goggles and helmets by construction workers to reduce the frequency of injuries) and **loss reduction** measures (such as placement of fire extinguishers in the home or workplace to reduce the severity of fire losses).

Some loss exposures are not easy to retain, avoid, or control. For example, Ming lives sixteen miles from his workplace, and no public transportation is available. He also needs a car for grocery shopping, running errands, and seeing friends. Owning and operating a motor vehicle makes sense for him. However, this creates loss exposures for Ming; the bodily injury or property damage that can result from his negligent operation of the automobile could reach hundreds of thousands of dollars. He cannot afford to retain such loss exposures, and it is not practical to avoid them. Though he may keep his vehicle well maintained and drive safely to control these loss exposures, he cannot be certain of avoiding or minimizing the financial consequences of a serious accident. For Ming, the best risk management technique may be transfer, so that the financial consequences of loss will be borne by another party. Ming could use forms of noninsurance transfer, but insurance is probably the most economically viable choice for him.

Insurance as a Risk Transfer System

Insurance is a system that enables a person, a family, or an organization to transfer the costs of losses (the potential financial consequences of certain loss exposures) to an insurer. The insurer, in turn, pays for covered losses and, in effect, distributes the costs of losses among all insureds (that is, all insureds share the cost of a loss). 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 insurers, 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.

Transferring the costs of losses to an insurer would be unnecessary, however, if there were no exposures to loss—that is, no possibility that losses would occur. A loss need not occur for a loss exposure to exist; there simply must be the possibility of a loss. For example, every home has a fire loss exposure; in other words, the possibility exists that a fire could occur and cause a financial loss to the homeowner.

Sharing the Costs of Losses

Insurance also involves sharing the costs of losses. The insurer pools premiums paid by insureds, and insureds who incur covered losses are paid from the insurer's pooled funds. The total cost of losses is thereby spread (or shared) among all insureds. Insurers estimate future losses and expenses to determine how much they must collect from insureds in premiums. Predicting future losses is based on past loss experience.

The law of large numbers is a mathematical principle that enables insurers to make predictions about losses. According to the law of large numbers, as the number of similar but independent exposure units increases, the relative accuracy of predictions about future outcomes (losses) also increases. **Exposure units** are independent to the extent that they are not generally subject to the same loss-causing event. Because insurers have large numbers of independent exposure units (the cars and houses of all their insureds, for example), they can predict the number of losses that all similar exposure units combined are likely to experience.

Exposure unit

A fundamental measure of the loss exposure assumed by an insurer.

Insurance as a Business

The insurance business can be divided into two sectors. As depicted in the "Property-Casualty and Life-Health Insurance Premiums" exhibit, the **property-casualty insurance** sector accounts for just under half of the industry's premiums. Prevalent examples of property-casualty insurance include homeowners insurance, automobile insurance, and commercial general liability insurance. Examples of **life-health insurance**, which constitutes the other sector, include life insurance, health insurance, and disability insurance. Overall, the insurance business (including property-casualty insurers, life-health insurers, agents, and brokers) provides about 2.9 million jobs in the United States. Insurance premiums in the U.S. are around $1 trillion a year, and worldwide premiums are around $4 trillion. More than 2,700 insurers sell property-casualty insurance in the U.S.[1] See the exhibit "Property-Casualty and Life-Health Insurance Premiums."

Property-casualty insurance

One of the two main sectors of the insurance industry, encompassing numerous types of insurance, most of which cover the financial consequences of damage to one's own property or legal liability to others.

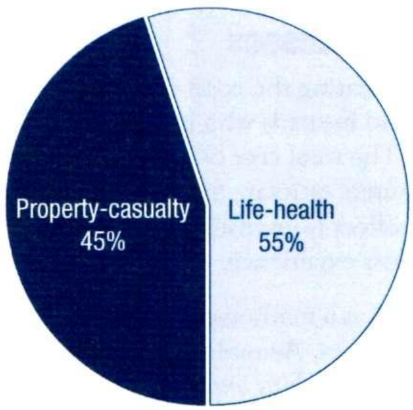
Life-health insurance

One of the two main sectors of the insurance industry, encompassing numerous types of insurance that cover the financial consequences of death, injury, or sickness.

Private (nongovernment) insurers vary enormously in size and structure, the products they sell, and the territories they serve; collectively they represent a substantial segment of business in the U.S. Despite their size and number, however, private insurers do not fill every insurance need. In some instances, federal and state governments provide insurance to meet the property and liability insurance needs of the public.

Through their insurance departments, state governments closely regulate the business of insurance. Private insurers must be licensed (for most types

Property-Casualty and Life-Health Insurance Premiums



Insurance Information Institute, The III Insurance Fact Book 2009 (New York: Insurance Information Institute, 2009), p. 13 [DA07610]

of insurance) in the states where they sell insurance. Because regulation of licensed insurers encompasses all insurer operations, state insurance regulators review insurance rates, policy forms, underwriting practices, claim practices, and financial performance. Regulators can revoke the licenses of insurers that do not fully comply with state regulations.

An insurer's revenue must, in the long run, match or exceed the amount it pays for claims and administrative expenses if the insurer is to remain financially viable. Therefore, an insurer's financial performance is very important, but not just to the insurer. State insurance regulators, insurance producers, stockholders, and insureds also need to be assured of an insurer's financial health.

The primary sources of revenue for insurers are premiums and investment income. Insurers have investments because they receive premiums before they pay for losses and expenses. Insurers invest the money in the meantime and receive investment income as a result. One of the goals of insurers is to generate enough revenue from premiums and income from investments to pay for losses, meet other expenses, and earn a reasonable profit.

In addition to loss payments, insurers incur several other types of expenses. Insurers have loss settlement expenses, which include the costs of investigating and settling claims. They also incur expenses to acquire new business (such as advertising costs and producers' commissions), and general expenses (such as salaries, employee benefits, utilities, telephones, and computer equipment). Insurers pay premium taxes, income taxes, and various licensing and other fees. Insurers have expenses associated with investment activities, such as the salaries of investment department staff members. The ability to pay these expenses and still make a reasonable profit is a measure of an insurer's success.

Insurance as a Contract

An insurance policy is a contract between the insurer and the insured. Through insurance policies, insureds transfer the possible costs of losses to insurers. In return for the premiums paid by insureds, insurers promise to pay for the losses covered by the insurance policy. This promise reduces the uncertainty or insecurity that insureds have about paying for losses that may occur. The coverage provided by insurance policies enables individuals, families, and organizations to protect their assets and minimize the adverse financial effects of losses. The contractual nature of the insurance policy gives legal force and protection to the rights and responsibilities of all of the parties.

An insurance policy must meet the same requirements as any other valid contract. That is, it must entail an agreement between competent parties for a legal purpose that involves the exchange of consideration. Additionally, insurance policies have certain special characteristics, including these key three:

- A contract of **utmost good faith**—Both parties to an insurance contract, the insured and the insurer, are expected to be ethical in their dealings with each other. An insurer that acts in bad faith, such as denying coverage for a claim that is clearly covered, could face serious penalties under the law. Conversely, an insurer could be released from a contract because of concealment or misrepresentation by the insured.
- A **contract of adhesion**—If a dispute arises between the insurer and the insured about the meaning of certain words or phrases in the policy, the insured and the insurer are not on an equal basis. The insurer either drafted the policy or used standard forms of its own choice; in contrast, the insured did not have any say in the policy wording. For that reason, if the policy wording is ambiguous, a court will generally apply the interpretation that favors the insured.
- A **contract of indemnity**—Property insurance generally pays the amount necessary to repair covered property that has been damaged or to replace it with similar property. The policy specifies the method for determining the amount of the loss. Liability insurance generally pays to a third-party claimant, on behalf of the insured, any amounts (up to the policy limit) that the insured becomes legally obligated to pay as damages because of a covered liability claim, as well as the legal costs associated with that claim. A contract of indemnity does not necessarily pay the full amount necessary to restore an insured who has suffered a covered loss to the same financial position. However, the amount the insurer pays is directly related to the amount of the insured's loss and will not enable the insured to profit from the loss.

Utmost good faith

An obligation to act in complete honesty and to disclose all relevant facts.

Contract of adhesion

Any contract in which one party must either accept the agreement as written by the other party or reject it.

Contract of indemnity

A contract in which the insurer agrees, in the event of a covered loss, to pay an amount directly related to the amount of the loss.

Self-contained policy

A single document that contains all the agreements between the insured and the insurer and that forms a complete insurance policy.

Modular policy

An insurance policy that consists of several different documents, none of which by itself forms a complete policy.

Insurers use two approaches when structuring an insurance policy. A policy's structure can be either self-contained or modular. One example of a **self-contained policy** is the Insurance Services Office (ISO) Personal Auto Policy. A widely used auto insurance policy, the Personal Auto Policy includes both property and liability insurance coverage in a single document. **Modular policies** combine coverage forms and other documents to tailor a policy to the insured's needs. Commercial package policies, for example, are modular policies.

COMMON TYPES OF PERSONAL AND COMMERCIAL INSURANCE

The coverage provided by personal and commercial insurance policies enables individuals, families, and businesses to protect their assets and minimize the adverse financial effects of loss.

Personal insurance policies cover individuals and families against their personal (nonbusiness) loss exposures. Commercial insurance policies cover for-profit businesses or not-for-profit organizations against their commercial loss exposures.

Personal Insurance

Personal insurance policies fall into these general categories:

Property insurance

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

Liability insurance

Insurance that covers losses resulting from the insured's liability to others.

- **Property insurance** protects an insured's assets by paying to repair or replace property that is damaged, lost, or destroyed, or by replacing the net income lost and the extra expenses incurred as a result of a property loss.
- **Liability insurance** provides for payment on behalf of the insured for injury to others or damage to others' property for which the insured is legally responsible. Liability insurance also covers the cost to defend the insured against claims or suits alleging that the insured is legally responsible for injury or damage that the policy covers.
- Life insurance replaces the income-earning potential lost through death and also helps to pay expenses related to an insured's death.
- Health insurance protects individuals and families from financial losses caused by sickness and accidents. Disability insurance is a form of health insurance that replaces an insured's income if the insured is unable to work because of illness or injury.

Personal insurance may be further divided into specific types of polices. See the exhibit "Common Types of Personal Insurance."

Common Types of Personal Insurance

- Homeowners
- Personal auto
- Personal watercraft
- Personal umbrella
- Life insurance
- Health insurance
- Annuities

[DA07568]

Property and Liability Insurance

A **homeowners policy** provides both property and liability coverage for individuals and families. The property coverage protects insureds for damage to the home and its contents caused by fire, wind, lightning, and other causes of loss. Most homeowners policies also include coverage for the theft or destruction of a home's personal contents. The homeowners policy also includes **personal liability coverage** for legal liability that covers an insured against allegations of negligence.

A **personal auto policy (PAP)** covers liability losses due to bodily injury to another person or damage to the property of others arising from an auto accident for which the insured is liable. It also covers damage to the vehicle resulting from a collision. **Comprehensive coverage** covers the vehicle for fire, theft, wind, contact with an animal, and other causes of loss.

The personal liability coverage in the homeowners policy and the auto liability coverage in the PAP exclude or limit coverage for operation of most watercraft. Therefore, a person who owns a boat may need a separate **personal watercraft policy** that covers both legal liability that may arise from accidents involving the boat and physical damage to the boat itself.

Juries often award large sums of money in liability cases. Additionally, many homeowners have significant assets to protect and may therefore require higher limits of insurance than those available under personal liability or personal auto coverage. The personal **umbrella liability policy** provides additional **liability coverage** for these two scenarios. It may also "drop down" to cover losses not insured under the underlying policies. Typical limits for a personal umbrella policy range from $1 million to $2 million or more. An excess policy provides an additional level of protection for large liability losses and brings peace of mind to clients with significant assets or unique exposures, such as a horse or a swimming pool.

Homeowners policy
Policy that covers most of the property and liability loss exposures that arise out of residential property ownership and occupancy, as well as property and liability loss exposures that individuals and families may have while they are away from their residences.

Personal liability coverage
Coverage for damages, plus costs of any defense, related to a claim or suit brought against the insured that resulted from bodily injury or property damage caused by an occurrence covered under the policy.

Personal auto policy (PAP)
An insurance policy that covers an individual or a family against loss exposures arising out of the ownership, maintenance, or use of automobiles.

Comprehensive coverage
Coverage for direct and accidental loss or damage to a covered auto by any peril except collision or overturn or a peril specifically excluded.

Personal watercraft policy
An insurance policy that covers an individual's or a family's loss exposures arising out of the ownership, maintenance, or use of watercraft used principally for recreational or personal transportation purposes.

Umbrella liability policy
A liability policy that provides excess coverage above underlying policies and may also provide coverage not available in the underlying policies, subject to a self-insured retention.

Liability coverage
Coverage that protects the insured from damages owed because of legal liability to another party. For auto policies, it protects insureds against liability arising out of the ownership or operation of automobiles.

Term life insurance
Life insurance that provides coverage for a specified period, such as ten or twenty years, with no cash value.

Permanent life insurance
Coverage until death.

Life and Health 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 replaces the income-earning potential lost through death and also helps to pay expenses related to an insured's death. Health insurance is designed to protect individuals and families from financial loss caused by accidents and sickness. Disability insurance is a form of health insurance that replaces an insured's income if the insured is unable to work because of illness or injury.

There are two main categories of life insurance: **term life insurance** and **permanent life insurance**. Term insurance may be an effective risk management strategy for young families who cannot afford high premiums but need protection for a parent's premature death. In contrast with term insurance, in which premiums increase at preset times in the life of the policy, permanent insurance premiums remain constant throughout the life of the policy.

Long-term care insurance
Insurance that pays for extended medical care or custodial care received in a nursing home, hospital, or home.

Annuity
A type of life insurance policy or contract that makes periodic payments to the recipient for a fixed period or for life in exchange for a specified premium.

Like life insurance, health insurance can be purchased on either an individual or a group basis. Medical insurance covers medical expenses that result from illness or injury. Disability income insurance provides periodic income payments to an insured who is unable to work because of sickness or injury. Disability insurance is primarily income replacement insurance that pays weekly or monthly benefits until the insured can return to work or until a maximum period has elapsed. **Long-term care insurance** provides coverage for nursing-home care and home-health care. As the United States population ages, long-term care coverage is becoming an increasingly important part of estate planning.

Annuities are an increasingly prevalent type of contract written by life insurers. The fundamental purpose of an annuity is to provide periodic income that an individual cannot outlive. Although an annuity's premiums are paid with after-tax dollars, the investment income is not currently taxable to the policyholder. The funds accumulate on a tax-deferred basis until they are actually received.

Commercial Package Policy (CPP)
Policy that covers two or more lines of business by combining ISO's commercial lines coverage parts.

Businessowners policy (BOP)
A package policy that combines most of the property and liability coverages needed by small and medium-sized businesses.

Commercial Insurance

Loss exposures that arise from business operations are covered under commercial insurance policies. See the exhibit "Common Types of Commercial Insurance."

Many business organizations purchase a **commercial package policy (CPP)** or a **businessowners policy (BOP)**. Both of these policies provide business owners with the necessary property, crime, and liability coverages in one policy. Traditionally, a business owner would have purchased several separate policies: one to protect the business against property losses, such as fire, and one or more to protect against potential liability losses. The CPP and the BOP protect the typical business owner from a variety of loss exposures. See the exhibit "Types of Insurance Policies—An Example."

Common Types of Commercial Insurance

- Commercial package
- Business owners
- Commercial auto
- Commercial property
- Commercial inland marine
- Commercial crime
- Commercial general liability
- Ocean marine
- Professional liability
- Environmental liability
- Commercial umbrella liability
- Workers compensation

[DA07569]

Types of Insurance Policies—An Example

Rob and his wife, Laurie, own a sandwich shop in a suburban shopping center. They also own a home and two cars. Rob and Laurie are concerned that damage to their business or home could result in substantial financial loss. They have contacted their insurance agent to discuss these concerns and to design an insurance program to meet their personal and commercial needs.

The insurance agent will determine Rob and Laurie's insurance policy needs by examining their loss exposures. Because Rob and Laurie have both personal and commercial loss exposures, they will need both personal and commercial insurance policies.

The personal insurance policies will cover losses arising out of Rob and Laurie's personal loss exposures related to the ownership of the home and cars. For loss exposures arising from the sandwich shop, Rob and Laurie will need commercial insurance policies.

[DA00422]

Commercial auto insurance covers an insured's legal liability arising out of the insured's ownership, maintenance, or use of an automobile. Legal costs to defend the insured are also included. **Auto physical damage coverage** provides protection for the loss of use or damage to a vehicle listed on the policy. Common causes of loss include collision, fire, theft, or collision with an animal.

Commercial property insurance covers damage to buildings and/or their contents resulting from fire, vandalism, and other causes of loss. Coverage

Commercial auto insurance
Insurance that covers a business or a not-for-profit organization against loss exposures arising out of the ownership, maintenance, or use of automobiles.

Auto physical damage coverage
Coverage for damage to or theft of a covered auto that can include both collision coverage and other than collision (comprehensive) coverage.

Commercial property insurance
Insurance that covers commercial buildings and their contents against various types of property loss.

is generally limited to property physically located on or near the insured's premises.

Ocean marine insurance

Insurance that covers vessels and their cargoes, including various vessel-related liability exposures.

Ocean marine insurance is one of the oldest forms of insurance. It covers ships and their cargo against losses like fire, lightning, and "perils of the sea." These include high winds, rough waters, running aground, and collision with other ships and objects. Most cargo that travels by water is insured as "ocean" or "wet" marine. Cargo transported by land is typically called "inland marine" or "dry marine."

Inland marine insurance

Insurance that covers many different classes of property that typically involve an element of transportation.

Commercial **inland marine insurance** covers mobile equipment and property used away from the insured premises by commercial enterprises. This coverage protects goods in domestic transit and property used in transportation and communication. While originally designed to protect cargo transported by land, inland marine insurance has changed to meet a growing global economy. It now covers property in transit worldwide and equipment used on job sites, such as backhoes and other mobile equipment.

Commercial crime insurance

Insurance that covers (1) money and securities against numerous perils (not limited to crime perils) and (2) property other than money and securities against crime perils, such as employee theft, robbery, theft by outsiders, and extortion.

Commercial crime insurance protects the insured against theft of contents such as cash registers, computers, and inventory. It also insures money that might be stolen in a robbery during business hours or in a burglary that occurs while the business is closed. Crime insurance can also cover theft of an employer's property (such as money or inventory) committed by employees.

Commercial general liability (CGL) insurance

Insurance that covers many of the common liability loss exposures faced by an organization, including its premises, operations, and products.

Commercial general liability (CGL) insurance offers broad protection against claims alleging that the insured is legally liable for bodily injury or for damage to the property of others. For example, a retail store could be responsible if a customer falls on the store's wet floor and is injured. Also, if a customer is injured by a product the store sold, the CGL policy would cover the store's legal liability. Even if a suit is groundless, the CGL policy offers protection and peace of mind to the business owner.

Professional liability insurance

Insurance that covers persons engaged in various occupations against liability resulting from their rendering or failing to render professional services.

Professional liability insurance covers professionals such as accountants, attorneys, or consultants for harm resulting from errors or omissions arising out of their professional practices. It also covers doctors, professional trainers, and other healthcare professionals, such as physical therapists, for injury to their customers or patients that results from their errors or omissions.

Environmental liability insurance offers business owners protection against environmental damage that may occur as a result of business operations. There are many federal, state, and local environmental statutes, regulations, and ordinances that can trigger enormous liability for business owners. Environmental liability insurance can help protect business owners from remediation and cleanup obligations triggered after an environmental incident, such as a leaking fuel tank. This type of coverage is desirable for businesses because the CGL policy excludes most pollution-related claims.

Commercial umbrella liability coverage is similar to the personal umbrella coverage. It provides additional limits beyond those provided by the CGL, commercial auto, and other policies, and protects the insured in the event of a large liability loss. It may also "drop down" to cover losses not insured under the underlying policies if the exposures are not excluded in the umbrella policy.

Workers compensation insurance pays the cost of medical care, lost wages, and other state-mandated benefits when employees are injured on the job or acquire a job-related illness, such as asbestosis. Because employers are required by law to pay certain benefits to injured or ill employees, these benefits are payable regardless of who caused the injury or illness. In return for this no-fault coverage, the employee generally loses the right to sue his or her employer.

Workers compensation insurance
Insurance that provides coverage for benefits an employer is obligated to pay under workers compensation laws.

Apply Your Knowledge

A firm of computer systems consultants would most likely purchase which one of the following types of coverage to protect them in the event that they provide incorrect advice that causes financial injury to a customer?

a. Commercial general liability insurance
b. Business auto insurance
c. Environmental liability insurance
d. Professional liability insurance

Feedback: d. Professional liability insurance covers professionals such as accountants, attorneys, or consultants for errors or omissions arising out of their professional practices.

IDEALLY INSURABLE LOSS EXPOSURES

Although insurers insure many loss exposures, not all loss exposures are ideally insurable. To be insurable, a loss exposure should have certain characteristics.

Most insured loss exposures do not completely embody all of the characteristics of an ideally insurable loss exposure. However, the criteria are useful to an insurer when deciding to offer new coverages or to continue offering existing coverages. See the exhibit "Six Characteristics of an Ideally Insurable Loss Exposure."

Pure Risk

The first characteristic of an ideally insurable loss exposure is that it should be associated with pure risk, not speculative risk. Pure risk entails a chance of loss or no loss, but no chance of gain. Conversely, a speculative risk presents the possibility of loss, no loss, or gain. Insurance is not designed to finance speculative risks. A purpose of insurance is to indemnify the insured for a loss,

Six Characteristics of an Ideally Insurable Loss Exposure

1. Pure risk—Involves pure risk, not speculative risk
2. Fortuitous losses—Subject to fortuitous loss from the insured's standpoint
3. Definite and measurable—Subject to losses that are definite in time, cause, and location and that are measurable
4. Large number of similar exposure units—One of a large number of similar exposure units
5. Independent and not catastrophic—Not subject to a loss that would simultaneously affect many other similar loss exposures; not catastrophic
6. Affordable—Premiums are economically feasible

[DA02747]

not to enable the insured to profit from the loss. Indemnification is the process of restoring the insured to a pre-loss financial condition. Limiting insurance coverage to only pure risks reduces the complexity of the loss exposures insured by the policy to two situations: having a loss or not having a loss.

Fortuitous Losses

The second characteristic of an ideally insurable loss exposure is that the loss associated with the loss exposure should be fortuitous (occurring by chance) from the insured's standpoint.

Some causes of loss may be fortuitous from one point of view only. For example, vandalism and theft are intentional (and therefore not fortuitous) acts from the perspective of the individual or organization committing the acts. However, vandalism and theft are fortuitous (and insurable) from the victim's standpoint because the victim did not intend or expect these acts to occur. Other causes of loss are fortuitous regardless of the perspective from which they are examined. For example, naturally occurring events such as windstorms, hail, or lightning are fortuitous events whether one is the insurer, the insured, or any third party associated with the loss exposure.

For a loss to be fortuitous, the insured cannot have control over whether or when a loss will occur. If the insured has control, the insured might have an incentive to cause a loss. This is known as a moral hazard. For example, arson committed by an insured is not a fortuitous act. Ideally, insurance is suitable for situations in which there is reasonable uncertainty about the probability or timing of a loss without the threat of a moral hazard. If insureds were compensated for losses they cause, they might be encouraged to generate losses for property they no longer wish to own. This practice could undermine the pricing structure for insurance and increase insurance premiums for all policyholders.

Definite and Measurable

The third characteristic of an ideally insurable loss exposure is that it is definite and measurable.

Three components are required for a loss exposure to be definite: time, cause, and location. The insurer must be able to determine the event (or series of events) that led to the loss, when the loss occurred, and where the loss occurred. For example, Cindy parks her car in a public parking lot and upon returning to her vehicle discovers that its driver's side door is badly damaged. She could state that this happened on a certain date and within a certain period of time. It was clear from the damage and transfer of paint chips that another vehicle had hit her car. Therefore, the cause of the damage is known. Because Cindy parked her car in the parking lot, the location was established.

All insurance policies have a policy period that specifies the precise dates and times of coverage. A typical property-casualty policy has a policy period ranging from six months to one year. As an example, the policy period for a homeowners policy is shown in the exhibit. In this policy, the policy period appears in the declarations.

The insurer usually needs to determine that the event occurred during the policy period. For some events, this may be a difficult process; insurers are reluctant to insure such events. For example, an insurer is considering insuring a gas station against environmental pollution. A definite environmental pollution loss would be a fire that ruptured an underground gas tank and caused gas to leak into the surrounding soil. However, had no fire occurred and had the tank been slowly leaking for an indeterminate number of years, it would be impossible to pinpoint the exact date or the cause of the pollution. Therefore, it may be impossible to determine whether the event occurred during the policy period. Because they are not definite, these types of loss exposures are not ideally insurable. See the exhibit "Homeowners Policy Declarations."

Homeowners Policy Declarations

Homeowners Policy Declarations

POLICYHOLDER: **(Named Insured)**	David M. and Joan G. Smith 216 Brookside Drive Anytown, USA 40000		**POLICY NUMBER:**	296 H 578661
POLICY PERIOD:	**Inception:** **Expiration:**	March 30, 20X1 March 30, 20X2	**Policy period begins 12:01 A.M. standard time at the residence premises.**	

A loss exposure also needs to be measurable to be ideally insurable. Insurers cannot determine an appropriate premium if they cannot measure the frequency or severity of the potential losses. For example, a house fire is a measurable loss exposure. Underwriters can analyze data from past fire losses to single-dwelling, wood-frame homes within a set geographic area. From the analysis, frequency and severity patterns are used to determine potential fire losses and the premium needed. In addition, the cost to repair or replace a house damaged by fire can be objectively measured before a loss, and coverage can be priced accordingly.

Conversely, contagious diseases are an example of a potential loss exposure that is difficult to measure. Flu viruses mutate constantly. The strength of the virus, as well as the age group susceptible, may vary from one flu season to the next. Also, the geographic territory where the virus strikes can vary from year to year. All these factors make it difficult for an underwriter to measure future losses. Insurers are reluctant to insure losses that are highly uncertain without receiving substantial compensation (high premiums).

Large Number of Similar Exposure Units

The fourth characteristic of an ideally insurable loss exposure is that the loss exposure is one of a large number of similar exposure units. Some common loss exposures that satisfy this requirement include homes, offices, and automobiles. Each exposure unit has a value that can be at risk when exposed to loss.

For example, Steve purchases a single-family home for $200,000. He faces loss exposures of fire, theft, burglary, windstorm, hail, collapse, and so forth. His exposure is the value of his home. If the home were destroyed by fire, he could not afford to replace it. This risk is transferred with the purchase of a homeowners insurance policy. The insurer does not want to insure only Steve's home, but rather thousands of single-family homes that face similar exposures. Based on past losses, the insurer knows that although all homes have a fire exposure, only a small percentage will experience a fire loss. The insurer can therefore spread the risk of fire loss over its entire pool of insured homes and thereby maintain manageable premium levels.

Independent and Not Catastrophic

The fifth characteristic of an ideally insurable loss exposure is that it is independent and not catastrophic. Independent means that a loss suffered by one insured does not affect any other insured or group of insureds. For example, Steve's home is located in a large subdivision of 1,000 homes and is surrounded by a wooded area. Steve's insurer would not want to insure all the homes in the subdivision because the forest fire loss exposure would put all 1,000 homes at risk of fire. The risk would not be independent for each home.

A catastrophic loss is severe; it involves numerous exposure units suffering the same type of loss simultaneously, with significant financial consequences for the insurer. Insurance operates economically because many insureds pay premiums that are small relative to the cost of the potential losses they could each incur. The cost can stay relatively small because insurers project that they will incur far fewer losses than the loss exposures they have. However, if a large number of insureds who are covered for the same type of loss were to incur losses simultaneously, the insurance mechanism would not operate economically and losses to the insurer could be catastrophic.

For example, to avoid a catastrophic hurricane loss, an insurer will diversify the homes and businesses it insures and will not have a large concentration in any one geographic area. Single events or a series of events can also present catastrophic risk to an insurer. Similarly, a small insurer should not insure a multimillion-dollar property, such as an oil refinery. Although the loss exposure may be independent of the other properties the insurer has chosen to insure, a loss at such a single location may cause the insurer severe financial difficulty.

Affordable

The final characteristic of an ideally insurable loss exposure is that the insurer is able to charge an economically feasible premium—one that the insured can afford to pay. Insurers seek to cover only loss exposures that are economically feasible to insure. Because of this constraint, loss exposures involving only small losses, as well as those involving a high probability of loss, are generally considered uninsurable.

Writing insurance to cover small losses may not make sense when the expense of providing the insurance probably exceeds the amount of potential losses. Insurance covering the disappearance of office supplies, for example, could require the insurer to spend more to investigate and to issue claim checks than it would for the insured to simply absorb the cost of replacing the supplies.

It also may not make sense to write insurance to cover losses that are almost certain to occur. The premiums would probably be as high as or higher than the potential amount of the loss. For example, insurers generally do not cover damage because of wear and tear on an automobile because automobiles are certain to incur such damage over time.

Apply Your Knowledge

Jim's summer job is to work as an intern for an insurance agency. When preparing a listing of the agency's homeowners book of business, Jim notes that seventy-five clients' homes are located within one-half mile of the river in a designated flood plain. Jim is concerned because one of the agents told him that flood exposure is not covered under the homeowners policy. Jim proposes to his manager that the agency sell a flood coverage endorsement to each of the homeowners clients. Jim's manager reviews with Jim the six characteristics of an ideally insurable loss exposure. Jim determines that the exposure of flood possesses only three of the six characteristics: pure risk, fortuitous losses, and definite and measurable.

If you were in Jim's position, how would you arrive at this determination?

Feedback: The exposure is a pure loss because a loss that occurs as a result of a flood does not result in financial gain for the insured; thus, there is either a loss or no loss. It is fortuitous because the insured does not have control over whether and when a flood loss will occur. It is definite in time, cause, and location, and flood data are available that can be measured. Conversely, there is not a large number of similar exposure units. Additionally, the loss is not independent because all of the homes in the flood plain will be exposed. Finally, because only those who believe they are at risk for a flood loss would purchase the flood endorsement, the insurer will not be able to offer an economically feasible premium.

BENEFITS OF INSURANCE

Insurance is a prominent risk management technique, and several risk financing measures involve the use of insurance to some degree. It is therefore important for risk management and insurance professionals to consider the benefits of insurance when selecting the most appropriate techniques for meeting risk management goals.

When used as a risk financing measure, insurance can help an individual or organization achieve risk financing goals such as paying for losses, managing cash flow uncertainty, and complying with legal requirements. Insurance also provides benefits to individuals, organizations, and society as a whole by promoting insureds' loss control activities, enabling insureds to use resources efficiently, providing support for insureds' credit, providing insurers with a source of investment funds, and reducing social burdens.

Paying for Losses

The primary role of insurance is to indemnify individuals and organizations for covered losses. This benefit is consistent with the risk financing goal of paying for losses. Provided that the loss is to a covered loss exposure and a covered cause of loss, insurance will indemnify the insured, subject to any applicable deductibles and policy limits.

Managing Cash Flow Uncertainty

Insurance also enables an individual or organization to meet the risk financing goal of managing cash flow uncertainty. Insurance provides the insured with some degree of financial security and stability. The insured can be confident that as long as a loss is covered, the financial effect on the insured's cash flow is reduced to any deductible payments and any loss amounts that exceed the policy limits. The remainder of the loss will be paid by the insurer, reducing the variation in the insured's cash flows.

Meeting Legal Requirements

The final risk financing goal that insurance meets is the goal of meeting legal requirements. Insurance is often used or required to satisfy both statutory requirements and contractual requirements that arise from business relationships.

For example, all states have laws that require employers to pay for the job-related injuries or illnesses of their employees. Employers generally purchase workers compensation insurance to meet this financial obligation. In addition, 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.

Promoting Risk Control

A major benefit of insurance is the promotion of risk control. Insurance often provides the insured with the incentive to undertake cost-effective risk control measures. Insurers provide this incentive through risk-sharing mechanisms such as deductibles, premium credit incentives, and contractual requirements.

Because these incentives can lead to a reduction in losses paid by the insurer and therefore lower premiums, they benefit not only the individual insured but also all other insureds. Furthermore, risk control measures can save not only financial resources but also the lives of individuals or employees. Therefore, society as a whole benefits.

Enabling Efficient Use of Resources

People and businesses that face an uncertain future often set aside funds to pay for future losses. However, insurance makes it unnecessary to set aside a large amount of money to pay for the financial consequences of loss exposures that can be insured. In exchange for a relatively small premium, individuals and organizations can free up additional funds. As a result, the money that would otherwise be set aside to pay for possible losses can be used to improve an individual's quality of life or to contribute to the growth of an organization.

Providing Support for Insured's Credit

Insurance can also provide support for an insured's credit. Before making a loan, a lender wants assurance that the money will be repaid. For example, when loaning money to a borrower to purchase property, the lender usually acquires a legal interest in that property. This legal interest enables the lender to take actions such as repossessing a car or foreclosing a home mortgage if the loan is not repaid. Without this ability to recover the loan amount, the lender would be less likely to make the loan. Insurance facilitates loans to individuals and organizations by guaranteeing that the lender will be paid if the collateral for the loan (such as a house or a commercial building) is destroyed or damaged by an insured event, thereby reducing the lender's uncertainty.

Providing Source of Investment Funds

Insurance provides a source of investment funds for both insureds and insurers:

- Insureds are not required to set aside large retention funds to pay for losses that are covered by insurance.
- The premiums collected by insurers are invested until needed to pay claims. Such investments can provide money for projects such as new construction, research, and technology advancements.

Insurers also invest in social projects, such as cultural events, education, and economic development projects. Investment funds promote economic growth and job creation that, in turn, benefit individuals, organizations, and society. Also, because investment brings additional funding to insurers in the form of interest, this additional income helps keep insurance premiums at a reasonable level.

Reducing Social Burdens

Finally, insurance can help reduce social burdens. For example, the social costs of natural disasters, such as Hurricanes Katrina and Rita in 2005, are increased by uninsured losses suffered by individuals and organizations that can amount to billions of dollars. Without other assistance, the victims of natural disasters would rely on the state or federal government. Insurance helps to reduce this burden by providing compensation to the affected parties.

Compulsory auto insurance is another example, because it provides compensation to auto accident victims who might otherwise be unable to afford proper medical care or who might be unable to work because of the accident. Without insurance, victims of job-related or auto accidents might become a burden to society and need some form of state welfare. See the exhibit "Benefits of Insurance."

Benefits of Insurance

Benefit	Explanation
Pay for losses	The primary role of insurance is to indemnify (restore to pre-loss status) individuals and organizations for covered losses.
Manage cash flow uncertainty	Insurance provides financial compensation when covered losses occur. Therefore, insurance greatly reduces the uncertainty created by many loss exposures.
Comply with legal requirements	Insurance can be used both to meet the statutory and contractual requirements of insurance coverage and to provide evidence of financial resources.
Promote risk control activity	Insurance policies may provide insureds with incentives to undertake risk control activities as a result of policy requirements or premium savings incentives.
Efficient use of insured's resources	Insurance makes it unnecessary to set aside a large amount of money to pay for the financial consequences of loss exposures that can be insured. This allows that money to be used more efficiently.
Support for insured's credit	Insurance facilitates loans to individuals and organizations by guaranteeing that the lender will be paid if the collateral for the loan (such as a house or a commercial building) is destroyed or damaged by an insured event, thereby reducing the lender's uncertainty.
Source of investment funds	The timing of insurer's cash flows, premiums collected up front, and claims paid at a later date enable insurers to invest funds in a variety of investment vehicles.
Reduce social burden	Insurance helps to reduce the burden to society of uncompensated accident victims.

[DA02722]

COSTS OF INSURANCE

Although not free, insurance has benefits that outweigh the costs, and insurance is considered to have a meaningful economic and social purpose.

The costs of insurance include these:

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

Premiums Paid by Insureds

Insurers charge premiums to generate the funds necessary to make loss payments. For an insurer to be fiscally sound, its total revenue (premiums and investment income) must equal or exceed the amount needed to pay for losses and business expenses. For example, an insurer may use eighty cents of every premium dollar to pay for losses and twenty-five cents for other expenses. If the insurer can earn an amount equal to 5 percent of its premiums on its investments, it can break even.

Despite the fact that insurance premiums, by law, must not be excessive, insureds may believe that their premiums are too high, because the benefits of insurance may be intangible unless the insured suffers a covered loss and the subsequent claim is paid. Realistically, insurance premiums should be considered a cost of living and doing business in an industrialized society.

Operating Costs of Insurers

As with any other business, an insurer has operating costs that must be paid to continue the day-to-day operations of the company. Insurers' operating costs include salaries, producers' commissions, advertising, building expenses, equipment, taxes, licensing fees, and so forth. In addition, most insurers are in business to earn a profit, so a reasonable amount of income must be calculated into the premiums paid by insureds to, in effect, compensate the investors in the company.

Opportunity Costs

Capital and labor being used in the insurance industry could be used elsewhere and could create other productive contributions to society. Therefore, the resources used in the operations of the insurance industry represent lost opportunities in other areas—that is, opportunity costs. These opportunity costs are one of the costs of insurance.

Increased Losses

The existence of insurance may encourage losses. Although insurers have an economic incentive to provide and encourage risk control measures, insureds may have an economic incentive to claim losses.

Recent statistics show that, in a single year, 26,500 structural fires and 15,000 vehicle fires were intentional. Property damage from these fires amounted to approximately \$684 million in structural damage and \$108 million in vehicle damage.[2] These figures do not include indirect costs, such as business interruption, loss of use, and temporary shelter costs, nor do they take into consideration human suffering and human loss exposure costs, such as medical expenses and funeral costs. Many cases of arson or suspected arson involve insurance—some property owners would rather have the insurance money than the property.

Arson is an intentionally staged event and constitutes insurance fraud, but a more prevalent form of insurance fraud is the intentional exaggeration of a loss in an otherwise-legitimate claim, also referred to as claim buildup. For example, an insured may claim that four items were lost rather than the actual three or that the items were worth more than they actually were. In liability claims, claimants may exaggerate the severity of their bodily injury or property damage. Physicians, lawyers, contractors, and auto body shop operators may also participate in claim buildup.

Insurers are actively involved in the fight against insurance fraud and use various techniques to detect and investigate suspicious claims. Nevertheless, insurance fraud is a serious problem that results in billions of dollars in excess insurance payments each year. Fraudulent claims increase costs for both insurers (in terms of payment for fraudulent claims and the costs of investigating and resisting fraud) and insureds (who pay increased premiums to help cover the costs of those who defraud insurers).

Some losses may not be deliberately caused, but they may result from carelessness on the part of an insured because insurance is available to pay for losses if they do occur. Routinely leaving the keys in an unlocked car is an example of such carelessness. If the car is stolen, the insured would suffer only minimal financial consequences because the insurer will pay for the loss. The additional losses that result from insureds' carelessness increase the cost of insurance for everyone, because insurers often pay for injuries and damage that insureds could have prevented.

SUMMARY

Insurance may be viewed as a risk management technique, as a transfer system in which one party (the insured) transfers the chance of financial loss to another party (the insurer), as a business, and as a contract between the insured and the insurer that states the 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.

Many types of property-casualty insurance policies cover personal loss exposures. The loss exposures of individuals and families are mainly related to their residences, personal vehicles, or owned watercraft. Common types of personal insurance policies are homeowners policies, PAPs, and watercraft policies. A variety of life and health policies protect the health, medical well-being, and lives of families and individuals. Life and health policies include life insurance, health insurance, disability insurance, long-term care insurance, and annuities.

Commercial insurance policies often combine coverages into a single CPP or a BOP and may include commercial auto, commercial property, ocean marine, commercial inland marine, commercial crime, CGL, professional liability, environmental liability, commercial umbrella, and workers compensation coverage.

These are the six characteristics of an ideally insurable loss exposure:

- Pure risk—Involves pure risk, not speculative risk.
- Fortuitous losses—Subject to fortuitous loss from the insured's standpoint.
- Definite and measurable—Subject to losses that are definite in time, cause, and location and that are measurable.
- Large number of similar exposure units—One of a large number of similar exposure units.
- Independent and not catastrophic—Not subject to a loss that would simultaneously affect many other similar loss exposures; loss would not be catastrophic.
- Affordable—Premiums are economically feasible.

The benefits of insurance include paying for losses, managing cash flow uncertainty, complying with the law, promoting risk control, allowing efficient use of the insured's resources, providing support for the insured's credit, providing a source of investment funds, and reducing social burdens.

The costs of insurance include these:

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

ASSIGNMENT NOTES

1. Insurance Information Institute, The III Insurance Fact Book 2009 (New York: Insurance Information Institute, 2009), p. 13.
2. Insurance Information Institute, The III Insurance Fact Book 2011 (New York: Insurance Information Institute, 2011), p. 147.