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Segment A:
Fundamentals of Insurance

Segment A introduces the concept of insurance as having three aspects: a transfer system, a business, and a contract. You will learn what insurance is, who provides it, and how the insurance business is regulated. The last chapter in this segment discusses the financial performance of insurance companies.

Chapter 1

Insurance: What Is It?

Educational Objectives

After studying this chapter, you should be able to:

1. Explain how insurance works as a system of transferring and sharing the costs of losses. (p. 1-4)
2. Explain the law of large numbers and its significance to the operation of insurance. (p. 1-5)
3. Identify and describe three major types of loss exposures. (pp. 1-5 to 1-7)
4. Identify and describe the characteristics of an ideally insurable loss exposure. (pp. 1-7 to 1-9)
5. Identify the three major types of private insurers. (p. 1-11)
6. Explain the need for government insurance, and give examples of (a) federal insurance programs and (b) state insurance programs. (pp. 1-11 to 1-12)
7. Briefly describe the major operations of insurance companies. (pp. 1-12 to 1-13)
8. Briefly explain why and how state insurance departments regulate insurers. (pp. 1-14 to 1-15)
9. Identify and describe the benefits of insurance. (pp. 1-15 to 1-18)

10. Identify and describe the costs of insurance. (pp. 1-18 to 1-20)
11. Describe and distinguish among the major types of property and liability insurance. (pp. 1-21 to 1-24)
12. Describe and distinguish among the major types of life and health insurance. (pp. 1-24 to 1-25)
13. Define or describe each of the Key Words and Phrases for this assignment. (All Key Words and Phrases appear in bold print in the text and in boxes in the margins throughout this chapter.)

Chapter 1

Insurance: What Is It?

Every person, family, and business needs insurance of some type to protect assets against unforeseen events that could cause financial hardship. Sometimes, insurance is needed to satisfy a contractual obligation, such as a homeowner's commitment to purchase insurance on the home to protect the mortgage company's investment in case the home is damaged or destroyed. Almost everyone needs insurance, but few people really understand it. What exactly *is* insurance?

Insurance is actually three things:

- A *transfer system*, in which one party—the **insured**—transfers the chance of financial loss to another party—the insurance company, or the **insurer**
- A *business*, which includes various operations that must be conducted in a way that generates sufficient income to pay claims and provide a reasonable profit for its owners
- A *contract* between the insured and the insurer that states what potential costs of loss the insured is transferring to the insurer and expresses the insurer's promise to pay for those costs of loss in exchange for a stated payment by the insured

An **insured** is a person, a business, or an organization whose property, life, or legal liability is covered by an insurance policy.

An **insurer** is an insurance company.

This chapter provides an introduction to these three aspects of insurance. Insurance as a transfer system is one technique of risk management, which Chapter 10 will cover. The insurance business and its various operations are discussed in Chapters 4 through 6, and insurance as a contract is covered in Chapter 7.

Educational Objective 1

Explain how insurance works as a system of transferring and sharing the costs of losses.

Insurance as a Transfer System

Insurance is a system that enables a person, family, or business to transfer the costs of losses to an insurance company. The insurance company, in turn, pays for **covered losses** and, in effect, distributes the costs of losses among all insureds (that is, all insureds share the cost of a loss). Thus, insurance is a system of both *transferring* and *sharing* the costs of losses.

Covered losses are the events for which insurance pays.

Transferring the Costs of Losses

By transferring the costs of their losses to insurance companies, insureds exchange the possibility of a large loss for the certainty of a much smaller, periodic payment (the premium that the insured pays for insurance coverage). This transfer is accomplished through insurance policies. An insurance policy is a contract that states the rights and duties of both the insured and the insurer regarding the transfer of the costs of losses.

There would be no need to transfer the costs of losses to an insurance company, however, if there were no exposures to loss, that is, no possibility that losses would occur. It is not necessary for a loss to occur for a **loss exposure** to exist; there simply must be the *possibility* of a loss. For example, every home has a fire loss exposure; in other words, the possibility exists that a fire could occur and cause a financial loss to the homeowner.

A **loss exposure**, or simply an **exposure**, is any condition or situation that presents the possibility of a loss.

Sharing the Costs of Losses

As a system of sharing, insurance involves the "pooling" by the insurance company of the premiums paid by insureds. Insureds who incur covered losses are paid from the insurer's funds, and the total cost of losses is thereby spread (or shared) among all insureds. Insurance companies estimate future losses and expenses to determine how much they must collect from insureds in premiums.

Educational Objective 2

Explain the law of large numbers and its significance to the operation of insurance.

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

The **law of large numbers** is a mathematical principle stating that as the number of similar but independent exposure units increases, the relative accuracy of predictions about future outcomes (losses) based on these exposure units also increases.

An **exposure unit** is a measure of loss potential and is used in pricing insurance. For example, in homeowners insurance, each home insured is an exposure unit.

For example, a homeowner is uncertain whether a fire will damage his or her home and transfers this uncertainty to an insurance company. The insurance company insures thousands of homes whose owners face the same uncertainty. Because of this large number of homes, the insurance company can, with a great deal of accuracy, predict the number of homes that will be damaged by fire during a given period. Based on this prediction, the insurance company can determine the amount of premiums that it needs to pay for the fire losses during that period.

Educational Objective 3

Identify and describe three major types of loss exposures.

Types of Loss Exposures

On a New Year's Eve some years ago, a fire swept through the ballroom and lower floors of a crowded hotel; more than 200 hotel guests and employees were killed or injured. All of the hotel's rooms were booked at the time of the fire, and it was alleged that the number of people occupying the ballroom exceeded its legal capacity. It was later discovered that disgruntled former employees had started the fire. Regardless of the cause of the fire, however, the hotel owners had not taken proper precautions to deal with a fire emergency. For example, the owners had not installed an automatic sprinkler system, fire walls were insufficient, exits were unlighted, and the hotel had no emergency plan to safely evacuate hotel occupants.

The hotel fire illustrates three major types of loss exposures that are useful in identifying and categorizing potential losses:

- Property loss exposures
- Liability loss exposures
- Human and personnel loss exposures

Property Loss Exposures

A **property loss exposure** is any condition or situation that presents the possibility that a property loss will happen.

Real property consists of land as well as buildings and other structures attached to the land or embedded in it.

Personal property consists of all tangible or intangible property that is not real property.

Every **property loss exposure** involves some type of property that is exposed to potential losses. Property includes real property and personal property. **Real property** is land and any property attached to it. A house, a storage shed, a swimming pool, a factory building, a flagpole, and an underground sewer pipe are all items of real property, as is the land where each is situated. All property that is not real property is **personal property**. Examples of personal property include the inventory of a retail merchant, furniture and fixtures in a restaurant, equipment and machinery in a factory building, contents of a dwelling, computers, money, securities, automobiles, patents, and copyrights.

In the hotel fire example, damage to the building and the personal property of the owners and others totaled several million dollars. For example, the hotel building was badly damaged and had to be repaired. Much of the furniture and carpeting in the hotel was damaged or destroyed and had to be replaced. The hotel guests' clothing and other personal property that were destroyed also had to be replaced.

Net income is income (or revenue) minus expenses during a given period.

Damage to property can also cause indirect losses, such as **net income** losses. All individuals, families, and businesses must generate an excess of income over expenses in order to remain financially sound. A net income loss can be the result of a reduction in revenue, an increase in expenses, or both. The net income losses of a business often greatly exceed the property loss that caused them, as in the hotel fire example.

While the damaged rooms in the hotel were being repaired and cleaned, the hotel's revenue decreased because guest rooms were empty. The hotel had to cancel social and business functions and close its restaurants and shops. Because of negative publicity about the fire, the hotel permanently lost some of its revenue to competition. The hotel also incurred increased expenses for overtime pay for some employees while it was being restored.

Liability Loss Exposures

A **liability loss exposure** is any condition or situation that presents the possibility that a *liability loss* will happen.

A **liability loss** is a claim for monetary damages because of injury to another party or damage to another party's property.

A **liability loss exposure** presents the possibility of a claim alleging legal responsibility of a person or business for injury or damage suffered by another party. Some liability claims result in a lawsuit; even if the lawsuit is groundless, the defendant might incur substantial expenses to defend against the suit. Liability claims might result from bodily injury, property damage, libel, slander, humiliation, defamation, invasion of privacy, and similar occurrences.

A **liability loss** usually results from one party negligently causing injury to another or damaging another's property. In the hotel fire example, the hotel owners were judged to be negligent for various reasons, including failure to take proper precautions to handle a fire emergency. As a result of the fire, the hotel incurred liability losses that included payments for medical expenses, rehabilitation costs, and pain and suffering experienced by the guests, employees, and others injured in the fire. Liability losses also included payments for damage to property belonging to guests and payments to survivors of people killed in the fire.

Human and Personnel Loss Exposures

Human loss exposures (also called **personal loss exposures**) can cause financial loss to individuals because of death, disability, or unemployment. The term human losses refers to the effect of death, disability, or unemployment on individuals or families. For example, a family would face a loss of income if a breadwinner died or became disabled or unemployed.

Personnel loss exposures, on the other hand, affect businesses. The term personnel losses generally refers to losses suffered by a business because of the death, disability, retirement, or resignation of key employees. For example, a business organization could face a financial loss if a key executive, sales representative, or product developer died, became disabled, or resigned and could not be readily replaced.

In the case of the hotel fire, if a key employee (such as the master chef) died in the fire, the hotel owners would experience a personnel loss. The chef's family and the families of others killed or injured by the fire would suffer human, or personal, losses.

A **human loss exposure**, also called a **personal loss exposure**, can be defined as any condition or situation that presents the possibility of a financial loss to an individual or a family by such causes as death, sickness, injury, or unemployment. (In a broader sense, the term *personal loss exposure* can also be used to include all loss exposures faced by individuals and families, including property and liability loss exposures.)

A **personnel loss exposure** is the possibility of a financial loss to a business because of the death, disability, retirement, or resignation of key employees.

Educational Objective 4

Identify and describe the characteristics of an ideally insurable loss exposure.

Ideally Insurable Loss Exposures

Insurance contracts cover events that might or might not happen. If the events do occur, a financial loss usually results. By transferring the potential costs of the uncertain event to the insurance company, the insured reduces or eliminates the possibility of suffering a financial loss. By charging a premium in return, the insurance company gains the opportunity to make a profit if it handles a volume of similar transactions efficiently. Therefore, each party to the contract receives some benefit from the transaction. However, the transaction is not likely to be advantageous to the insurer unless the loss exposure has certain characteristics that make it ideally insurable from the insurer's standpoint. Insurance companies generally prefer to provide insurance for the financial consequences of loss exposures that have the following characteristics:

- Large number of similar exposure units
- Losses that are accidental
- Losses that are definite and measurable
- Losses that are not catastrophic
- Losses that are economically feasible to insure

Large Number of Similar Exposure Units

An ideally insurable loss exposure must be common enough that the insurer can pool a large number of homogeneous, or similar, exposure units. This characteristic is important because it enables the insurer to predict losses accurately and to determine appropriate premiums.

Loss exposures that satisfy this requirement, such as the possibility of damage to homes or automobiles, allow the insurance company to take advantage of the law of large numbers. The insurance company can determine appropriate premiums based on the experience of thousands of similar exposure units and make reasonably accurate predictions about losses.

On the other hand, predicting the number of losses each year to space stations in outer space would be difficult, since there are very few exposure units. Moreover, each loss could drastically affect the profitability of an insurance company and the insurance business as a whole. The inability of insurance companies to predict losses and thus to determine adequate premiums makes most insurers reluctant to insure unusual loss exposures such as those represented by space stations.

Losses That Are Accidental

An ideally insurable loss exposure also involves a potential loss that is accidental from the standpoint of the insured. If the insured has some control over whether a loss will occur, the insurance company is at a disadvantage because the insured might have an incentive to cause a loss. If losses are not accidental, the insurance company cannot calculate an appropriate premium because the chance of a loss could increase as soon as a policy is issued. If the loss exposure involves only accidental losses, the insurer can better estimate future losses and calculate an adequate premium for the exposure.

Losses That Are Definite and Measurable

To be insurable, a loss should have a definite time and place of occurrence, and the amount of the loss must be measurable in dollars. Insurable loss exposures should be definite and measurable for practical reasons. If the time and location of a loss cannot be definitely determined and the amount of the loss cannot be measured, writing an insurance policy that defines what claims to pay and how much to pay for them becomes extremely difficult. Also, losses are impossible to predict if they cannot be measured. For example, the sudden bursting of a water pipe that causes water damage in the insured's bathroom is an occurrence that has a definite time and place and that can thus be insured. However, if a slow leak in the pipe causes decay and rotting of the insured's bathroom floor over several years, the resulting loss does not have a definite time of occurrence and is generally not insurable.

Losses That Are Not Catastrophic

Effective pooling of exposure units assumes that the exposure units are independent. Independence means that a loss suffered by one insured does not affect any other insured or group of insureds. If exposure units are not independent, a single catastrophe could cause losses to a sizable proportion of insureds at the same time. For example, if an insurance company insured all of the homes and businesses in a particular city, the insurance company would probably suffer a financial disaster if a hurricane leveled the city. The insurer would be unlikely to have the financial resources to pay all claims of all the insureds affected by the hurricane.

This tendency of insurers not to insure catastrophic losses does not mean that hurricane damage to property is not insurable. Coverage for windstorm damage, including hurricane and tornado damage, is readily available throughout most of the country. However, an insurance company avoids possible financial disaster by managing its pool of insureds in such a way that it does not have a large proportion of its insureds exposed to loss in any single event. For windstorm coverage, the insurance company must diversify the homes and businesses it insures so that it does not have a heavy concentration of insureds in any one geographic area. Consequently, the insurer maintains as much independence as possible among its insureds. If each of many insurers issued a relatively small number of policies in the city devastated by the hurricane, no one insurer would face financial ruin.

Losses That Are Economically Feasible To Insure

Insurance companies seek to cover only loss exposures that are economically feasible to insure. Because of this constraint, loss exposures involving small losses as well as those involving a high probability of loss are generally considered uninsurable. Writing insurance to cover small losses does not make sense when the expense of providing the insurance probably exceeds the amount of potential losses. Insurance to cover the disappearance of office supplies, for example, could require the insurer to spend more to issue claim checks than it would to pay for the claims. It also does not make sense to write insurance to cover losses that are almost certain to occur. In such a situation, the premium would probably be as high as or higher than the potential amount of the loss. For example, insurers generally do not cover damage due to wear and tear of an automobile, because autos are certain to incur such damage over time.

Insurance as a Business

The insurance business in the United States provides well over 2 million jobs and, in the late 1990s, had combined assets totaling more than $3.1 trillion. Nearly 8,000 insurance companies are based in the United States, of which well over 3,000 sell property and liability insurance and other related types of insurance. Property and liability insurance companies employ over 600,000 people. In addition, over 700,000 people work in insurance agencies, brokerage firms, and insurance service agencies.[1]

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

Through their insurance departments, state governments closely regulate the business of insurance. Private insurers must be licensed in the states in which they sell insurance. Since regulation of licensed insurers encompasses all insurer operations, state insurance regulators review insurance rates, policy forms, underwriting practices, claim practices, and financial performance of insurance companies. Regulators can revoke the licenses of insurers that do not fully comply with state regulations.

This section provides a brief overview of the business of insurance in regard to the following:

- Types of insurers
- Insurance operations
- Financial performance of insurers
- State insurance regulation
- Benefits and costs of insurance

Types of Insurers

Many different types of private insurers offer various types of insurance. The federal government and state governments also provide insurance. In some cases, government insurance plans supply the same types of insurance as private insurers; in other cases, government insurance provides coverage that is not available from private insurers.

Educational Objective 5

Identify the three major types of private insurers.

Private Insurers

The three major types of private insurers are as follows:

- Stock insurance companies, which are corporations owned by stockholders
- Mutual insurance companies, which are corporations owned by their policyholders
- Reciprocal insurance exchanges (also known as an interinsurance exchanges), which are unincorporated associations that provide insurance services to their members, often called subscribers

Other private providers of insurance include Lloyd's of London, captive insurance companies, and reinsurance companies. Chapter 2 will discuss these types of insurance providers.

Educational Objective 6

Explain the need for government insurance, and give examples of (a) federal insurance programs and (b) state insurance programs.

Federal Government Insurance Programs

Some federal government insurance programs exist because of the huge amount of financial resources needed to provide certain types of coverage and because the government has the authority to require mandatory coverage. Social Security is the best example of such a program. Private insurers provide some benefits similar to those provided by the Social Security program, but the number of Social Security beneficiaries and the range of coverages are beyond the scope of private insurers.

In addition to the Social Security program, the federal government provides coverage that only certain segments of the population need. The National Flood Insurance Program provides insurance for owners of property located in flood-prone areas and for others concerned about the exposure of flooding. The Federal Crop Insurance Program insures farmers against damage to their crops by drought, insects, hail, and other causes. The federal government also insures depositors against loss resulting from the failure or insolvency of banks (through the Federal Deposit Insurance Corporation) and credit unions (through the National Credit Union Administration).

State Government Insurance Programs

State governments also offer insurance programs to assure the availability of certain types of coverage considered necessary to protect the public. All states require that employers be able to meet the financial obligations based on workers compensation laws. Some states sell workers compensation insurance to employers. Depending on the state, the state workers compensation insurance program might be the employers' only option, or it might be one of several options available to employers to meet their obligations.

In addition, state governments operate unemployment insurance plans, which ensure at least a minimum level of protection for eligible workers who are unemployed. Fair Access to Insurance Requirements (FAIR) plans have been implemented in many states to provide basic property insurance to property owners who cannot otherwise obtain needed coverage. Through automobile insurance plans and other programs, states make auto insurance available to drivers who have difficulty obtaining such insurance from private insurers.

Educational Objective 7

Briefly describe the major operations of insurance companies.

Insurance Operations

An insurance company must take great care in arranging the insurance it agrees to provide, not only to make certain it can meet its commitments to insureds to pay for covered losses, but also to collect enough premiums to earn a reasonable profit after paying those losses. The insurer must market effectively in order to cover enough customers to enable it to operate economically. It must also decide which potential customers to insure, what coverage to offer, and what premium to charge so that customers are adequately insured and the insurer can operate profitably. The insurer must then determine which losses sustained by its customers are covered and the amount to be paid for covered losses.

To accomplish these objectives, insurance companies engage in the following operations, all of which upcoming chapters will discuss:

- Marketing
- Underwriting
- Claim handling
- Ratemaking

Marketing is the process of identifying customers and selling and delivering a product or service. Insurance marketing enables insurers to reach potential customers and retain current ones. Insurance producers are an integral part of insurance marketing because they represent insurance companies in providing insurance products to the public. Other important aspects of marketing are advertising and marketing management. Marketing management comprises producer supervision and motivation, as well as product management.

Underwriting is the process by which insurance companies decide which potential customers to insure and what coverage to offer them. Underwriters are the insurance company employees responsible for selecting insureds, pricing coverage, and determining policy terms and conditions. Effective underwriting enables insurers to provide the coverage needed by insureds and to be reasonably certain that the loss fund will be sufficient to pay for their losses.

Claim handling enables insurance companies to determine whether a covered loss has occurred and, if so, the amount to be paid for the loss. The role of a claim representative is to satisfy the insurer's obligations under an insurance policy by promptly responding to claims and gathering the information necessary to evaluate a claim properly and reach a fair settlement.

Ratemaking, another important insurance operation, is the process by which insurers determine the rates to charge the thousands (or millions) of similar but independent insureds. Insurers need appropriate rates to have enough money to pay for losses, cover operating expenses, and earn a reasonable profit.

To support their operations, insurance companies process vast amounts of data. They rely on computers to process most of that data and to generate information. Insurers use computers to process applications, to issue and renew policies, to generate invoices, to keep records of claims and loss payments, and to maintain accounting records and statistical reports. In addition to insurance-related information, insurance companies use computers in the same way that other businesses do. That is, they use computers to generate management information reports and to store and retrieve data relating to employees, investments, customers, suppliers, and other matters.

All of these operations are aspects of the insurance business. An insurance company's income must, in the long run, exceed the amount it pays for claims and administrative expenses if the company is to remain financially viable. Therefore, an insurance company's financial performance is very important, but not just to the insurance company. State insurance regulators, insurance producers, stockholders, and insureds also need to be assured of the financial health of an insurance company.

Financial Performance of Insurers

The primary sources of income for insurance companies are premiums and investments. Insurance companies have investments because they receive premiums before they pay for losses and expenses. Insurers invest the money in the meantime and receive investment income as a result. One of the goals of insurers is to generate enough revenues from premiums and investments to pay for losses, meet other expenses, and earn a reasonable profit. In addition to loss payments, insurance companies incur several other types of expenses. Insurers have loss settlement expenses, which include the costs of investigating and settling claims. They also incur expenses to acquire new business, such as advertising costs and producers' commissions, and general expenses, such as salaries, employee benefits, utilities, telephones, and computer equipment. Insurance companies pay premium taxes, income taxes, and various licensing and other fees. Insurers have expenses associated with investment activities, such as the salaries of investment department staff members. The ability to pay these expenses and still make a reasonable profit is a measure of an insurance company's solvency, that is, its long-term financial strength.

Educational Objective 8

Briefly explain why and how state insurance departments regulate insurers.

State Insurance Regulation

A major concern of insurance regulators is that insurers be able to meet their obligations to insureds. A financially weak insurer may not have the resources necessary to meet its obligations. Therefore, insurance regulators closely monitor the financial condition of insurance companies and take actions necessary to prevent insurer insolvency.

Every state has an insurance department that regulates the insurers doing business in the state. Almost all aspects of the insurance business are regulated to some degree, but most insurance regulation deals with rates, insurer solvency, and consumer protection.

State insurance departments regulate insurance rates to protect consumers from inadequate, excessive, or unfairly discriminatory rates. Adequate rates are necessary for insurers to earn enough premium income to pay for losses and other expenses while generating a reasonable profit. Alternatively, if rates were excessive, insurers could earn unreasonable profits. Insurance rates should reflect the exposures to loss presented by insureds, and insureds with similar loss exposures are grouped together in a single rating class and charged the same rate. Although other insureds may be grouped in a different rating class and charged a different rate, that rate must reflect the group's exposures to loss. It would be unfair, however, if the different rate reflected characteristics of the group that had no bearing on their exposures to loss. Therefore, rates based on such characteristics would not be permitted because they would be unfairly discriminatory. What constitutes "unfair discrimination" varies by state, and some states no longer allow discrimination based on such characteristics as age and sex for certain types of insurance.

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To recognize the value of payment for losses, consider the aftermath of a loss for those who have no insurance. If fire destroys the home of a family with no insurance, the family members might be left without the financial resources to repair their home or to replace their belongings; they might also face the immediate lack of a place to live. A business can incur bankruptcy as the result of a liability judgment it cannot pay, and the employees and owners of the business will suddenly be unemployed. By indemnifying insureds, insurance provides some degree of financial security and stability for individuals, families, and businesses.

Reduction of Uncertainty

Because insurance provides financial compensation when covered losses occur, it greatly reduces the uncertainty created by many loss exposures. A family's major financial concerns, for example, would probably center around the possibility of a breadwinner's death or the destruction of a home. If the family transfers the uncertainty about the financial consequences of such losses to an insurance company, the family practically eliminates these concerns. Insurance companies have greater certainty than individuals about losses, because the law of large numbers enables them to predict the number of losses that are likely to occur and the financial effects of those losses.

Loss Control Activities

Insurance companies often recommend loss control practices that people and businesses can implement. *Loss control* means taking measures to prevent some losses from occurring or to reduce the financial consequences of losses that do occur. Individuals, families, and businesses can use measures such as burglar alarms, smoke alarms, and deadbolt locks to prevent or reduce losses. Loss control generally reduces the amount of money insurers must pay in claims. As a result, loss control helps to improve the financial results of insurers and to reduce insurance costs to consumers. Thus, society benefits from activities that prevent and reduce losses.

Efficient Use of Resources

People and businesses that face an uncertain future often set aside funds to pay for future losses. Insurance makes it unnecessary to set aside a large amount of money to pay for the financial consequences of loss exposures that can be insured. Money that would otherwise be set aside to pay for possible losses can be used to improve a family's quality of life or to contribute to the growth of a business. In exchange for a relatively small premium, families and businesses can free up additional funds that they would otherwise need to reserve to pay for unforeseen future losses.

Support for Credit

Before making a loan, a lender wants assurance that the money will be repaid. When a lender loans money to a borrower to purchase property, the lender usually acquires a legal interest in that property. The lender can repossess a car or foreclose a home mortgage if the loan is not repaid. However, the lender would be less likely to make loans if it did not have some assurance of getting back its money if the car or house were destroyed or if the borrower died or became disabled before the loan was paid in full. Insurance makes loans to individuals and businesses possible by guaranteeing that the lender will be paid if the collateral for the loan (such as a house or a commercial building) is destroyed or damaged by an insured event, thereby reducing the lender's uncertainty.

Satisfaction of Legal Requirements

Insurance is often used or required to satisfy legal requirements. In many states, for example, automobile owners must prove they have auto liability insurance before they can register their autos. All states have laws that require employers to pay for the job-related injuries or illnesses of their employees, and employers generally purchase workers compensation insurance to meet this financial obligation.

Satisfaction of Business Requirements

Certain business relationships require proof of insurance. For example, building contractors are usually required to provide evidence of liability insurance before a construction contract is granted. In fact, almost anyone who provides a service to the public, from an architect to a tree trimmer, might need to prove that he or she has liability insurance before being awarded a contract for services.

Source of Investment Funds

One of the greatest benefits of insurance is that it provides funds for investment. When insurers collect premiums, they do not usually need funds immediately to pay losses and expenses. Insurance companies use some of these funds to make loans to businesses. Such loans provide investment money for projects such as new construction, research, and technology. Investment funds promote economic growth and job creation. Insurance companies also invest in social projects, such as cultural events, education, and economic development projects. Investment brings additional funding to insurers in the form of interest; this additional income helps to keep insurance premiums at a reasonable level.

Reduction of Social Burdens

Uncompensated accident victims can be a serious burden to society. Insurance helps to reduce this burden by providing compensation to such injured persons. For example, workers compensation insurance provides payment to injured workers for medical expenses, lost wages, and rehabilitation, as well as death benefits to survivors. Compulsory auto insurance is another example, because it provides compensation to auto accident victims who might otherwise be unable to afford proper medical care or who might be unable to work because of the accident. Without insurance, victims of job-related or auto accidents might become a burden to society and need some form of state welfare.

Educational Objective 10

Identify and describe the costs of insurance.

Costs of Insurance

The benefits of insurance are not cost-free. However, the benefits of insurance far outweigh the costs, and insurance is generally considered to be a tremendous economic and social benefit. Among the costs of insurance are both direct and indirect costs, including the following:

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

Premiums Paid by Insureds

Insurers must charge premiums in order to have the funds necessary to make loss payments. In fact, an insurance company must collect a total amount of premiums that exceeds the amount needed to pay for losses in order to cover its costs of doing business. For example, an insurance company might use seventy-five cents of every premium dollar to pay for losses and twenty-five cents for other expenses. Although insurance premiums by law must not be excessive, some insureds believe that their premiums are too high. All those who are insured must consider premiums as a cost of living and doing business in an industrialized society.

Operating Costs of Insurers

Like any business, an insurance company has operating costs that must be paid to run the day-to-day operations of the company. Those costs include salaries, agent commissions, advertising, building expenses, equipment, taxes, licensing fees, and many others. In addition, most insurers are in business to make a profit, just like any other business. A reasonable amount of profit must be calculated in the cost of insurance that insureds pay.

Opportunity Costs

If capital and labor were not being used in the business of insurance, they could be used elsewhere and could be making other productive contributions to society. Therefore, whatever resources the insurance industry uses in its operations represent lost opportunities in other areas—in other words, opportunity costs. These opportunity costs represent one of the costs of insurance.

Increased Losses

The existence of insurance might encourage losses to some extent. Although insurers have an economic incentive to provide and to encourage loss control measures, insurance sometimes provides an economic incentive for insureds to have losses. Because of insurance, a person might intentionally cause a loss or exaggerate a loss that has occurred. For example, it was estimated that 85,500 structural fires and 47,000 vehicle fires in a recent year were of incendiary or suspicious origin. Property damage from these fires amounted to more than $1.4 billion in structural damage and $202 million in vehicle damage; these figures do not include indirect costs, such as business interruption, loss of use, and temporary shelter costs; nor do they take into consideration the human suffering and human loss exposure costs, such as medical expenses and funeral costs, associated with fire losses.[2] Many cases of arson or suspected arson involve insurance; some property owners would rather have the insurance money than the property.

Inflated claims of loss are more common than deliberate losses. For example, an insured might claim that four items were lost rather than the actual three or that the items were worth more than their actual value. In liability claims, claimants might exaggerate the severity of their bodily injury or property damage. In some cases, other parties such as physicians, lawyers, contractors, and auto body shop operators support the exaggerated claims, thus driving up the cost of claims and eventually the total cost of insurance, because insurers must increase premiums to pay the cost of inflated claims. Insurance fraud, involving both deliberate and inflated losses, is a serious problem that results in billions of dollars in fraudulent claims each year. Fraudulent claims increase costs for both insurers (in terms of both payment for fraudulent claims and the cost of investigating fraud) and insureds (who pay increased premiums to help cover the cost of those who defraud insurance companies).

Some losses might not be deliberately caused, but they might result from carelessness on the part of an insured. Sometimes an insured is not as careful as he or she would be without insurance and does not try to prevent losses because insurance is available to pay for losses if they occur. Routinely leaving the keys in an unlocked car and storing oily rags in the basement are examples of such carelessness. If the car is stolen or the rags cause a fire, the insured would suffer only minimal financial harm because the insurance company will pay for the loss. The insured's attitude is "Who cares? I have insurance." The additional losses that result from the carelessness of insureds increase the cost of insurance for everyone because insurance companies often pay for injuries and damage that insureds could have prevented.

Increased Lawsuits

The number of liability lawsuits has increased steadily in recent years. One reason for this increase is that liability insurers often pay large sums of money to persons who have been injured. Liability insurance is intended to protect people who might be responsible for injury to someone else or damage to someone's property. However, many people seem to view liability insurance as a pool of money available to anyone who has suffered injury or damage, with little regard given to fault. The increase in lawsuits in the United States is an unfortunate cost of insurance in our society.

Insurance as a Contract

An insurance policy is a contract between the insurance company and the insured. Through insurance policies, insureds transfer the possible costs of losses to insurance companies. In return for the premiums paid by insureds, insurers promise to pay for the losses covered by the insurance policy. As noted, this promise reduces the uncertainty or insecurity that insureds have about paying for losses that might occur. The coverage provided by insurance policies enables individuals, families, businesses, and organizations to protect their assets and minimize the adverse financial effects of losses.

The four basic types of insurance (property, liability, life, and health) are generally divided into two broad categories:

- Property/liability insurance
- Life/health insurance

Property insurance provides coverage for property and net income loss exposures. It protects an insured's assets by paying to repair or replace property that is damaged, lost, or destroyed or by replacing the net income lost and the extra expenses incurred as a result of a property loss. Liability insurance covers liability loss exposures. It provides for payment on behalf of the insured for injury to others or damage to others' property for which the insured is legally responsible.

Life insurance and health insurance cover the financial consequences of human (personal) loss exposures. Life insurance replaces the income-earning potential lost through death and also helps to pay expenses related to an insured's death. Health insurance provides additional economic security by paying medical expenses. Disability insurance is a form of health insurance that replaces an insured's income if the insured is unable to work because of illness or injury.

These types (or *lines*) of insurance are briefly described below. They are discussed in detail in INS 22 (*Personal Insurance*) and INS 23 (*Commercial Insurance*).

Jargon Alert!

Line of insurance is just another way of saying type of insurance. For example, "personal lines insurance" means any type of insurance purchased by individuals and families to cover nonbusiness loss exposures. "Commercial lines insurance" is any type of insurance that covers loss exposures for businesses and organizations.

"Fire Insurance" and "Casualty Insurance"

The terms "fire insurance" and "casualty insurance" are historical terms that have their roots in insurance regulation, but they are still used in the insurance business today. Before the 1950s, there were three categories of insurers: (1) life, (2) fire and marine, and (3) casualty and surety (bonds).

When these separate categories existed, fire insurers could insure only property. Thus, fire insurance and property insurance became almost synonymous terms. Property insurance is still often referred to as fire insurance, although it generally covers much more than fire losses.

Likewise, the term casualty insurance is sometimes used in place of liability insurance and encompasses liability insurance and other related types of insurance (such as workers compensation) that cover losses resulting from casualties. In the past, when insurance companies were either fire companies or casualty companies, separate policies from different insurance companies had to be issued on a house or a commercial building and the personal property inside (fire insurance) and on the owner's liability exposures (casualty insurance). This fire/casualty division has given way almost entirely to a property/liability division, although many insurance professionals continue to use the terms fire insurance to describe property coverages and casualty insurance to describe liability and related coverages.

Educational Objective 11

Describe and distinguish among the major types of property and liability insurance.

Property Insurance

Property insurance covers the costs of accidental losses to an insured's property. The insured could be a person insuring his or her house and personal property or a business insuring its building, inventory, and equipment. When the insured experiences a loss, such as fire damage to a house, the insured deals directly with the insurance company to settle the loss and receive payment.

Many types of insurance are classified as property insurance, such as the following:

- Fire and allied lines
- Business income
- Crime
- Ocean and inland marine
- Auto physical damage

A brief discussion of these types of property insurance follows.

Fire and allied lines insurance covers direct damage to or loss of insured property.

Fire and allied lines insurance generally covers direct damage to or loss of property, such as buildings and personal property, at a fixed location or locations described in the policy. The term "allied lines" refers to insurance against causes of loss usually written with (allied to) fire insurance, such as windstorm, hail, smoke, explosion, vandalism, and others. Examples of policies that cover fire and allied lines insurance are a dwelling policy and a commercial property policy.

Business income insurance covers the loss of net income or additional expenses incurred by a business as the result of a covered loss to its property.

Business income insurance, traditionally called business interruption insurance, pays a business for its loss of net income or additional expenses as a result of a covered loss such as fire. For example, when a business has a serious fire, it might have to close until repairs to the building are made and personal property is replaced. The resulting loss of net income occurs over time. Business income insurance pays the insured for the loss of income or additional expenses that the insured incurs because of the loss during the time needed to restore the business to its pre-loss condition.

Crime insurance protects the insured against loss to covered property from various causes of loss such as burglary, robbery, theft, and employee dishonesty.

Crime insurance covers money, securities, merchandise, and other property from various causes of loss such as burglary, robbery, theft, and employee dishonesty. Coverage for crime losses that a business might suffer is usually provided by separate policies that insure specific types of property against specific crime losses. Crime losses that a person or family might suffer are usually insured under a homeowners policy.

Ocean marine insurance includes hull insurance (which covers ships) and cargo insurance (which covers the goods transported by ships).

Inland marine insurance covers miscellaneous types of property, such as movable property, goods in domestic transit, and property used in transportation and communication.

Ocean marine insurance, one of the oldest forms of insurance, covers ships and their cargo against such causes of loss as fire, lightning, and "perils of the seas," which include high winds, rough waters, running aground, and collision with other ships or objects. **Inland marine insurance** was originally developed to provide coverage for losses to cargo transported over land. Inland marine insurance now covers many different types of property in addition to goods in transit.

Auto physical damage insurance is usually part of a policy that also provides auto liability coverage, such as a personal auto policy or a business auto policy. Auto physical damage is generally considered to mean loss or damage to specified vehicles from collision, fire, theft, or other causes.

Auto physical damage insurance covers loss of or damage to specified vehicles owned by the insured and sometimes covers vehicles borrowed or rented by the insured.

Liability Insurance

An insurance policy is a contract between the insured and the insurance company, and these two are usually the only parties involved in a property loss. Liability insurance, however, is sometimes called "third-party insurance" because three parties are involved in a liability loss: the insured, the insurance company, and the party who is injured or whose property is damaged by the insured. (The third party is usually called the claimant.) The insurance company pays the claimant *on behalf of the insured* if the insured is legally liable for the injury or damage. An insured's legal liability for injury or damage is often the result of a negligent act, but there are other sources of liability as well. Examples of liability insurance include the following:

- Auto liability
- Commercial general liability
- Personal liability
- Professional liability

Auto liability insurance provides protection against an insured's legal liability arising out of the ownership or operation of an automobile. The legal costs of defending the insured against lawsuits are also covered when such defense is necessary. The personal auto policy and the business auto policy are the most widely used auto insurance policies. These policies can include coverage for both auto liability and auto physical damage losses.

Auto liability insurance covers an insured's liability for bodily injury to others and damage to the property of others resulting from automobile accidents.

Commercial general liability insurance covers liability loss exposures arising from a business organization's premises and operations, its products, or its completed work. The following examples of liability claims against an appliance store illustrate the various ways that a business can be liable for the injuries or property damage suffered by others:

Commercial general liability insurance covers businesses for their liability for bodily injury and property damage. It can also include liability coverage for various other offenses that might give rise to claims, such as libel, slander, false arrest, and advertising injury.

- *Premises*: A customer whose finger was caught in a revolving door incurred medical expenses for treatment in a hospital emergency room.
- *Business operations*: Employees broke a water pipe while installing a dishwasher in an apartment, causing substantial water damage to property in the apartment below.
- *Products*: A customer's face was cut when an electric mixer sold to the customer malfunctioned and shattered a glass mixing bowl.

- *Completed operations*: A short circuit developed in an electric stove incorrectly installed by employees and caused a fire that damaged the customer's kitchen.

Personal liability insurance provides liability coverage to individuals and families for bodily injury and property damage arising from the insured's personal premises or activities.

Personal liability insurance provides broad liability coverage to individuals and families. As mentioned, in most instances, the liability arises from the insured's negligence. For example, a visitor to the insured's home might slip and fall on the insured's icy driveway, or the insured might hit a golf ball that accidentally strikes a pedestrian in the head. This type of coverage is included in all homeowners policies.

Professional liability insurance protects physicians, accountants, architects, engineers, attorneys, insurance agents and brokers, and other professionals against liability arising out of their professional acts or omissions.

Professional liability insurance provides liability coverage to professionals for errors and omissions arising out of their professional duties. Medical malpractice insurance, which covers doctors and other healthcare providers, is probably the best known type of professional liability insurance, but similar coverage is available to other types of professionals, including insurance producers, attorneys, architects, and engineers.

Educational Objective 12

Describe and distinguish among the major types of life and health insurance.

Life Insurance

One of the most severe causes of financial loss to a family is the premature death of a family member, especially the primary wage earner. Life insurance can greatly reduce the adverse financial consequences of premature death by providing funds to replace lost income and to pay expenses associated with the final illness, when necessary, and the funeral.

Although there are many variations of life insurance, three basic types are commonly sold today:

- Whole life insurance
- Term insurance
- Universal life insurance

Whole life insurance provides lifetime protection (to age 100). Whole life insurance policies accrue cash value and have premiums that remain unchanged during the insured's lifetime.

Cash value is a savings fund that accumulates in a whole life insurance policy and that the policyholder can access in several ways, including borrowing, purchasing paid-up life insurance, and surrendering the policy in exchange for the cash value.

Whole life insurance provides lifetime protection (for the insured's whole life) and is considered permanent insurance. Whole life policies accrue a cash value that the policyholder can borrow after a policy has been in effect for a specified number of years. Whole life insurance is used when a consumer wants lifetime protection with a level premium and a savings element, which is called **cash value**.

Term insurance is a type of life insurance that provides temporary protection (for a certain period) with no cash value.

Term insurance provides coverage for a specified period, such as five or ten years, and is therefore not permanent insurance. A term life insurance policy has no cash value and is used when the consumer wants the maximum amount of life insurance protection available at the lowest cost.

Universal life insurance is frequently sold as an investment vehicle that combines life insurance protection with savings. The policyowner has a cash value account that is credited with the premiums paid less a deduction for the cost of the insurance protection and expenses charged. The balance in the account is then credited with interest at a specified rate. If the policyowner surrenders the policy, the cash value account may be reduced by a surrender charge to determine the surrender value paid to the policyowner.

Universal life insurance combines life insurance protection with savings. A universal life insurance policy is a flexible-premium policy that separates the protection, savings, and expense components.

Some life insurance policies are sold directly to individuals, while other life insurance policies cover a group of insureds. Such group policies are usually term insurance policies arranged through an employer or an association. Life insurance is discussed in more detail in INS 22.

Health Insurance

Health insurance is designed to protect individuals and families from financial losses caused by accidents and sickness and, like life insurance, is issued on either an individual or a group basis. The various types of health insurance policies can be classified as either medical insurance or disability insurance. **Medical insurance** covers medical expenses that result from illness or injury. **Disability income insurance** provides periodic benefits to an insured who is unable to work as a result of an accident or sickness. Disability insurance is primarily income replacement insurance that pays weekly or monthly benefits until the insured can return to work or until a maximum period has elapsed. Health insurance is also discussed in INS 22.

Medical insurance covers the cost of medical care, including doctors' bills, hospital charges (including room and board), laboratory charges, and related expenses.

Disability income insurance is a type of health insurance that provides periodic income payments to an insured who is unable to work because of sickness or injury.

Educational Objective 13

Define or describe each of the Key Words and Phrases for this assignment. (All Key Words and Phrases appear in bold print in the text and in boxes in the margins throughout this chapter.)

Summary

Every individual, family, and business organization needs insurance. Insurance is actually three things: a transfer system, a business, and a contract.

The key elements of insurance as a transfer system are transfer and sharing. An insured transfers the financial consequences of loss to an insurance company, thereby exchanging the possibility of a large loss for the certainty of a much smaller periodic payment (the premium). The sharing element of insurance requires the insurance company to pool the premiums paid by insureds into a loss fund from which covered losses are paid. Although the insurance company does not expect all insureds to experience a loss, all insureds share in the cost of losses because their premiums make up the loss fund. Because of the law of large numbers, insurers can accurately predict the number of losses that are likely to occur and thus the amount of premium to be paid by each insured.

The need for insurance exists because everyone faces exposures to loss, that is, the possibility that a loss will occur. Loss exposures can give rise to three major types of loss: property loss (including net income loss), liability loss, and human and personnel loss. The role of insurance is to protect insureds' assets from the financial consequences of loss. However, insurance companies prefer to provide insurance for loss exposures that are considered ideally insurable.

The business of insurance provides more than 2 million jobs in the United States; property and liability insurance companies, agencies, and brokerage firms employ almost 1.3 million people. Private insurers provide most insurance, but federal and state government insurance programs also exist.

The states regulate many of the operations of insurance companies. These operations include marketing, underwriting, claim handling, and ratemaking, as well as information processing. Regulators, insureds, and others need to be assured of the financial stability of insurance companies. To protect consumers, state insurance departments regulate insurance rates and policy forms, monitor insurer solvency, and investigate complaints against insurance companies.

In addition to payment for losses, the business of insurance offers several benefits to insureds and to society as a whole. However, both direct and indirect costs are associated with insurance.

An insurance policy, which is a contract between the insured and the insurer, states the rights and duties of each party with regard to losses. The four basic types of insurance are property insurance, liability insurance, life insurance, and health insurance. Each of these types of insurance is provided through contracts between the insured and the insurer.

Chapter Notes

1. Insurance Information Institute, *The Fact Book 1998: Property/Casualty Insurance Facts* (New York: Insurance Information Institute, 1997), p. 5.
2. *The Fact Book 1998*, p. 65.