General Insurance

Before you learn the different types of policies that you will encounter as an insurance producer, you will need to understand some basic terminology and concepts. First you need to understand what insurance is and who or what may become insured. This chapter will discuss some basic underwriting concepts, address different classifications of insurers, and will end with an explanation of contracts. In general, this chapter will help build a foundation of concepts that will make it easier for you to learn the rest of the material in this course, so it is important for you to master these ideas before moving on to the next chapter.

TERMS TO KNOW

Agent/Producer — a legal representative of an insurance company; the classification of *producer* usually includes agents and brokers; *agents* are the agents of the insurer
Applicant or proposed insured — a person applying for insurance
Beneficiary — a person who receives the benefits of an insurance policy
Broker — an insurance producer not appointed by an insurer and is deemed to represent the client
Indemnity — main principle of insurance, meaning that the insured cannot recover more than their loss; the purpose of insurance is to restore the insured to the same position as before the loss
Insurance policy — a contract between a policyowner (and/or insured) and an insurance company which agrees to pay the insured or the beneficiary for loss caused by specific events
Insured — the person covered by the insurance policy. This person may or may not be the policyowner
Insurer (principal) — the company who issues an insurance policy
Law of large numbers — the larger the number of people with a similar exposure to loss, the more predictable actual losses will be
Policyowner — the person entitled to exercise the rights and privileges in the policy
Premium — the money paid to the insurance company for the insurance policy
Reciprocity/Reciprocal — a mutual interchange of rights and privileges

A. Key Terms And Concepts

1. Insurance

Insurance is a contract in which one party (the insurance company) agrees to indemnify (make whole) the insured party against loss, damage or liability arising from an unknown event. In life insurance, the policy protects survivors from losses suffered after an insured's death.

Insurance is a **transfer** of risk of loss from an individual or a business entity to an insurance company, which, in turn, spreads the costs of unexpected losses to many individuals. If there were no insurance mechanism, the cost of a loss would have to be borne solely by the individual who suffered the loss.

Know This! Insurance is the *transfer of risk* of loss. The cost of an insured's loss is transferred over to the insurer and spread among other insureds.

Insurance Transaction

The term **insurance transaction** includes any of the following (by mail or any other means):

- Solicitation;
- Negotiations;
- Sale (effectuation of a contract of insurance); and
- Advising an individual concerning coverage or claims.

2. Risk Management Key Terms

Risk

Risk is the uncertainty or chance of a loss occurring. The two types of risks are pure and speculative, only one of which is insurable.

- **Pure risk** refers to situations that can only result in a loss or no change. There is no opportunity for financial gain. Pure risk is the only type of risk that insurance companies are willing to accept.
- **Speculative risk** involves the opportunity for either loss or gain. An example of speculative risk is gambling. These types of risks are not insurable.

Know This! Only *pure* risks are insurable.

Hazard

Hazards are conditions or situations that increase the probability of an insured loss occurring. Hazards are classified as physical hazards, moral hazards, or morale hazards. Conditions such as lifestyle and existing health, or activities such as scuba diving, are hazards and may increase the chance of a loss occurring.

Physical hazards are individual characteristics that increase the chances of the cause of loss. Physical hazards exist because of a physical condition, past medical history, or a condition at birth, such as blindness.

Moral hazards are tendencies towards increased risk. Moral hazards involve evaluating the character and reputation of the proposed insured. Moral hazards refer to those applicants who may lie on an application for insurance, or in the past, have submitted fraudulent claims against an insurer.

Morale hazards are similar to moral hazards, except that they arise from a state of mind that causes indifference to loss, such as carelessness. Actions taken without a forethought may cause physical injuries.

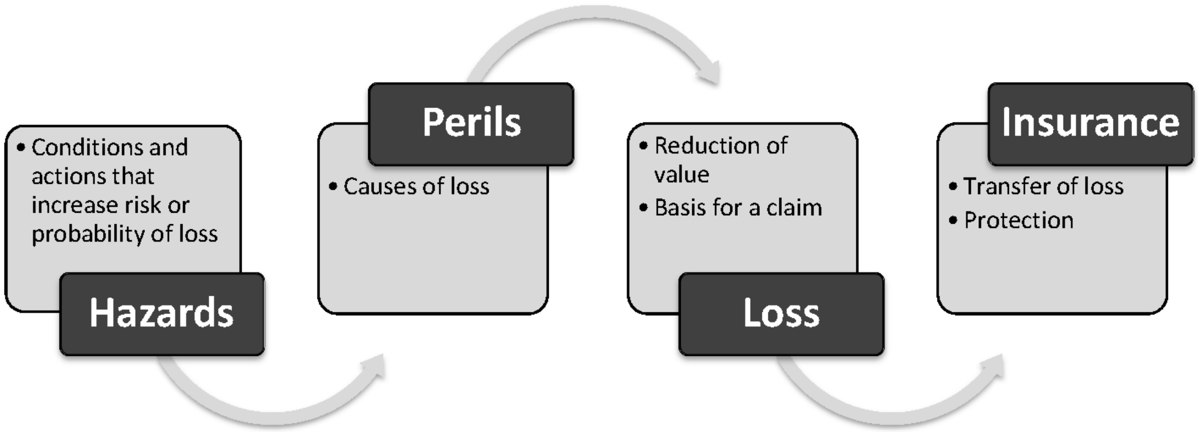
Peril

Perils are the **causes** of loss insured against in an insurance policy.

- *Life insurance* insures against the financial loss caused by the premature death of the insured;
- *Health insurance* insures against the medical expenses and/or loss of income caused by the insured's sickness or accidental injury;
- *Property insurance* insures against the loss of physical property or the loss of its income-producing abilities;
- *Casualty insurance* insures against the loss and/or damage of property and resulting liabilities.

Loss

Loss is defined as the reduction, decrease, or disappearance of value of the person or property insured in a policy, caused by a named peril. Insurance provides a means to transfer loss.



Know This! A risk is a *chance* that a loss will occur; a hazard increases the *probability of loss*; a peril is the *cause* of loss.

3. Methods of Handling Risk

Avoidance

One of the methods of dealing with risk is **avoidance**, which means eliminating exposure to a loss. *For example,* if a person wanted to avoid the risk of being killed in an airplane crash, he/she might choose never to fly in an airplane. Risk avoidance is effective, but seldom practical.

Retention

Risk **retention** is the planned assumption of risk by an insured through the use of deductibles, co-payments, or self-insurance. It is also known as self-insurance when the insured accepts the responsibility for the loss before the insurance company pays. The purpose of retention is

1. To reduce expenses and improve cash flow;
2. To increase control of claim reserving and claims settlements; and
3. To fund for losses that cannot be insured.

Sharing

Sharing is a method of dealing with risk for a group of individual persons or businesses with the same or similar exposure to loss to share the losses that occur within that group. A reciprocal insurance exchange is a formal risk-sharing arrangement.

Reduction

Since we usually cannot avoid risk entirely, we often attempt to lessen the possibility or severity of a loss. **Reduction** would include actions such as installing smoke detectors in our homes, having an annual physical to detect health problems early, or perhaps making a change in our lifestyles.

Transfer

The most effective way to handle risk is to **transfer** it so that the loss is borne by another party. Insurance is the most common method of transferring risk from an individual or group to an insurance company. Though the purchasing of insurance will not eliminate the risk of death or illness, it relieves the insured of the financial losses these risks bring.

There are several ways to transfer risk, such as hold harmless agreements and other contractual agreements, but the safest and most common method is to purchase insurance coverage.

4. Elements of Insurable Risks

Not all risks are insurable. As noted earlier, insurers will insure only **pure risks,** or those that involve only the chance of loss with no chance of gain. Furthermore, even pure risks must have certain characteristics in order to be insurable. Insurable risks involve the following characteristics:

- **Due to chance** — A loss that is outside the insured's control.
- **Definite and measurable** — A loss that is specific as to the cause, time, place and amount. An insurer must be able to determine how much the benefit will be and when it becomes payable.
- **Statistically predictable** — Insurers must be able to estimate the average frequency and severity of future losses and set appropriate premium rates. (In life and health insurance, the use of mortality tables and morbidity tables allows the insurer to project losses based on statistics.)
- **Not catastrophic** — Insurers need to be reasonably certain their losses will not exceed specific limits. That is why insurance policies usually exclude coverage for loss caused by war or nuclear events: There is no statistical data that allows for the development of rates that would be necessary to cover losses from events of this nature.
- **Randomly selected and large loss exposure** — There must be a sufficiently large pool of the insured that represents a random selection of risks in terms of age, gender, occupation, health and economic status, and geographic location.

B. Classification Of Insurers

Insurance is available from both private companies and the government. The major difference between government and private insurance is that the government programs are funded with taxes and serve national and state social purposes, while private policies are funded by premiums.

Private insurance companies can be classified in a variety of ways:

- Ownership;
- Authority to transact business;
- Location (domicile);
- Marketing and distribution systems; or
- Rating (financial strength).

As you read about different classifications of insurers, keep in mind that these categories are not mutually exclusive, and the same company can be described based on where it is located and allowed to transact the business of insurance, who owns it, and what type of agents it appoints.

1. Ownership

The following are the most common types of ownership.

Stock Companies

Stock companies are owned by the stockholders who provide the capital necessary to establish and operate the insurance company and who share in any profits or losses. Officers are elected by the stockholders and manage stock insurance companies. Traditionally, stock companies issue **nonparticipating** policies, in which policyowners do not share in profits or losses.

A nonparticipating (stock) policy does not pay dividends to policyowners; however, **taxable dividends are paid to stockholders**. The dividends are not guaranteed as they are based on company profit.

Mutual Companies

Mutual companies are owned by the policyowners and issue **participating** policies. With participating policies, policyowners are entitled to dividends, which, in the case of mutual companies, are a return of excess premiums and are, therefore, **nontaxable**. Dividends are generated when the premiums and the earnings combined exceed the actual costs of providing coverage, creating a surplus. **Dividends are not guaranteed.**

2. Admitted vs. Nonadmitted Insurers

Before insurers may transact business in a specific state, they must apply for and be granted a license or **Certificate of Authority** from the state department of insurance and meet any financial (capital and surplus) requirements set by the state. Insurers who meet the state's financial requirements and are approved to transact business in the state are considered **authorized or admitted** into the state as a legal insurer. Those insurers who have not been approved to do business in the state are considered **unauthorized or nonadmitted**. Most states have laws that prohibit unauthorized insurers from conducting business in the state, except through licensed excess and surplus lines brokers.

Know This! Insurers must obtain a Certificate of Authority prior to transacting business in this state.

3. Domestic, Foreign and Alien Insurers

Insurance companies are classified according to the **location of incorporation** (domicile). Regardless of where an insurance company is incorporated, it must obtain a Certificate of Authority before transacting insurance within the state.

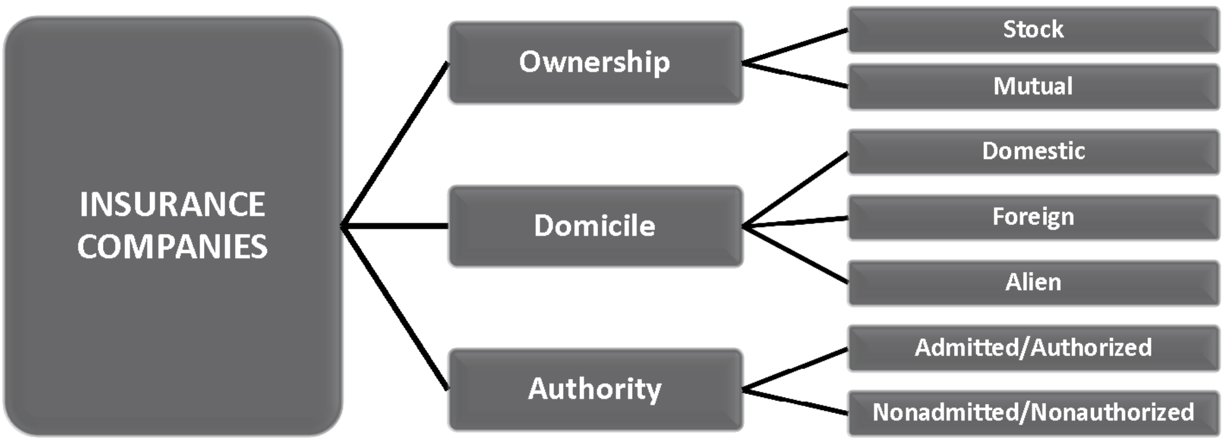
Know This! A *domicile* refers to the location where an insurer is incorporated, not necessarily where the insurer conducts business.

A **domestic** insurer is an insurance company that is incorporated in this state. In most cases, the company's home office is in the state in which it was formed — the company's domicile. *For instance,* a company chartered in Pennsylvania would be considered a Pennsylvania domestic company.

A **foreign** insurer is an insurance company that is incorporated in another state, the District of Columbia, or a territorial possession. Currently, the United States has 5 major U.S. territories: American Samoa, Guam, the Northern Mariana Islands, Puerto Rico, and the U.S. Virgin Islands.

For example, a company chartered in California would be a foreign insurer within the state of New York. A company chartered in Puerto Rico will be foreign in any U.S. state.

An **alien** insurer is an insurance company that is incorporated outside the United States.



C. Producers And General Rules Of Agency

An agent/producer is an individual licensed to sell, solicit or negotiate insurance contracts on behalf of the **principal (insurer).** The **law of agency** defines the relationship between the principal and the agent/producer: the acts of the agent/producer within the scope of authority are deemed to be the acts of the insurer.

In this relationship, it is a given that

- An agent represents the insurer, not the insured;

- Any knowledge of the agent is presumed to be knowledge of the insurer;
- If the agent is working within the conditions of his/her contract, the insurer is fully responsible; and
- When the insured submits payment to the agent, it is the same as submitting a payment to the insurer.

The agent is responsible for accurately completing applications for insurance, submitting the application to the insurer for underwriting, and delivering the policy to the policyowner.

Know This! Insurance agents represent the *insurer* (principal). "Who is your pal? The princi<u>pal</u>!"

1. Authority and Powers of Producers

The agency contract details the authority an agent has within his/her company. Contractually, only those actions that the agent is authorized to perform can bind the principal (insurer). In reality, an agent's authority is much broader. There are 3 types of agent authority: express, implied, and apparent.

Express

Express authority is the authority a principal intends to grant to an agent by means of the agent’s contract. It is the authority that is written in the contract.

Implied

Implied authority is authority that is **not expressed or written into the contract, but which the agent is assumed to have in order to transact the business** of insurance for the principal. Implied authority is incidental to and derives from express authority since not every single detail of an agent’s authority can be spelled out in the written contract.

<u>Example:</u>

If the agency contract does not specifically authorize the agent to collect premiums and remit them to the insurer, but the agent routinely does so in the process of solicitation and delivery of policies, the agent has the implied authority to collect and remit premiums.

Apparent

Apparent authority (also known as *perceived* authority) is the appearance or the assumption of authority based on the actions, words, or deeds of the principal or because of circumstances the principal created. *For example,* if an agent uses insurer's stationery when soliciting coverage, an applicant may believe that the agent is authorized to transact insurance on behalf of the insurer.

2. Responsibilities to the Applicant and Insured

Although the agents act for the insurer, they are legally obligated to treat applicants and insureds in an ethical manner. Because an agent handles the funds of the insured and the insurer, he/she has **fiduciary responsibility**. A *fiduciary* is someone in a position of trust. More specifically, it is illegal for insurance producers to commingle premiums collected from the applicants with their own personal funds.

Market conduct describes the way companies and producers should conduct their business. It is a **Code of Ethics** for producers. Producers must adhere to certain established procedures, and failure to comply will result in penalties. Some of the market conduct regulations include, but are not limited to, the following:

- Conflict of interest;
- A request of a gift or loan as a condition to complete business; and
- Supplying confidential information.

Producers are required to perform in a professional manner at all times. *Professionalism* means that a person is engaged in an occupation requiring an advanced level of training, knowledge, or skill. Being professional means placing the public's interest above one's own in all situations. Any deviation could result in a penalty.

D. Contracts

A ***contract*** is an agreement between two or more parties enforceable by law. Because of unique aspects of insurance transactions, the general law of contracts had to be modified to fit the needs of insurance.

1. Elements of a Legal Contract

In order for insurance contracts to be legally binding, they must have 4 essential elements:

1. Agreement — offer and acceptance;
2. Consideration;
3. Competent parties; and
4. Legal purpose.

Agreement - Offer and Acceptance

There must be a definite offer by one party, and the other party must accept this offer in its exact terms. In insurance, the applicant usually makes the **offer** when submitting the application. **Acceptance** takes place when an insurer's underwriter approves the application and issues a policy.

Consideration

The binding force in any contract is the **consideration**. Consideration is something of value that each party gives to the other. The consideration on the part of the insured is the payment of premium and the representations made in the application. The consideration on the part of the insurer is the promise to pay in the event of loss.

Know This! *Insurer's consideration* is the promise to pay for losses;

insured's consideration is the payment of premium and statements on the application.

Competent Parties

The **parties to a contract** must be capable of entering into a contract in the eyes of the law. Generally, this requires that both parties be of legal age, mentally competent to understand the contract, and not under the influence of drugs or alcohol.

Legal Purpose

The purpose of the contract must be **legal** and not against public policy. To ensure legal purpose of a Life Insurance policy, for example, it must have both: insurable interest and consent. A contract without a legal purpose is considered void, and cannot be enforced by any party.

2. Legal Interpretations Affecting Contracts

Reasonable Expectations

It is not always practical or necessary to state every direct and indirect provision or coverage offered by an insurance policy. If an agent implies through advertising, sales literature or statements that these provisions exist, an insured could **reasonably expect coverage**.

Indemnity

Indemnity (sometimes referred to as **reimbursement**) is a provision in an insurance policy that states that in the event of loss, an insured or a beneficiary is permitted to collect only to the extent of the financial loss, and is not allowed to gain financially because of the existence of an insurance contract. The purpose of insurance is to restore, but not let an insured or a beneficiary profit from the loss.

Life and Health Example:

Brenda has a health insurance policy for $20,000. After she was hospitalized, her medical expenses added up to $15,000. The insurance policy will reimburse Brenda only for $15,000 (the amount of the loss), and not for $20,000 (the total amount of insurance).

Property and Casualty Example:

Brenda has a homeowners insurance policy for $200,000. After her home was destroyed, her expense to rebuild the home added up to $150,000. The insurance policy will reimburse Brenda only for $150,000 (the amount of the loss), and not for $200,000 (the total amount of insurance).

Know This! Indemnity means insureds cannot recover more than their loss.

Utmost Good Faith

The principle of **utmost good faith** implies that there will be no fraud, misrepresentation or concealment between the parties. As it pertains to insurance policies, both the insurer and insured must be able to rely on the other for relevant information. The insured is expected to provide accurate information on the application for insurance, and the insurer must clearly and truthfully describe policy features and benefits, and must not conceal or mislead the insured.

Representations and Misrepresentations

Representations are statements believed to be true to the best of one's knowledge, but they are not guaranteed to be true. For insurance purposes, representations are the answers the insured gives to the questions on the insurance application.

Untrue statements on the application are considered **misrepresentations** and could void the contract. A **material misrepresentation** is a statement that, if discovered, would alter the underwriting decision of the insurance company. Furthermore, if material misrepresentations are **intentional**, they are considered fraud.

Know This! Representations are statements *believed to be true.*
Insured's statements on the application are *representations*.

Warranties

A **warranty** is an absolutely true statement upon which the validity of the insurance policy depends. Breach of warranties can be considered grounds for voiding the policy or a return of premium. Because of such a strict definition, statements made by applicants for life and health insurance policies, for example, are usually not considered warranties, except in cases of fraud.

Concealment

Concealment is the legal term for the intentional withholding of information of a material fact that is crucial in making a decision. In insurance, concealment is the withholding of information by the applicant that will result in an imprecise underwriting decision. Concealment may void a policy.

Fraud

Fraud is the intentional misrepresentation or intentional concealment of a material fact used to induce another party to make or refrain from making a contract, or to deceive or cheat a party. Fraud is grounds for voiding an insurance contract.

E. Chapter Recap

This chapter was all about giving you the basics of insurance. Let's recap some of the major points:

GENERAL CONCEPTS

Insurance
- Transfers the risk of loss from an individual to an insurer
- Based on the principle of indemnity
- Based on the spreading of risk (risk pooling) and the law of large numbers

Hazards
- Conditions that increase the probability of loss occurring
- 3 types of hazards:
  - Physical - a physical condition;
  - Moral - a tendency toward increased risk;
  - Morale - an indifference to loss

Risk
- Uncertainty regarding financial loss
- 2 types of risks:
  - Pure - insurable because it involves a chance of loss only;
  - Speculative - not insurable because it involves a chance of gain
- Methods of handling risk:
  - Avoidance
  - Retention
  - Sharing
  - Reduction
  - Transfer

Elements of Insurance Risk

All of the following elements apply to an insurable risk:

- *Due to chance:* chance of loss beyond insured's control
- *Definite and measurable:* loss must have definite time, place and amount
- *Predictable:* number of losses must be statistically predictable
- *Not catastrophic:* there must be limits that the loss can't exceed
- *Large exposure:* insurer must be able to predict losses based on the law of large numbers
- *Randomly selected exposure:* insurer must have a fair proportion of both good and poor risks

INSURERS

Stock
- Owned by stockholders
- Issue nonparticipating policies (nonpar)

Mutual
- Owned by policyowners (policyholders)
- Issue participating policies (par)
- Pay dividends to policyholders which are a refund of excess premiums

AGENT'S AUTHORITY

Express

Powers specifically stated in the contract

Implied Not specifically stated in the contract, but is assumed necessary to conduct insurance business

Apparent The appearance of a relationship between the agent and principal based on words or actions

COMPANY DOMICILE AND AUTHORIZATION

Domicile
- *Domestic* - incorporated in this state
- *Foreign* - incorporated in another state of territory
- *Alien* - incorporated in another country

Authorized/ Admitted
- Approved by the Department of Insurance
- Has a Certificate of Authority

Unauthorized/ Nonadmitted
- No Certificate of Authority
- Cannot transact business in this state

INSURANCE CONTRACTS

Elements of a Legal Contract

All of the following requirements apply:

Legal Interpretations	• *Agreement:* offer and acceptance • *Consideration:* premiums and representations on the part of the insured; payment of claims on the part of the insurer • *Competent parties:* of legal age, sound mental capacity, and not under the influence of drugs or alcohol • *Legal purpose:* not against public policy • *Indemnity* - insurer is only liable for the extent of a loss; insurance restores to the condition prior to loss • The insured can *reasonably expect coverage* based on the agent's words and actions • *Utmost good faith* - parties rely on each other for information • *Representations* - statements believed to be true (statements on the application); warranties are guaranteed to be true • *Material misrepresentations* (if intentional), *breach of warranties, concealment, fraud* - all can void the contract