CHAPTER EIGHT

ANALYSIS OF INSURANCE CONTRACTS

8.1 Components of Insurance Contract

Despite their complexities, insurance contracts generally can be divided into the following parts:

- Declarations
- Definitions
- Insuring agreement
- Exclusions
- Conditions
- Miscellaneous provisions

1. Declarations

The declarations section is the first part of an insurance contract. Declarations *are statements that provide information about the particular property or activity to be insured.* Information contained in the declarations section is used for underwriting and rating purposes and for identification of the property or activity that is insured. The declarations section usually can be found on the first page of the policy or on a policy insert. In property insurance, the declarations page typically contains information concerning the identification of the insurer, name of the insured, location of the property, period of protection, amount of insurance, amount of the premium, size of the deductible (if any), and other relevant information. In life insurance, it contains the insured's name, age, premium amount, issue date, and policy number.

2. Definitions

Insurance contracts typically contain a page or section of definitions. Key words or phrases have quotation marks (". . .") around them. For example, the insurer is frequently referred to as "we," "our," or "us." The named insured is referred to as "you" and "your." The purpose of the various definitions is to define clearly the meaning of key words or phrases so that coverage under the policy can be determined more easily.

3. Insuring Agreement

The insuring agreement is the heart of an insurance contract. *The* insuring agreement *summarizes the major promises of the insurer.* The insurer agrees to do certain things, such as paying losses from covered perils, providing certain services (such as loss-prevention services), or agreeing to defend the insured in a liability lawsuit. There are two basic forms of an insuring agreement in property insurance:

(1) Named-perils coverage: *Under a* named-perils policy**,** *only those perils specifically named in the policy are covered.* If the peril is not named, it is not covered.

(2) open-perils coverage (formerly called "all-risks" coverage).

4. Exclusions

They form a basic part of any insurance contract. There are three major types of exclusions

(1) Excluded perils,

(2) Excluded losses, and

(3) Excluded property.

Excluded Perils The contract may exclude certain perils, or causes of loss. In a homeowner's policy, the perils of flood, earth movement, and nuclear radiation or radioactive contamination are specifically excluded. In the physical damage section of the personal auto policy, loss to a covered auto is specifically excluded if the car is used as a public taxi.

Excluded Losses Certain types of losses may be excluded. For example, in a homeowner's policy, failure of an insured to protect the property from further damage after a loss occurs is excluded. In the personal liability section of a homeowner's policy, a liability lawsuit arising out of the operation of an automobile is excluded. Professional liability losses are also excluded; a specific professional liability policy is needed to cover this exposure.

Excluded Property The contract may exclude or place limitations on the coverage of certain property. For example, in a homeowner's policy, certain types of personal property are excluded, such as cars, planes, animals, birds, and fish.

8.2 Need for Exclusions

Exclusions are necessary for the following reasons:

■ *Certain perils considered uninsurable:* Exclusions are necessary because the peril may be considered uninsurable by commercial insurers. A given peril may depart substantially from the ideal requirements of an insurable risk.

■ *Presence of extraordinary hazards*: *Exclusions are also used because extraordinary hazards are present.* A hazard is a condition that increases the chance of loss or severity of loss. Because of an extraordinary increase in hazard, a loss may be excluded. As such personal car and a passenger service vehicle (PSV) should not be charged similar premiums.

■ *Coverage provided by other contracts: Exclusions are also necessary because coverage can be better provided by other contracts.* Exclusions are used to avoid duplication of coverage and to limit coverage to the policy best designed to provide it. For example, a car is excluded under a homeowner's policy because it is covered under the personal auto policy and other auto insurance contracts.

■ *Moral hazard problems: Certain property is excluded because of moral hazard or difficulty in determining and measuring the amount of loss.* A homeless policy may limit coverage of money to say Ksh. 15,000/= to avoid unlimited coverage which would increase fraudulent claims.

■ *Attitudinal hazard problems: Exclusions are also used to deal with attitudinal hazard (morale hazard).* Attitudinal hazard is carelessness or indifference to a loss, which increases the frequency or severity of loss. Exclusions force individuals to bear losses that result from their own carelessness.

■ *Coverage not needed by typical insureds: Finally, exclusions are used because the coverage is not needed by the typical insured.*

5. Conditions

Conditions refers to another important part of an insurance contract. Conditions *are provisions in the policy that qualify or place limitations on the insurer's promise to perform.* In effect, the conditions section imposes certain duties on the insured. If the policy conditions are not met, the insurer can refuse to pay the claim. Common policy conditions include notifying the insurer if a loss occurs, protecting the property after a loss, preparing an inventory of damaged personal property, and cooperating with the insurer in the event of a liability suit.

6. Miscellaneous Provisions

Insurance contracts also contain a number of miscellaneous provisions. In property and casualty insurance, miscellaneous provisions include cancellation, subrogation, and requirements if a loss occurs, assignment of the policy, and other-insurance provisions. In life and health insurance, typical miscellaneous provisions include the grace period, reinstatement of a lapsed policy, and misstatement of age.

8.3 Coinsurance and Reinsurance

8.3.1 Coinsurance

Coinsurance is a contractual provision that often appears in property insurance contracts. This is especially true of commercial property insurance contracts.

8.3.2 Nature of Coinsurance

A coinsurance clause *in a property insurance contract encourages the insured to insure the property to a stated percentage of its insurable value. If the coinsurance requirement is not met at the time of loss, the insured must share in the loss as a co-insurer*. The insurable value of the property is the actual cash value, replacement cost, or some other value described in the valuation clause of the policy. If the insured wants to collect in full for a partial loss, the coinsurance requirement must be satisfied. Otherwise, the insured will be penalized if a partial loss occurs. A coinsurance formula is used to determine the amount paid for a covered loss. The coinsurance formula is as follows:

$$\text{Amount of recovery} = \frac{\text{Amount of insurance earned}}{\text{Amount of insurance required}} * \text{Loss}$$

For example, assume that a commercial building has an actual cash value of Ksh 1,000,000 and that the owner has insured it for only Ksh600,000. If an 80 % coinsurance clause is present in the policy, the required amount of insurance based on actual cash value is Ksh800,000= (80% * Ksh1,000,000). If a replacement cost policy is used, the required amount of insurance would be based on replacement cost. Thus, if a Ksh100,000 loss occurs, only Ksh75,000 will be paid by the insurer. This calculation can be illustrated as follows:

$$Amount\ of\ recovery = \frac{600{,}000}{800{,}000} * 100{,}000 = 75{,}000$$

Since the insured has only three-fourths of the required amount of insurance in force at the time of loss, only three-fourths of the loss, or Ksh75,000, will be paid. Because the coinsurance requirement is not met, the insured must absorb the remaining amount of the loss. When applying the coinsurance formula, two additional points should be kept in mind.

8.4 Reinsurance

Reinsurance *is an arrangement by which the primary insurer that initially writes the insurance transfers to another insurer (called the reinsurer) part or all of the potential losses associated with such insurance.* The primary insurer that initially writes the insurance is called the ceding company. The insurer that accepts risk is called the reinsurer**.** The amount of insurance retained by the ceding company for its own account is called the retention limit or net retention. The amount of insurance ceded to the reinsurer is known as the cession. The reinsurer in turn may reinsure part or all of the risk with another insurer. This is known as a retrocession. In this case, the second reinsurer is called a retrocessionaire.

8.4.1 Reasons for Reinsurance

Reinsurance is used for several reasons. The most important reasons include the following:

- ■ Increase underwriting capacity
- ■ Stabilize profits
- ■ Reduce the unearned premium reserve
- ■ Provide protection against a catastrophic loss

1. **Increase Underwriting Capacity**

Reinsurance can be used to increase the insurance company's underwriting capacity to write new business. Reinsurance permits the primary company to issue a single policy in excess of its retention limit for the full amount of insurance. The company may be asked to assume liability for losses in excess of its retention limit. Without reinsurance, the agent would have to place large amounts of insurance with several companies or not accept the risk.

2. **Stabilize Profits** Reinsurance is used to stabilize profits. An insurer may wish to avoid large fluctuations in annual financial results. Loss experience can fluctuate widely because of social and economic conditions, natural disasters, and chance. Reinsurance can be used to stabilize the effects of poor loss experience. For example, reinsurance may be used to cover a large exposure. If a large, unexpected loss occurs, the reinsurer would pay that portion of the loss in excess of some specified limit.

3. Reduce the Unearned Premium Reserve

Reinsurance can be used to reduce the unearned premium reserve. For some insurers, especially newer and smaller companies, the ability to write large amounts of new insurance may be restricted by the unearned premium reserve requirement. *The* unearned premium reserve *is a liability item on the insurer's balance sheet that represents the unearned portion of gross premiums on all outstanding policies at the time of valuation.* In effect, the unearned premium reserve reflects the fact that premiums are paid in advance, but the period of protection has not yet expired.

4. Provide Protection against a Catastrophic Loss

Reinsurance also provides financial protection against a catastrophic loss. Insurers often experience catastrophic losses because of hurricanes and other natural disasters, industrial explosions, commercial airline disasters, and similar events. Reinsurance can provide considerable protection to the ceding company that experiences a catastrophic loss. The reinsurer pays part or all of the losses that exceed the ceding company's retention up to some specified maximum limit.

8.5 Benefits of Insurance to Society

The major social and economic benefits of insurance include the following:

- ■ Indemnification for loss
- ■ Reduction of worry and fear
- ■ Source of investment funds
- ■ Loss prevention
- ■ Enhancement of credit

1. Indemnification for Loss

Indemnification permits individuals and families to be restored to their former financial position after a loss occurs. As a result, they can maintain their financial security. Because insureds are restored either in part or in whole after a loss occurs, they are less likely to apply for public assistance or welfare benefits, or to seek financial assistance from relatives and friends. Indemnification to business firms also permits firms to remain in business and employees to keep their jobs. Suppliers continue to receive orders, and customers receive the goods and services they desire. The community also benefits because its tax base is not eroded. In short, the indemnification function contributes greatly to family and business stability and therefore is one of the most important social and economic benefits of insurance.

2. Reduction of Worry and Fear

A second benefit of insurance is that worry and fear are reduced. This is true both before and after a loss. For example, if family heads have adequate amounts of life insurance, they are less likely to worry about the financial security of their dependents in the event of premature death; persons insured for long-term disability do not have to worry about the loss of earnings if a serious illness or accident occurs; and property owners who are insured enjoy greater peace of mind because they know they are covered if a loss occurs. Worry and fear are also reduced after a loss occurs, because the insureds know that they have insurance that will pay for the loss.

3. Source of Investment Funds

The insurance industry is an important source of funds for capital investment and accumulation. Premiums are collected in advance of the loss, and funds not needed to pay immediate losses and expenses can be loaned to business firms. These funds typically are invested in shopping centres, hospitals, factories, housing developments, and new machinery and equipment. The investments increase society's stock of capital goods, and promote economic growth and full employment. Insurers also invest in social investments, such as housing, nursing homes, and economic development projects. In addition, because the total supply of loanable funds is increased by the advance payment of insurance premiums, the cost of capital to business firms that borrow is lower than it would be in the absence of insurance.

4. Loss Prevention

Insurance companies are actively involved in numerous loss-prevention programs and also employ a wide variety of loss-prevention personnel, including safety engineers and specialists in fire prevention, occupational safety and health, and products liability. The loss-prevention activities reduce both direct and indirect, or consequential, losses. Society benefits, because both types of losses are reduced.

5. Enhancement of Credit

A final benefit is that insurance enhances a person's credit. Insurance makes a borrower a better credit risk because it guarantees the value of the borrower's collateral or gives greater assurance that the loan will be repaid. For example, when a house is purchased, the lending institution normally requires property insurance on the house before the mortgage loan is granted. The property insurance protects the lender's financial interest if the property is damaged or destroyed. Thus, insurance can enhance a person's credit.