1. Property & Casualty Insurance Basics

Let's start by discussing some important insurance terms and concepts.

Insurance

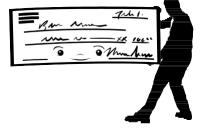
The concept of insurance is really quite simple. Insurance is a method for spreading the risk of a financial loss among a large number of people. By spreading the risk, we are reducing the financial impact of an individual loss. So how do we do that? You, along with millions of other people, simply purchase an insurance policy from an insurance company—although not necessarily at the same time. In return, this transfers your risk of loss to the insurance company reducing the amount that you will be financially responsible for in the event of a covered loss.

Purpose of Insurance

As you can probably guess, insurance has evolved considerably since its very early days. Although it is a complex subject that can be confusing, the basic purpose for insurance has remained the same throughout history: **spreading risk to make losses more manageable.**







Purchase auto policy

Have auto accident

Insurance company pays

Insurance Company (Insurer or Company)

The insurance company is the entity that agrees to indemnify (make financially whole again) insureds against covered losses. The insurance company writes the policy language and includes the rights of the company within the guidelines of the insurance statutes (laws). Using actuaries, the company establishes rates to charge policyholders before making policies available for distribution.

Lines of Insurance

Property

Property Insurance includes various types of insurance designed to insure property from financial loss. The typical types of property items insured would be your house, auto, furniture, jewelry, business property or any type of physical property. The perils covered will depend on the type of property contract that you purchase; however, the basic perils typically covered include fire, hail, windstorm, etc.

The following types of insurance are generally considered to be property insurance:

- 1. Dwelling
- 2. Homeowners
- 3. Commercial Property
- 4. Inland Marine
- 5. Ocean Marine
- 6. Crime

There are **two parties** involved with a property insurance contract: (1) the insured, and (2) the insurance company. With property insurance, any insurance benefit payments by the insurance company will be paid directly to the insured or other specifically named interests.

Casualty (Liability)

Casualty insurance mainly protects you against legal liability for **bodily injury (BI)** and/or **property damage (PD)** *you* cause to other people. In other words, liability or casualty coverage will pay for **accidental** damage you cause to another person or their property. There are three parties to a liability insurance contract— 1) the insured (you), 2) the insurer (insurance) company, and 3) the injured party.

Casualty Insurance includes various unrelated insurance products, such as:

- 1. Aviation
- 2. Auto
- 3. Liability
- 4. Workers Compensation
- 5. Surety Bonds

Personal Lines Insurance

Personal lines refer to property and casualty insurance for an individual as opposed to a business. Coverages would include homeowners, renters, auto, and personal umbrella to name a few. These policies include both **property** and **casualty** coverages. For example, coverage is available in auto policies to cover damage to your car (property) and accidental damage you cause to another person's car (casualty or liability).

Commercial Lines Insurance

Commercial lines refer to property and casualty insurance to cover a business as opposed to personal lines, which cover personal risks. Examples include commercial general liability, workers' compensation, and commercial property insurance.

Purchasing Insurance

So How Does It Work?



When you complete an insurance application, you will normally pay an initial amount of money with the application. In legal jargon, the money that you pay in exchange for insurance coverage is called the **consideration**. In insurance jargon, it is called the **premium**. Actually, the **statements** that you make in the application along with payment of the initial premium are part of the consideration. Of course, your statements must be truthful.

The premium amount is set by the insurance company and is based on a number of factors related to what is being insured. In return for the premium, the insurance company agrees to **pay for losses** according to the terms of the insurance policy.

Deductible

While the agent is discussing coverage details with the applicant, various deductible amounts will be presented to the applicant. As the deductible, the lower the premium will be.

A deductible is the portion of a covered loss that is not paid by the insurance company. Therefore, the insured is responsible for any deductible amount at the time of loss. The insurance company will pay the remaining portion of any covered loss up to the policy limits.

The insurance company is accomplishing two objectives by requiring a deductible:

- 1. Deductibles help minimize frequent claims; and
- 2. Deductibles help eliminate small claims.

By having a \$250, \$500, or even a \$1,000 deductible or higher, an insured will not usually report any claims up to the deductible amount.

Binder

After completing the application for insurance, the agent should issue a binder to the applicant. A binder is an **oral** or **written** agreement that provides **temporary** evidence of insurance until a policy can be issued. Note, that a binder does not guarantee that a policy will be issued. It only provides **temporary** coverage while the application is underwritten at the home office. No binder can be valid beyond the issue date of the policy or beyond its effective date, whichever period is shorter.

Once completed, the agent will forward the application and any initial premium to the insurance company for underwriting. Insurance **underwriting** is the *process* of *classification*, *rating*, and *selection* of risks. In other words, it's the process of determining whether to accept a risk or not. If the risk is acceptable, the underwriters will determine the amount of coverage to issue and the premium amount to charge.

Who Are Insured's

It's important to know who is insured under the policy.

The person or entity that is listed first on the declarations page is referred to as the first named insured. The first named insured is the primary insured and holds the highest rank among all insureds and has broader rights and obligations under the contract than any other insured.

Examples of additional rights of the first named insured are the right to cancel the policy, the right to initiate policy changes, and the receipt of any return premiums.

Insurance Terms

Risk

Risk is defined as the **possibility** or **chance** of loss. It is not the actual loss. For example, while driving to work each day, you may have an automobile accident. Or, you might accidentally slip, fall, and injure yourself while running on your treadmill. It is uncertain if either of these accidents will actually occur—but the *possibility* (risk) does exist.

Speculative Risk vs. Pure Risk

There are two types of risk: **speculative** and **pure**. Speculative risk offers the chance of loss as well as the opportunity for gain. An example of a speculative risk is *gambling*. With gambling, you have a choice to risk something for a possible gain.



Before we continue, let me introduce you to an old friend, Joe Consumer. Joe enjoys playing cards a few times each week, wherever he can find a game. Joe bets a small sum of money on each hand for the chance of winning or gaining a large sum of money. He may win or lose depending on the outcome of his poker skills and hands he is dealt. This has the opportunity for a win or a loss... a speculative risk. Keep in mind that speculative risks are not generally insurable.

When was the last time you heard of an insurance company offering Texas Hold'em coverage??

Unlike speculative risks, pure risks only offer the possibility of loss. There is no opportunity for gain or profit with pure risks. For example, let's suppose Joe has a hot year playing cards and decides to buy a new house. He walks into your insurance office decked out in a new Gucci navy pinstripe suit and sporting a dazzling Pave Diamond Dial Rolex Day Date Super President watch. Joe requests a homeowner's policy for his new house and some additional life insurance just in case he has a stressful year playing cards and dies of a heart attack. The insurance on Joe's house and his life are considered **pure risks**.

Characteristics (Elements) of Insurable Risks

While insurance is the most common method to handle risk, not every risk can be insured. Insurers will only insure pure risks, which are risks that have only the possibility of a loss. With a pure risk, there is not an opportunity to profit or gain from a loss.

To be insurable, the risk must:

1. Be a Predictable Loss



An insurer must be capable of statistically predicting the possibility of the loss. As mentioned earlier, insurers require a large number of homogeneous (similar) risks to accurately calculate the frequency and the severity of losses, and to set their premiums accordingly. Insurers are able to measure risk and accurately predict losses based on the law of large numbers.

2. Be a Chance Occurrence

The risk must be outside the insured's control. The loss must be unexpected, accidental, or uncertain.

Insurance cannot be provided for losses that are certain to occur. For example, the risk of loss due to an automobile accident may be unexpected; however, the risk that the tires on your car will eventually wear out is not an unexpected loss, and therefore not insurable. Tires are expected to wear out sooner or later.

3. Not be Catastrophic



Insurers typically will not insure risks that will expose them to losses that may occur to a large number of insureds at the same time. These causes of loss are not predictable; therefore, they are not insurable. Examples are war, nuclear hazards, and flood.

Remember, insurers must have a predictable limit to the losses they insure. Some insurers will cover catastrophic losses for a very high premium; however, most high risk insurance is purchased through excess and surplus lines companies that we discuss later in this lesson.

4. Be Measurable and Definitive

An insurable risk is a loss that has a definite monetary value. The insurer must be able to measure or value a potential loss. Insurers will not simply insure a risk with an unknown value. Insurers must know the value or the limit they will have to pay if a loss occurs.

For example, with home and auto coverage, the insurer must know the economic value of the property to be insured.

5. Be Affordable

The loss must cause a financial or economic hardship to the insured or to the insured's family. Losses that are too small to cause a financial hardship are not considered insurable.

For example, if a tire on an auto runs over a sharp object and causes a blow-out, this loss by itself would not be an insurable risk. Replacing a single tire would not normally represent a large enough financial risk to be insurable. However, if you accidently collided with another person's car causing bodily injury to the person and property damage to their car, this would be considered a financial hardship and, therefore, an insurable risk.

Exposure

Exposure means almost the same as risk. An exposure can be defined as a condition or situation that presents the possibility of a loss. For example, Joe takes a part-time job as a window washer for Skyscraper. He is exposing himself to the possibility of a long fall.

Loss

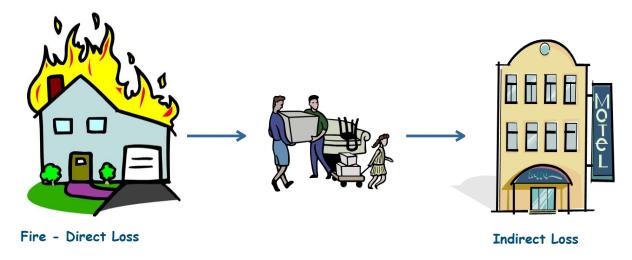
Loss is the amount of financial damage to your property caused by perils for which you are insured for. Losses can be **total** or **partial** and are stated as a dollar amount.

Direct Loss

Some property insurance policies cover only "direct" losses, some cover only "indirect" losses and some cover both. This is a direct **physical loss** that occurs to your property by a covered peril such as a fire damaging your home or an auto collision involving your covered auto.

Indirect Loss

An indirect (or consequential) loss occurs is the result of a direct loss. For example, if your home is damaged by fire and is deemed unsafe to occupy, then you may need money to pay for a temporary place to live while repairs are being made. In this situation, the damage as a result of the fire is the direct loss while the temporary housing is an indirect loss.



Law of Large Numbers

The **Law of Large Numbers** tells us that it is possible to accurately predict what will happen to a large group of similar risks. The larger the group becomes, the more accurate the predictions become. These statistics allow insurance companies to more accurately predict future losses.

For example, with property and casualty insurance, the company has no idea which houses will burn this year, but rather approximately how many house fires will occur during the year. Companies must know this information before they can set insurance premiums. These predictions contribute to the rates that underwriters use to calculate the premium for a specific risk.

Peril

A peril is the *cause of a loss*. Some examples of common perils are:

Fire: If your house burns down—fire is the peril.

Accidents: If you run a red light and hit another car—the collision is the peril.

Explosions: If a gas stove explodes in your home—the explosion is the peril.

Flood: If a river overflows and floods your home—the flood is the peril.

Disease: If you suffer from heart disease—the heart disease is the peril.

Death: If you die from the heart disease—death is the peril.

Perils are generally named in an insurance policy as **covered perils**, meaning that only the perils listed in the policy are covered. For example, if collision is not listed in the automobile policy with a limit of insurance, then collision is not included in the coverage. Unless flood is specifically listed as a covered peril in a Homeowners policy, it will be excluded from coverage.

Hazards

A hazard is a **condition** or the **source** that increases the *chance and/or severity* of a peril. Hazards typically will be present *before* a peril occurs; however, it is the peril that actually causes the loss. For example, driving on icy roads may cause you to slide off the road and hit a telephone pole. In this situation, what is the hazard and what is the peril? Hazard = ice... peril = collision with pole.

Let's review three types of common hazards.

1. Moral Hazard

A moral (more-ul) hazard results from a decision to do something wrong or to be less conscious of your actions since you know your insurance will pay for the loss. Have you ever been tempted to fake an accident to collect from insurance? Be honest... I said, tempted, not actually do it. If you followed through on that temptation, that would be considered a moral hazard. You are creating a loss (either by design or by lack of care for the situation) to profit from an insurance claim.

2. Morale Hazard



A morale (more-al) hazard is created when your careless and/or reckless actions or attitudes cause a loss to occur. For example, **texting while driving** an automobile would be a morale hazard. Also, **failing to wear a seatbelt** would be a morale hazard.

3. Physical Hazard

This one is easy. Physical hazards are the physical sources that cause or increase the chances of a loss. Common physical hazards include slippery floors, icy road conditions, and faulty structural defects in a building.

Occurrence

Occurrence is often associated with the term "accident", which is a sudden and unexpected event. For example, an auto accident (which happens at a specific place and time) is considered a single occurrence.

However, some policies define occurrence to also include "continuous or repeated exposure which results in bodily injury or property damage which is not expected or intended by the insured." If you were unaware of a slow carbon monoxide leak in your home due to a faulty CO detector, this would be an example of an occurrence that is a continuous and repeated exposure which could cause you bodily injury. You can't see or smell carbon monoxide, but over a period of months you become very ill.

Vacancy and Unoccupancy

Vacant means **both** the absence of people and personal property from the insured premises. Unoccupancy is **only** the absence of people. Vacant and unoccupied property has an increased chance of loss; therefore, most insurance policies will exclude or limit coverage for losses when property is vacant or unoccupied.

Blanket vs. Specific

Blanket coverage provides coverage for different classes of property under **one** policy. For example, you may insure several items, such as "all personal property located at 123 Main Street."

Specific insurance is when you insure a specific item or specific kind of property.

Burglary

Burglary is the taking of property from a premise that is closed and locked tight. There must be evidence of **forced entry or exit.** Burglary also includes the robbery of a guard or watchperson... forcing a mall security guard to open a locked store would be considered burglary.

Robbery

Robbery is the taking of property from a person by **violence** or threat of violence.

Theft

Theft is the **unlawful taking of property**-money, securities or other property. Typically, the peril of theft covers loss by burglary, robbery, and larceny.

Mysterious Disappearance

Mysterious disappearance is simply an unexplained loss of property. You are not sure how the loss occurred and there is no evidence that it was actually stolen.

Certificate of Insurance

This is a document that serves to provide evidence that you have purchased certain types of insurance coverages and limits. These may be required as proof of coverage in certain situations.

Exclusions

This is the part of the policy that states what perils are not covered. It eliminates coverage for certain acts, property, types of damage or locations. There is no need to memorize them all; just become familiar with the most common exclusions.

Conditions

The Conditions are provisions in the policy that qualify or place limitations on the insurer's promise to pay or perform. If the policy conditions are not met, the insurer can refuse to pay a claim. Common conditions in a policy include the requirement to file a proof of loss with the company, how to protect property after a loss, and how to cancel the policy,

Endorsements

Most insurance policies contain certain exclusions and/or limitations. For example, if your homeowners' policy excludes yachts and you don't own a yacht, you don't fret the exclusion, however if your policy limits jewelry to \$1,500 for theft and you have \$25,000 worth of jewelry, you may be concerned.

To ensure coverage you have two options: (1) purchase an endorsement to your homeowners' coverage or, (2) purchase a separate jewelry policy to increase the limits for your jewelry. So basically, an endorsement is a written **modification** that either **adds** or **deletes** one or more provisions of the standard policy to serve particular needs.

Insurance Concepts

Risk Management Methods

Risk management refers to the methods you can use to deal with the uncertainty of loss (risk). You are exposed to various types of risks each day, whether you are consciously aware of it or not.

Many risks are small in nature and do not present a serious or substantial financial impact; however, losses such as automobile accidents, serious health conditions, or loss of life can have a financially devastating effect. So, how can you manage (not prevent) risk? Here are five basic methods:

(Acron ym STARR)

1. Sharing Risk

Sharing risk distributes risk among a particular number of individuals. Each individual is responsible for a portion of the risk in direct relation to what that specific individual has invested. If you and I decide to jointly buy a boat together and pay \$10,000 cash for it. We agree that I will pay \$4,000 and you will pay \$6,000. Instead of paying insurance premiums, we decide to self-insure the boat. I will be responsible for 40% of any loss that occurs and you will be will responsible for 60%.

2. Transfer Risk

Insurance is the most common way—but not the only way—to transfer risk. When you purchase insurance of any type, you are transferring your risk to an insurance company. You purchase auto or homeowners insurance—you are transferring the risk of loss on your car or home to an insurer.

Another risk transfer method used in some circumstances is a **hold-harmless agreement**. This is an agreement or contract in which one party agrees to hold the other free from the responsibility for any liability or damage that might arise out of the transaction involved. For example, I agree to allow your janitorial company to provide cleaning services to our office building, but require you to sign a hold-harmless agreement indemnifying (securing against loss) me if you negligently leave a dangerous condition that injures a visitor. I have transferred that risk to you.

3. Avoid Risk

To keep it uncomplicated, just do not perform an activity that could carry risk. You can avoid the risk of being in an automobile accident, for example, by never getting into an automobile. You won't have to worry about losing value in your retirement portfolio if you stick with fixed rate investments. You are avoiding the riskier investments.

4. Reduce Risk

Since risk cannot be completely avoided, the possibility or severity of a loss can be reduced by using risk control techniques. For example, while you may not be able to completely prevent a fire from occurring in your home, the possibility or severity of a fire can be greatly reduced by installing a fire suppression system. Or, you can reduce your risk of dying from a sky-diving accident by giving up your hobby of sky-diving.

5. Retain Risk

Risk retention is choosing to be financially responsible for all or part of a risk. It's on you if a loss occurs. A good example is the boat that you and I just bought. While we shared the risk of loss with each other, we each *retained* an amount equal to what we invested when purchasing the boat.

Another common example of retaining risk is when you choose to buy insurance with a deductible.

You retain or self-insure the amount of the deductible.

Reinsurance

Reinsurance is a risk management tool used by most insurance companies to lessen their risk exposure. Companies (insurers) purchase insurance from another insurance company (reinsurer) to transfer some risk from the insurer to the reinsurer. The reinsurer has the company's back when losses occur. Here is how it works...

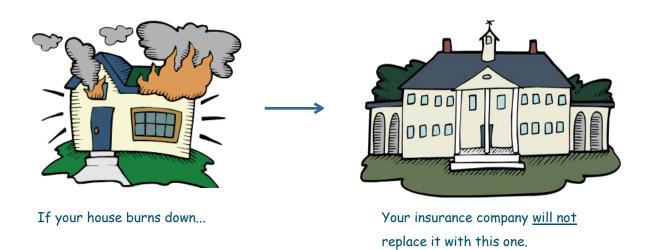
The reinsurer and the insurer enter into a reinsurance agreement which details the conditions upon which the reinsurer would pay the insurer's losses (either in excess of a certain amount or a percentage). The reinsurer is paid a reinsurance premium by the insurer, and the insurer then issues thousands of policies.

As an example, assume Large Insurance Company sells 1,000 policies with an average policy limit of \$1 million to American Re (the reinsurer). Theoretically, the insurer could lose \$1 billion (1,000 x \$1M). It may make more sense for Large to transfer some of their risk to American Re to help minimize their risk. So in basic terms, a reinsurer is an insurance company's insurance company.

Principle of Indemnity

Associate the word "restore" with indemnity as it relates to a covered loss. The principle of indemnity states that the insurance company will **restore** you to the same financial position you were in before the loss occurred—no profit, no loss. To indemnify means to secure against loss and make whole after a loss occurs. However, you should not be compensated by the insurance company in an amount exceeding your economic loss. *There should be no gain from your pain...* just restoration.

For example, if your house burns down, the insurance company will pay to rebuild your house to the same level it was prior to your loss. They will not build a larger, more elaborate house for you. If you remember, we discussed earlier that insurance companies will only insure pure risks. There is no opportunity for gain or profit with pure risks.



Insurable Interest

Insurable interest usually results from property rights, contract rights, and potential legal liability. You cannot directly benefit from any insurance unless you would lose money or value if the insured property suffers a loss. Insurable interest is the extent of your financial interest at the time of loss.

For example, if your house is damaged by fire, its value will be reduced; therefore, you have an insurable interest in your home since there would a financial loss resulting from the fire. On the other hand, if your neighbor's house is damaged by fire, you will not suffer a financial loss. You have an insurable interest in your own house but not in your neighbor's house.

You also have an insurable interest in our boat equal to 60% of the actual cash value, while I have a 40% insurable interest.

What about your bank or mortgage company? Do they have an insurable interest in your home? If they hold a mortgage on your house, you bet they do. Just cancel your homeowners policy and see what happens. The insurance company is directed to notify the bank/mortgage company, as the mortgage holder, of the cancellation. If this becomes an issue, the bank/mortgage company will purchase insurance to cover their insurable interest in your house and send you the bill. This coverage may not be nearly as inexpensive as the coverage you just cancelled.

When you take out a mortgage, the bank/mortgage company will usually require you to insure the home and name the bank/mortgage company as an **additional insured** on your Homeowners policy.

Coinsurance/Insuranceto Value

Coinsurance describes a splitting or spreading of risk among the insurance company and the insured. It rewards you when you buy adequate amounts of coverage; however, it can be brutal if you do not. The issue in this case is called the **coinsurance penalty**. The good news is the coinsurance penalty in a property and casualty policy can be avoided altogether if you purchase the right amounts of insurance.

For example, let's say that you purchased a new house—the house of your dreams. Your insurance company determines that it has a replacement value of \$750,000. Your insurance policy has an 80% coinsurance requirement, so you must insure it for at least 80% of the \$750,000 (\$600,000) if you want all **partial losses** to be paid without a coinsurance penalty. Of course, if you only insure for \$400,000, then you will be responsible for any loss amount exceeding that amount.

Even though most losses are partial losses, it may not be a good idea to insure less than what the coinsurance amount. In this case, if you insured your house for \$400,000 to save a few premium dollars, what would happen if you were to have a \$100,000 partial loss? Would you collect \$100,000? The answer is NO...too bad, so sad. You will be penalized by the **coinsurance clause.** Since you only purchased 67% of the coverage you should have, the company will pay only 67% of your claim—with a \$100,000 loss, this would be only \$67,000 minus your deductible. You will have to come up with an extra \$33,000 out-of-pocket for repairs to your dream home. That's a stiff penalty for being a tightwad!

To make sure you understand how we arrived at these numbers, let's take a closer look at the numbers.

(Amount of Insurance Carried \div Amount of Insurance Required) x Amount of Loss = Claim Payment $(400,000 \div 600,000 = .67) \times 100,000 = \$67,000$, minus your deductible.

Step #1: Determine *minimum* amount of insurance you should buy: \$750,000 x 80% = \$600,000

Step #2: Amount of insurance purchased: \$400,000

Step #3: Actual loss amount: \$100,000

Step #4: Divide the amount purchased by the amount that should have purchased, and then multiply that percentage by the amount of loss.

Loss Valuation

This is simply a method insurance companies use to decide how much to pay you for a loss. There are several methods companies use.

Actual Cash Value (ACV)

ACV is computed by subtracting **depreciation** from the replacement cost. The depreciation is usually calculated by establishing a useful life of the item and determining what percentage of that life remains. This percentage multiplied by the replacement cost equals the ACV. For example, the television set you purchased five years ago for \$2,000 was recently destroyed in a house fire. Your insurance company calculates that all televisions have a useful life of 10 years. A similar television today costs \$2,500. The destroyed television had 50% (5 years) of its life remaining. The ACV equals \$2,500 (replacement cost) times 50% (useful life remaining) or \$1,250.

Replacement Cost Value (RCV)

Replacement cost is the actual cost to replace an item or structure at its pre-loss condition. This may not



be the "market value" of the item and is typically distinguished from the ACV method which includes a deduction for depreciation. For example, what happens if a burglar steals your six-year old television set? With actual cash value coverage, you get only what you would expect to pay for a six-year-old television set. With replacement cost coverage, the insurance company pays to replace your TV with a new set similar to the stolen one.

Market Value



Market value is what the property could be sold for. This is different from replacement value. The replacement value is what the insurance company would pay to rebuild the home in case of a total loss. As an example, if you purchased a home in a depressed market for \$200,000 and the house burned down, it may take \$275,000 in building materials and labor costs to replace it. The market value is currently \$200,000, but you would want to insure the house for the full \$275,000 to replace it.

Stated Value

Stated value coverage pays the cost to repair an insured item or the stated value of the insured item, whichever is less. For example, when you purchase a homeowners policy, you will be asked the value of your personal items such as furniture, clothing, appliances, lawn mower, tools, etc.

If you report a value of \$100,000, that becomes your stated value. But, if a loss occurred, you will have to show proof that you lost that much and the insurance company certainly has the right to dispute your figures.

Salvage Condition

This condition allows the insurance company to settle with you by taking possession of the damaged property, then paying the full loss amount. After the insurance company sells the salvaged property, the proceeds can reduce the cost of the claim to the insurance company.

For example, you have an auto accident that totals your car. Your insurance company considers it a total loss. After the company pays the claim, they sell the car to a salvage dealer. The proceeds from the sale will help offset the claim paid.

Adverse Selection

One of the functions of the underwriting department is to protect the insurer from adverse selection. The concept of adverse selection suggests that the people who are poor risks are more likely to purchase insurance than average risks.

For example, someone just diagnosed with cancer would probably want to purchase a cancer policy if possible. If the person's doctor tells them that they will die from the cancer within 6 months, the person may want to purchase additional life insurance too. In these cases, the insurance company would not sell a policy to the person for obvious reasons.

Conversely, healthy people tend to delay purchasing insurance, or shop less often.



Types of Insurers

The insurance industry is a huge financial industry with over a thousand insurance companies operating in the United States today. Insurance companies are categorized according to how they are organized and operated.

Stock Company

A stock insurer is owned by a group of stockholders who are not necessarily policyholders. Shareholders or stockholders purchase shares of an insurance company's stock. By owning company stock, the stockholders are allowed to participate in company earnings. Similar to most other publicly traded companies, if the insurer makes money, then the stockholders benefit with increased stock values and stock dividends (not the same as mutual company surplus dividends).

In return, the shareholder pays taxes on those dividends as it is a return on their investment.

In most cases a stock company does not yield any direct surplus monies (dividends) to policyholders, so they are considered a **nonparticipating** insurance company which issues nonparticipating (nonpar) policies.

Mutual Companies

There are no stockholders in Mutual companies. Instead, the owners of a mutual insurance company are the policyholders.

Mutual companies generally sell **participating (par)** policies that pay policy dividends to the policyowner when declared by the company. Dividends are simply surplus company profits at year end that the insurer divides up among the policyholders. The decision to pay dividends or not each year rests with the company's board of trustees.

Note that participating policies generally have somewhat higher premiums than nonparticipating policies due to an allowance for future dividends.

There are other possible forms for an insurance company to operate under. Let's take a closer look at a few more.

Fraternal Benefit Societies

Fraternal societies have memberships based on religious, national, or ethnic affiliations. They are well-known for their social, charitable, and benevolent activities. These companies primarily sell life insurance.

Before you can purchase insurance from a fraternal company, you must become a member of the fraternal organization. The membership application is normally completed along with the application for insurance.

Fraternal societies are regulated somewhat differently from stock and mutual companies, but they closely resemble mutual companies in their organization and operation. These societies are for the benefit of their members, and have no stockholders, yet they pay dividends to policyholders.

Reciprocals

This is an unincorporated group of individuals or organizations (called subscribers) that agree to pool their risks together for the purpose of paying losses and purchasing reinsurance. They are managed by an **attorney-in-fact--**someone who is authorized to act for the group. Subscribers have a responsibility for paying the losses of the reciprocal.

Risk Retention Groups

A Risk Retention Group will allow members who engage in similar or related business or activities to write liability insurance for all or any portion of the exposures of group members.

For example, if liability insurance premiums for building contractors in a specific state go through the roof, all the building contractors in that state may join together and form a RRG. Each of the contractors will pay money into a common pool which would pay any liability claims filed against any member contractor.

Lloyd's Associations

Lloyd's is the world's best known, but probably least understood insurance brand. This is because Lloyd's is not an insurance company but rather a society of members, both corporate and individual, who underwrite in syndicates on whose behalf professional underwriters accept risk. Lloyd's provides a meeting facility and administrative services to its members. Capital is provided by investment institutions, specialist investors, international insurance companies, and individuals.

Together, the syndicates underwriting at Lloyd's form one of the world's largest commercial insurers and a leading reinsurer.

Lloyd's is best known for insuring most any risk for the right premium. Lloyd's underwriters have agreed to insure everything from the first airplane to the legs of famous movie stars. From shipwrecks and piracy to kidnap and ransom, Lloyd's can often find a way to cover those risks.

Private vs. Government Insurers

The federal and state governments provide social insurance programs in those areas where private insurers either cannot or will not write insurance. The U.S. government is the largest insurer in the world today.

Examples of government insurance programs include Social Security, Medicare, Medicaid, and state worker's compensation programs. Additionally, there are insurance programs available to the military and their families such as Service members Group Life Insurance (SGLI) and Tricare.

Other coverages include the National Flood Insurance Program (NFIP) to help provide flood insurance for catastrophic flood losses which insurers would not cover without government support.

Note that government insurance programs are primarily funded with taxes and serve national and state public interest.

In comparing social insurance programs with private insurance, there are four primary areas that differ:

- **1.** Participation in government insurance programs is mandatory and automatic for all citizens.
- 2. The government does not provide benefits under an insurance contract or policy. These benefits are in place as the result of the passage of certain laws. The only way to change any of these benefits is to change the laws that affect them.
- **3.** Social insurance programs are designed to be adequate enough to meet public needs rather than equitable. As the government redistributes income through the system, individuals who contribute the least amount into the system (the indigent, elderly, and those with a large number of dependents) receive greater benefits.
- **4.** The government has a clear and strong monopoly as an insurance provider.

Authorized and Non-authorized Companies (Admitted and Non-admitted)

Before an insurer may transact business in a specific state, they must apply for and receive a **Certificate of Authority** from the Insurance Commissioner and meet the capital and surplus requirements required by that state. Insurers who meet these 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 **non-admitted**.

Note that once a certificate of authority is issued, it belongs to the state rather than to the insurer.

Domicile

Domestic Company - This is the state where the insurer's home office is located. The insurer is considered to be a domestic company in their home state.

Foreign Company - This is a state—*other than* the insurer's home state—where the insurer is admitted to conduct business. The insurer is considered to be a foreign company in those states.

Alien Company - This is an insurer whose home office is located in a different country. Canada Life would be an alien company in Colorado, or any other state.

Insurance Distribution Systems

Insurance is sold by many different types of companies through an assortment of different distribution systems. The majority of consumers buy insurance through an insurance producer who represents an insurance company.

An insurance producer may be either an agent who represents a specific company or a broker who represents many different insurance companies.

1. Captive (Exclusive) Agency System

Captive agencies are similar to branch offices of stock and mutual insurance companies that represent one particular insurer in a specific geographical area.

Captive agencies recruit insurance producers who are trained and supervised by a company employee or a General Agent.

Depending on the insurance company, General Agents may act exclusively as a manager or as a manager and insurance producer combined.

a. Producer Category

A captive or exclusive producer is an agent who represents one insurance company and sells only that company's insurance products. The captive producer represents the insurance company, not the insured.

Producers who are new to the insurance business are usually paid first year commissions (FYC) of approximately 50% on annual life premium, plus a training allowance for the first two or three years. They also usually receive renewal commissions of approximately of 10%.

2. Independent Agency System

The independent agency system is a spin-off of the property and casualty insurance industry. Independent producers are not affiliated with a particular insurer; therefore, they are independent producers who represent various insurers.

a. Producer Category

Independent producers usually work for themselves, or for a General Agent (GA), or Managing General Agent (MGA). The independent producer represents the insured rather than the insurer. The independent producer may represent as many insurers as they desire, and are paid commissions on the business they write.

The independent producer owns the policy expirations that allow the producer to place an insured's business with another insurer at renewal time, if it is in the insured's best interest.

3. Managing General Agent System (MGA)

A personal producing general agency system recruits, hires, trains, and supervises other producers through a contractual agreement with an insurer. However, any producers hired by an MGA are employees or independent contractors of the MGA and not the insurance company.

The MGA's primary responsibilities are two-fold:

- 1. To sell insurance
- To build and supervise a sales force of producers in which the MGA receives an override commission.

MGA's are usually responsible for the overhead of maintaining their offices and administrative staff.

a. Producer Category

Generally, producers hired by an MGA will only sell products through contractual arrangements with insurers the MGA represents; however, there are many different types of agreements or arrangements permitted under the MGA system.

4. Brokers

Brokers are independent producers who sell insurance through many different insurance companies. A producer acting as a broker represents the insured in selecting the best coverage available from the various companies they represent. Brokers do not have binding authority.

5. Direct Response

Certain insurance marketing is conducted through direct selling methods in the mass media. This type of marketing is referred to as Direct-Response Marketing.

This method uses advertisements in newspapers, magazines, television, and other mass media sources to market policies directly to consumers. The policies offered usually have low premiums and low benefits.

a. Producer Category

Direct response systems do not normally use agents for the sale of insurance. Instead, insurance is sold through mass media advertising, typically with the customer responding by calling an advertised

telephone number that links the customer directly to the insurance company, or by mailing a direct response card or application provided by the insurance company.

6. Direct Writing Companies

Direct writing companies sell their policies through company employees who are compensated by salary or a combination of salary plus commission. The representatives do not own the policy expirations, so they do not have the choice of moving a policy to another company when the policy renews. Therefore, the insurer owns all of the business written.

a. Producer Category

Generally, producers are salaried employees of the direct writing company.

7. Internet Insurance Sales Systems

This is a relatively new insurance distribution system, offering many different lines of insurance coverage. Insurance can be purchased online directly from the insurance company or agent.

a. Producer Category

Many property & casualty and life & health insurers have websites available, either for direct purchase or to locate an agent.

8. Franchise Marketing Systems

Franchise marketing provides insurance coverage to groups of employees that are too small to meet the requirements of a group policy. Individual policies are issued with premiums payable by payroll deduction. Each policy will vary as to the amount of coverage issued and premium amounts. Individual underwriting is required; therefore, no group underwriting or premium rate reduction is given.

9. Non-Insurance Marketing Systems

This system markets insurance products through financial institutions that issue credit cards. The purchase of the insurance product can be deducted from the credit cards or banking accounts held by the financial institutions marketing the insurance product.

Policy and Rate Filings

Insurers are required to file any policy forms and rates offered in a particular state with the regulatory agency of that state. The regulatory agency is usually the Department of Insurance (DOI).

Rating laws apply to property and liability insurance. The principal rating laws that allow an insurer to change their rates vary with each jurisdiction, but generally fall into one of the following categories:

#1- Prior Approval - This law can present problems for most insurers. Insurers are generally required to receive approval from the DOI for a rate change **before** they can change it, which usually means the company must justify and show good cause for changing the rate. In most states, the general procedure is that if the Commissioner does not disapprove the rate change within a specific period of time, such as 30 or 60 days, the rate is deemed approved.

#2- File and Use - Insurers must file rate changes with the DOI, but do not need to wait for approval to put them into effect.

#3-Use and File - This law allows the insurance company to change rates immediately, but must file the new rate with the DOI within a specific time—typically 15 to 60 days.

#4- Open-Competition Laws - These laws eliminate all filing requirements; however, insurers may be required to furnish rate schedules to the DOI, if requested. Rates under this law are naturally regulated by competition.

Premium Determination and Rating

The pricing goal for insurers is to charge a premium that is proportional to their loss exposure. To accomplish this goal, the premium charged for each insured should be adequate enough so that the total premiums paid by a large group of similar insureds will pay the losses and expenses of that group. Additionally, the premiums must also include a reasonable profit for the insurer.

How do insurers know how much to charge? First, they must classify the applicant by category of loss exposure. For example, if you live in a \$500,000 home and have no homeowner's insurance, you will have a loss exposure of \$500,000. The insurer must then determine a premium by applying an appropriate rate to your exposure units. The rate then will be the price of insurance charged per exposure unit. An exposure unit is a unit measure of loss potential used in rating insurance.

The exposure unit used depends on the type of insurance:

For Property Insurance: Each \$100 of insurance;

Auto Liability Insurance: Each insured month (one car insured for one year would be 12 exposure units).

To determine the premium amount, you must multiply the rate by the number of exposure units. For example, the premium for property insurance with a limit of \$500,000 at a rate of \$0.25 per \$100 of insurance is \$1,250.

Premium = $\frac{$500,000}{$100}$ (5,000 units × \$0.25 per unit = \$1,250)

Rate Types

When the underwriter is ready to issue the policy, a rate is determined for the application. Rates may vary according to several factors.

There are 3 common types of ratings:

1. Judgment Rating

Rates are determined based on the knowledge and experience of the underwriter, rather than using an actual premium manual.

2. Manual or Class Rating

Rates for all states are contained in a manual provided by the insurer. Manual rates may be modified by using merit rating or experience rating.

Under **experience rating**, the manual rate is modified based on the insured's loss history for claims filed during a specific period. If past loss experience is worse than the average loss experience expected for this class of insured, the insured will pay more than the manual premium. If the insured's past loss experience is better than average, the insured will pay less than the manual premium.

Under **retrospective rating**, the insured's premium is based on losses that are incurred during the policy period. The final premium is based on the insured's actual loss experience during the policy term, sometimes subject to a minimum and maximum premium, with the final premium determined by a formula.

3. Merit Rating

Merit rating charges more to those who are more likely to have losses, and charges less to those less likely to have losses. For example, with auto insurance, an applicant with a good driving record will most likely receive a lower premium than a person who can't seem to drive between the lines or stay within the speed limits.

Loss Costs

This is a factor which insurers use in calculating insurance rates. It represents the amount an insurer should collect to cover expected losses.

Loss Ratio

Loss ratios help an insurer to determine if the business they are writing is profitable. Insurers need to determine if the company can pay for current losses out of current premium income.

Basic loss ratios can be determined by the following formula:

Losses ÷ Earned premium = Loss ratio

 $100,000 \div 200,000 = 50\%$ Loss ratio

Loss ratios that are under 100% mean that the insurer is making an underwriting profit. Conversely, loss ratios that exceed 100% mean that the insurer is losing money.

Lesson Wrap-Up

To pass the state insurance exam, you will need to **master** all of the following:

Memorize all insurance terms and definitions in this chapter—all of them! Don't proceed to the next lesson without mastering this lesson first. You will get bogged down later if you do.

Become familiar with all of the insurance concepts, paying special attention to how the concepts work in real life situations. For example—how coinsurance is calculated, direct loss vs. indirect loss, principle of indemnity, and so on.

There is no secret to this—no magic formula. Take notes, review this lesson several times, and then proceed to your lesson Driller-this is your end of chapter 'open book quiz'. You can do this!