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ADVOCATE

Insurance 101: Property-Casualty Basics

Every day, individuals and businesses face a variety of potentially catastrophic risks. By creating tools to manage uncertainty and loss, property-casualty insurers are able to provide vital personal and professional protection. In addition, property-casualty insurance helps provide and maintain a reliable foundation for our economy. Despite these fundamental roles property-casualty insurance plays in the lives of virtually every American, relatively few people outside of the insurance industry understand how it works.

*This issue of the **AIA Advocate** looks at the basic concepts of property-casualty insurance, providing a plain-English primer on several key topics. The middle pullout page provides background on how insurance benefits our economy and society, as well as a glossary of common insurance terms.*

Insurance Helps People Manage Risk

Risk is inevitable in society; insurance helps address that reality. Insurance allows individuals or organizations to exchange the risk of a large loss for the certainty of smaller periodic payments, known as *premiums*. The exchange (or transfer) of risk is laid out in a legal contract called the insurance *policy*, which spells out the coverage, compensation, and/or other benefits.

Insurance takes on (or assumes) "pure" risk — the possibility of suffering harm or loss. (Insurance is not for "speculative" risks, like gambling, where financial gain is possible.) If a loss occurs, the policyholder simply is restored to the same condition as before the loss. Examples of risk covered by insurance include fire, theft, tornadoes, motor vehicle crashes, and being sued for causing harm to another person.

Risk has two key dimensions—frequency and severity—and both help determine insurability. "Frequency" relates to how often a loss occurs, i.e., whether the risk/event is common or relatively rare. "Severity" relates to how costly losses resulting from that risk could be, i.e., whether they could be relatively inexpensive or truly catastrophic in nature.

Severity ↑		
	LOW FREQUENCY HIGH SEVERITY	HIGH FREQUENCY HIGH SEVERITY
	LOW FREQUENCY LOW SEVERITY	HIGH FREQUENCY LOW SEVERITY
	Frequency →	

In the table above, insurance can be an appropriate method of risk transfer for low-frequency, high-severity losses (e.g., house fires or tornadoes), as well as for high-frequency, low-severity losses (e.g., motor vehicle crashes). However, insurance may not be the most appropriate method for treating all risks facing individuals and businesses. For example, insurance could be too expensive for certain risks (low-frequency, low-severity) or unavailable for other risks (such as high-frequency, high-severity risks, or risks whose frequency and/or severity is difficult to predict, such as terrorism). Additionally, insurance may be unable to fully compensate for a loss (e.g., the destruction of family photos, which have great emotional value but little financial value).

In taking on massive amounts of societal risk, the insurance industry relies on two fundamental tools: *pooling* and the *Law of Large Numbers*. An insurer can cover the risk of losses from a few policyholders by combining (pooling) together the premiums from a much larger group of policyholders. This also improves predictability, thanks to a statistical principle known as the Law of Large Numbers, which states that the accuracy of loss prediction increases with the number of policyholders in the pool.

Insurance also handles risk by working to prevent losses to lives and property. Loss prevention (also known as loss control or mitigation) is a core function of the insurance business and has benefited society immeasurably. See "Two Functions of Property-Casualty Insurance" in the pullout section for some examples of how the property-casualty industry created and continues to support many important public safety systems and world-class safety organizations.

Property-Casualty Insurance: Origins and Types

Property-casualty insurance traces its modern history back to marine insurance in the late Middle Ages. With an increase in maritime trading, merchants and bankers became concerned about the safety of shipments due to piracy, storms, and other perils. The bankers provided guarantees against loss; in return, merchants paid the bankers a fee for this protection.

Fire insurance, and what became the modern insurance industry, developed primarily in England after the Great London Fire in 1666. The U.S. property-casualty insurance market evolved from British practices; the first U.S. fire insurer was started by Benjamin Franklin in 1752. By the early 1900s, many major types (or "lines") of insurance we know today had developed.

Today, this segment of the insurance industry provides protection from risk in two basic areas: protection for physical items, such as houses, personal possessions, cars, commercial buildings, and inventory (property), and protection against legal liability (casualty).

Property insurance is a "first-party" coverage for losses related to a policyholder's own person/property. Casualty (or liability) insurance is a "third-party" coverage for a policyholder's legal obligations against losses the policyholder may cause to others.

These two basic types of coverage are written for both individuals or families ("personal lines" policies) and businesses ("commercial lines" policies).

Personal lines policies include homeowners insurance, renters insurance, and vehicle coverage. For example, homeowners policies cover both fire damage to a house and/or contents, plus legal defense costs and liabilities should a person be injured on the policyholder's property.

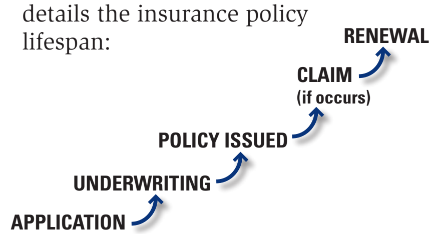
Commercial lines products are written for businesses and other organizations (churches, schools, cities, non-profits), and include packages such as "Business Owners Policies" as well as commercial general liability, workers' compensation, commercial property, and product liability insurance.

Commercial property policies cover buildings and the organization's property, and include a type of coverage known as "business interruption" designed to help a company continue operating if it is put out of its office/physical plant by a covered risk. Commercial liability policies protect policyholders against financial responsibility for injury or property damage resulting from a policyholder's premises, products, services, or other operations. One example of commercial casualty coverage is workers' compensation, which deals with lost earnings and medical expenses of employees injured on the job.

The specific scope and limits of coverage in all of these examples are spelled out by an individual insurance policy. The next section of this ***AIA Advocate*** examines this essential contract.

The Insurance Transaction

An insurance policy is a binding legal contract with very specific terms, conditions, and promises by both insurance company and policyholder. The policy describes in detail what is—and what is not—covered. The following diagram details the insurance policy lifespan:



Using the example of a typical homeowners insurance product, here is how the process works:

Application – The customer contacts an insurance agent or insurance company directly to inquire about the types of coverage available and costs related to coverage for a specific need (such as a new house). The customer fills out an application, which is then sent to an insurance company underwriter.

Underwriting – Through the underwriting process, the insurance company determines which customers to insure and what coverages to offer. The insurer considers the insurance agent's recommendation (if an agent is involved), the amount of coverage requested, the policyholder's loss and insurance history, as well as several other objective, actuarially derived factors. The insurance company will accept the application, reject the application, or accept the application with modifications. Except as limited by state law, these modifications can include higher deductibles, changes to the coverage limits or premium, or changes to the coverage by the use of "endorsements" (specific policy revisions that provide greater or lesser coverage than allowed under the standard/base policy form).

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How Insurance Benefits Society and the Economy

- **Improving consumer and worker safety:** Insurance makes businesses and individuals more aware of the risks they face and provides motivation to prevent losses. For example, insurers provide premium discounts to safe drivers and to businesses that implement effective worker safety programs.

- **Protecting consumer transactions:** Most consumers have to borrow money to buy homes and cars; lenders require insurance in order to secure the loans they make for these purchases. Without insurance, few people could obtain an auto loan or home mortgage.

- **Protecting business transactions:** Without insurance, most businesses would find that they could not operate. Insurance enables businesses of all sizes and types to manage the risks that are an inherent part of any business operation (e.g., signing contracts, financing and expanding operations, manufacturing and distributing products, providing services, hiring employees).

- **Providing recovery from catastrophes:** Hurricanes, winter storms, fires, and other disasters can cause tremendous, sudden loss to many people all at once. Insurance coverage enables businesses to replace inventories and rebuild buildings, and allows homeowners to repair and rebuild homes and replace property.

- **Providing trillions of dollars to the U.S. economy each year:**

  - The property-casualty insurance industry pays out more than $300 billion annually in policy benefits.

  - Property-casualty insurers doing business in the United States have more than $1 trillion invested in the economy, through stock, corporate and government bonds, and real estate mortgages. These investments finance building construction and provide other crucial support to economic development projects all across the country.

  - Property-casualty insurers are a major source of capital for state and local government in the United States. Insurers held a total of over $266.4 billion in state municipal bonds in 2004. This represents approximately 16 percent of the current outstanding state and local government debt. Insurers invest in a variety of public projects, such as airport, hospital, and highway construction. Insurers also purchase general obligation bonds used to finance ongoing government operations.

  - There are approximately 3,000 companies providing property-casualty insurance coverage in the United States. About 100 of these companies provide the majority of the property-casualty coverage.

  - About 1.3 million people are employed by the property-casualty industry, including insurance companies, agencies, and brokerages. ●

Two Functions of Property-Casualty Insurance

Preventing Losses

Property-casualty insurance is about preventing losses (injuries, deaths, and/or property damage) from occurring in the first place; through their everyday business practices, insurers are dedicated to reducing injuries, deaths, and property damage; in this way, the interests of insurers, their customers, and the general public are exactly in line.

Listed below are a few of the many public safety organizations that insurers have started throughout their history.

Insurance companies were the first firefighters. They started the fire service, and supported, improved, and standardized it. Fire brigades in the early days were run by insurance companies, and even after fire-fighting was undertaken by local governments, the industry still played an active role through the National Board of Fire Underwriters (NBFU), which was created in 1866. (AIA is descended from the NBFU).

Insurance companies created the National Fire Protection Association (NFPA) in 1896. The NFPA remains the world's leading advocate of fire prevention and public safety. The organization was the driving force behind building and electrical codes; and now NFPA codes influence every building, design, and installation in the United States as well as many across the world.

Insurers started the Underwriters Laboratories over a hundred years ago. The UL mark is among the most universally recognized and sought consumer product safety certifications.

The Insurance Institute for Highway Safety (IIHS) was founded in 1969 for the specific purpose of conducting high-quality, independent research looking at motor vehicle technology and design, driver and occupant safety systems and behavior, and roadway engineering. IIHS research has led to safety innovations that have saved thousands of lives; its work has spread worldwide.

Individual homes and commercial buildings are made safer through the work of the Institute for Business & Home Safety (IBHS). IBHS was established by the insurance industry to reduce the social and economic effects of natural disasters and other property losses by conducting research and advocating improved construction, maintenance, and preparation practices.

Helping Recover from Loss

Property-casualty insurance is about facilitating recovery from losses suffered by individuals or businesses – whether those losses are relatively small (such as a fender bender) or truly catastrophic (such as a hurricane).

- Insurance helps individuals, businesses, and entire communities stay financially stable and recover from unanticipated – and potentially ruinous – losses. As a result, jobs are protected, taxes continue to be paid, and goods and services continue to be produced and provided.

- Insurance policies (contracts) provide protection against financial losses that occur as the result of certain specified causes. For example, if you are involved in an automobile crash, health insurance or auto insurance would pay your medical bills and those of your passengers; auto insurance would pay for repairs to your vehicle, and for losses your driving causes to other people or property. ●

Brief Glossary of Key Property-Casualty Insurance Terms

Assigned Risk Plans (Automobile Insurance Plans): A mechanism used in some states to insure people who cannot obtain insurance in the voluntary market. There is one rate level and the individual policies are assigned to specific companies according to the percentage of the market they insure.

Combined (Loss/Expense) Ratio: An important measure of underwriting and profitability, this figure represents the percentage of each premium dollar that an insurer spends on claims and expenses (i.e., a combination of the "loss ratio" and "expense ratio"). A combined ratio of less than 100 percent indicates a profit; anything over 100 represents a loss.

Exclusion: A provision in an insurance policy that denies coverage for certain perils, persons, property, or location.

Expense Ratio: This figure represents the insurer's operating expenses divided by net premiums written (expenses include salaries, commissions, administrative expenses, losses, and loss adjustment expenses).

FAIR (Fair Access to Insurance Requirements) Plan: A facility, operating under a government-insurance industry cooperative program, to make fire insurance and other forms of property insurance readily available to people who have difficulty obtaining such coverage.

Loss Control: Methods to reduce the cost and/or frequency of risk through prevention and mitigation. Simple, common examples of risk management/loss control include wearing a seat belt, installing deadbolt locks or security systems, making factory workers wear safety goggles, and installing fire suppression systems.

Loss Ratio: Percentage of each premium dollar that an insurer spends on claims. Example: A loss ratio of 94 means that the insurer spends 94 percent of each $1 of premiums on claims.

Pool: An organization of insurers or reinsurers through which particular types of risks are underwritten with premiums, losses, and expenses shared in agreed ratios.

Reinsurance: Just as individuals purchase insurance to spread the risk of possible losses, primary insurers need a way to transfer some of these losses too, so they turn to "reinsurers." Reinsurance is an agreement between two property-casualty insurers to share financial consequences of a loss. The primary insurer buys reinsurance (essentially, insurance for insurance companies) in order to diversify and transfer risks, and to share potentially devastating losses.

Reserve: This term can apply to: 1) an amount representing actual or potential liabilities kept by an insurer to cover obligations to policyholders and third-party claimants; or, 2) an amount allocated for a special purpose. Note: A reserve is usually a liability and not an extra fund. On occasion, a reserve may be an asset, such as a reserve for taxes not yet due.

Residual Market: A general term describing the total of all consumers who have had difficulty purchasing insurance through normal channels. Automobile Insurance Plans, FAIR Plans, reinsurance facilities, and Joint Underwriting Associations all service this market.

Risk Retention: A term meaning that the policyholder pays for part or all of the losses associated with a particular risk. Retention can be deliberate or unintentional. Deliberate risk retention includes such things as: 1) agreeing to a particular level of "deductible" as part of purchasing an insurance policy; or 2) a business or individual covering the cost of low frequency-low severity events, or high frequency-low severity events (such as flat tires on cars, shoplifting at grocery stores, or damage to household possessions). Unintentional risk retention may result because an individual or business simply did not realize that some type of risk was not covered by their insurance policy.

Statutory Accounting Principles (SAP): State legal requirements that insurers must follow when submitting financial statements to the various state insurance departments. Such principles differ from Generally Accepted Accounting Principles (GAAP) in some important respects. For example, SAP requires that expenses must be recorded immediately and cannot be deferred to track with premiums as they are earned and taken into revenue.

Surplus Lines: Any risk or part thereof for which insurance is not available through a company licensed in the policyholder's state (licensed insurers are also known as "admitted" insurers). The business, therefore, is placed with "non-admitted" insurers (insurers not licensed in the state) in accordance with surplus or excess lines provisions of state insurance laws.

TYPES OF INSURERS

Stock Companies: Formed to make money for shareholders, who actually own the company. Also known as "public" companies, because their shares are publicly traded.

Mutual Companies: Owned by the policyholders; like shareholders at stock companies, policyholders of mutual companies receive dividends if operations are profitable.

Captives: Wholly owned subsidiary of a business organization or group of affiliated organizations that exists for a limited purpose: to provide all or part of the parent organization's insurance coverage.

Risk Retention Groups: Limited by law to providing product liability and other commercial liability insurance coverage for collections of similar entities with similar risk exposures.

Reciprocals: Unincorporated associations that provide insurance services only to their members, known as "subscribers." ●

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Issuing the Policy – The policy is then sent to the policyholder (also known as an "insured"). The policy includes the following: a "declarations page" (important information about the policyholder, exposures and coverage to be provided); an insuring agreement (the insurer's promise to pay for covered losses); modifications ("exclusions" eliminate coverage for certain property or situations, while "conditions" specify what is required of the policyholder and insurer to ensure that losses are covered); and endorsements. It is the policyholder's responsibility to read the policy and make sure the coverage provided is what was requested. At this time, the policyholder also is required to submit the premium payment.

Claims – Fortunately, most policyholders do not suffer losses that lead them to submit claims under their insurance policies. When a claim is made, how it is handled depends on the type of loss involved.

Property claim: In the event of loss, the policyholder calls their agent or company claims department to report the loss/file a claim. The claims representative (known as an "adjuster") will investigate the loss, including verifying coverage for the particular risk; they also will determine whether a policy is in force, and prepare a repair estimate.

Liability claim: If a third party makes a claim alleging that the policyholder is responsible for damage to/losses by the claimant (e.g., a guest falls down the policyholder's stairs and injures their back), the insurance company claims representative would assess the claim, verify insurance coverage, and interview the policyholder, claimant, and the claimant's medical doctor to determine the extent of injuries and negligence.

Liability claim costs generally are broken down into two categories: 1) special damages, which include the claimant's out-of-pocket expenses and lost wages; and, 2) general damages, which cover compensation for pain and suffering (often called non-economic damages).

The claim representative/adjuster has the responsibility to offer a fair settlement to the injured party (whether first- or third-party), but can offer only up to the dollar limits of the policy. Once the claimant and company agree on the amount of loss, the company pays that amount (less the amount of a deductible in first-party claims). If there is disagreement over the claim, the matter may go to arbitration, mediation, or court for resolution.

Renewal – Most policies (especially personal lines) run for either six months or 12 months and are renewed at the end of that period. However, policies also can be cancelled or non-renewed by either the policyholder or the insurer. The policyholder can choose to cancel the policy during the policy period or move to another insurer at the end of the policy period (non-renew). The insurer can decide to non-renew a policy if the insured has had an unacceptable number of claims, and can cancel a policy during the policy period for non-payment of premium or other specific reasons. State laws place restrictions on the ability of insurance companies to cancel or non-renew. Advance notice to the policyholder is required in both instances.

The Challenge of Determining Premiums

The lifespan of the insurance policy outlined above illustrates one of the fundamental differences between insurance products and other products. Issuing the policy (and thus collecting premiums) comes before paying out the claims, sometimes years or even decades before.

For most economic goods, the cost of the product to the business is known at the time the customer is given a price and the customer purchases the product/service. However, for insurance products, the actual cost of providing coverage is unknown to the insurer for some time. Nonetheless, the insurer remains obligated to pay claims in the face of this uncertainty, even if the premium it received turns out to be wholly inadequate.

Premiums are fundamentally derived from projected cost of claims (losses) and other expenses. While each insurance entity's operational expenses vary, they are relatively predictable. Claims costs, on the other hand, are not always predictable. Insurers use statistics and historical loss information to forecast an accurate estimate of the amount of losses to be paid in the future—sometimes the distant future—for a particular pool of risks. The accuracy of the estimate depends on the type of risk, policyholder characteristics, and the size of the pool.

The bottom line is that as the cost of the things insurance pays for rises or falls, the price policyholders pay for coverage typically rises or falls as well. This also means that when regulators, public policymakers, the courts, and/or the public want insurance companies to increase benefits under an insurance policy, the purchasers of that policy must pay more for coverage.

A more expansive discussion of how premiums are determined and where premium dollars are spent can be found in an upcoming ***AIA Advocate*** on insurer finance that will serve as a companion to this edition.

Insurance Regulation

Property-casualty insurance is heavily regulated at the state level; this is particularly true for personal lines and for workers' compensation. Generally speaking, state regulators have oversight of market conduct; insurance company and agent licensing; insurance rates; policy language; financial condition (solvency) of insurance companies; and, consumer protection in insurance transactions.

Ideally, regulators focus their resources on making sure that insurance rates are adequate to cover losses, so that claims can be paid in full. They also are responsible for making sure that rates are neither unreasonably high nor unfairly discriminatory. Another key regulatory duty is to make sure that insurers remain solvent, i.e., that they maintain enough capital to pay policyholder losses as they come due.

States also have laws in place to protect insurance consumers, such as Unfair Trade Practices Acts (which prohibit coercion of consumers during the sales process) and Unfair Claims Practices Acts (which prohibit insurers from settling a claim for less than should be paid).

Regulators (whose titles range from commissioner to superintendent to director) in every state and in the District of Columbia administer insurance laws for their jurisdictions. The vast majority of insurance regulators are appointed; in about a dozen states, insurance regulators are elected to office.

All states provide mechanisms for relatively high-risk individuals who seek insurance from the private market, but are unable to find it; these individuals are known as the "residual market." For example, high-risk drivers who are required to carry liability insurance by state law, but cannot obtain auto insurance in the regular or "voluntary" market because of the high likelihood of costly losses (which insurers may not be able to reflect in rates due to government price controls) can go to their state's residual market mechanisms for coverage. All insurers licensed in the state must participate in these mechanisms for their particular lines of coverage, whether that is auto insurance, property insurance, or workers' compensation.

A few federal insurance programs either directly provide or enable private sector provision of property-casualty coverage. These include the National Flood Insurance Program (private insurers sell coverage and adjust claims; but coverage is underwritten and claims are paid wholly by the government); the Overseas Private Investment Corporation (provides political risk coverage for U.S. businesses with operations overseas); the Terrorism Risk Insurance Act program (a public-private risk-sharing mechanism for catastrophic terrorist attacks); and the Federal Crop Insurance Corporation (federally reinsured coverage against adverse weather, plant diseases, and insect infestations). ●

This basic primer is meant to provide a quick, relatively simple overview of the property-casualty insurance product and market. A companion issue will follow later this year covering the basics of insurer finance. For further information on any of the topics covered in this issue of the ***AIA Advocate****, please contact the American Insurance Association's Public Affairs Department at (202) 828-7100, or at webmaster@aiadc.org.*