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Principles of Insurance

OBJECTIVES OF THIS COURSE

Congratulations on your decision to become a part of the challenging property-casualty insurance industry. As an insurance professional, you will have broad responsibilities to your company, the industry and the public that you will serve.

This course will prepare you to begin these new responsibilities with confidence. You will learn about the principles underlying insurance and how the insurance industry operates. You will become familiar with all of the major categories of property-casualty products, the kinds of situations they are designed to cover and the characteristics that make them unique.

Of course, no one training program will tell you everything you'll ever want to know about insurance. *Property-Casualty Concepts* will give you the knowledge you need to take your first career steps and prepare you for the challenges and training opportunities that lie ahead.

RISK

To understand what insurance is and how it works, you must first understand something about **risk**. Risk means the same thing in insurance that it does in everyday language. **Risk is the chance or uncertainty of loss.** For instance, the possibility that your house might be burglarized, or that you might be hit by a car while crossing the street, represents uncertainty of loss. Both are risks.

Now notice that risk is not the loss itself, but the *uncertainty* of loss. There are some losses that are certain to occur eventually, such as when a rug finally wears out after years of use or a car runs out of gas. Such losses are not risks because they represent a certainty, instead of an uncertainty, of loss.

Another term that means almost the same thing as risk is **exposure**. An exposure is a condition or situation that presents a possibility of loss. For example, a home that is built on a flood plain is *exposed* to the possibility of flood damage.

MANAGING RISK

We spend our entire lives coping with risk: crossing the street, going swimming, buying a new house, traveling by plane. These risks sometimes result in small losses, like a stubbed toe or a lost pocket comb, that we accept as a normal part of life. But risks may also result in serious financial losses, such as when a house burns down or a person is injured in a car accident. The consequences of such serious financial losses can be quite severe and far-reaching.

People have developed several different methods for **managing the risk** of serious financial loss. One method is simply to **avoid** risk. For example, you can avoid the risk of being in an auto collision by never getting into a car.

But it isn't practical to avoid all risks. Fortunately, that isn't the only method of managing risk. You can also **control** risk to some extent. For example, training workers in the safe use of welding tools can curtail the frequency of fires on the job. Risk control techniques that curtail **loss frequency** come under the

heading of **loss prevention**. Or, installing a sprinkler system in a factory won't prevent a fire from occurring, but it will limit the severity of any fire that does occur. Risk control techniques that limit **loss severity** come under the heading of **risk reduction**.

In some cases, people simply **retain** a risk. That is, if any loss occurs, they will pay for it themselves. Sometimes people retain only a portion of a risk—the portion that remains after other means of managing the risk have been employed. If people are aware of a risk and decide to retain it (or a portion of it), then they do so intentionally. If people are not aware of a risk, they may retain it unintentionally, and they may be surprised if a loss occurs.

The final method of managing risk is to **transfer** it. This option includes, but is not limited to, insurance. For example, a **hold harmless agreement** may shift liability from an owner or contractor to a tenant or subcontractor. (A hold harmless agreement is a contractual arrangement where one party assumes the liability of a situation and relieves the other party of responsibility.) However, for many risks, the best way to transfer them is through insurance. We'll focus on this way of handling the possibility of loss in the rest of this unit.

Exercise

Match the method of managing risk on the left with its correct description on the right.

- | | | |
|-----------------|-------|--|
| 1. Avoid risk | _____ | A. George always wears his seat belt in the car. |
| 2. Control risk | _____ | B. Terry's car is not insured. |
| 3. Retain risk | _____ | C. Gretchen doesn't own a car because she doesn't know how to drive. |

Answers: 2 A.; 3 B.; 1 C.

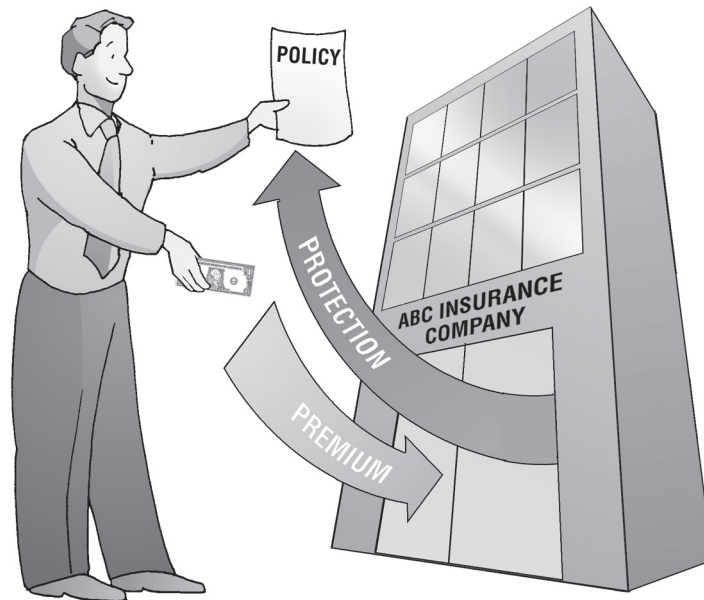
INSURANCE

You learned that one way of managing risk is to transfer it. This is what insurance does. The purpose of insurance is not to avoid or eliminate risk, but to transfer risk. To see how it works, let's look at the hypothetical town of Middlefield.

Middlefield has 200 homes, each worth \$100,000. Usually, one home in Middlefield burns to the ground each year. If the homeowner has to pay for the house, the owner will suffer a \$100,000 loss. However, if that loss were divided among each of Middlefield's homeowners, it would be only \$500. Wouldn't you agree to pay \$500, knowing that if your house burned down, you would receive \$100,000?

This is basically how insurance works. Instead of paying each other, people pay insurance companies, thus transferring the risk and responsibility for paying for any losses that occur to the company in exchange for a premium. The

insurance company accumulates these premiums to provide the funds to pay for losses. This means that even though people don't pay each other directly, they still **share** in the cost of each other's losses.



So, a formal definition of insurance would be: **A contract or device for transferring risk from a person, business or organization to an insurance company that agrees, in exchange for a premium, to pay for losses through an accumulation of premiums.**

LAW OF LARGE NUMBERS

Overall, we're a pretty "safe" group of people. Everyone doesn't have a loss all the time. For this reason, by *predicting* the number of losses that will occur, an insurance company can provide large amounts of insurance for relatively little money. To help them predict their losses accurately so they can charge the proper premiums needed to accumulate adequate funds, insurance companies rely on the **law of large numbers**. The law of large numbers says that the more examples used to develop any statistic, the more reliable the statistic will be.

Consider these statistics:

- Four out of five homes have defective wiring. To determine this, 15 homes were checked.
- Three out of four automobiles will suffer some form of damage each year. Five million auto owners were surveyed.

The law of large numbers tells us that the tire statistic will be more accurate than the wiring statistic in predicting what will happen in the future because the tire statistic is based on many more examples.

ELEMENTS OF INSURABILITY

Pure Risk, Speculative Risk

Although theoretically almost anyone could purchase insurance to cover almost any risk, there are certain rules that establish a practical basis regarding who can be insured and for what.

For instance, insurance cannot be used to handle **speculative risks**. Speculative risks are risks in which there exists both the possibility of gain and the possibility of loss. A poker game is an example of a speculative risk. Insurance can only be used to manage **pure risks**, which involve only the possibility of loss. A person can buy insurance to protect against loss if a fur coat is stolen (pure risk) but not to protect against loss if the price of stock goes down (speculative risk).

Exercise

For each of the examples listed below, indicate whether it is a pure risk (**P**) or a speculative risk (**S**).

- _____ A. Harry feels lucky, so he buys a lottery ticket at the neighborhood convenience store.
- _____ B. Joan hopes her fur coat is safe at the storage warehouse.
- _____ C. The lightning rods aren't up on Frank's new house yet, and a severe thunderstorm has been predicted.
- _____ D. Donna purchases several shares of stock in a computer company.

Answers: S A.; P B.; P C.; S D.

Insurable Interest

A basic rule concerning *who* can be insured states that before you can benefit from insurance, you must have a chance of financial loss or a financial interest in the property. This is called an **insurable interest**. You have an insurable interest in your own home, but not your neighbor's home.



Other Elements of Insurability

There are additional rules that govern what risks are considered suitable subjects for insurance. Risks that do not meet these criteria are probably better handled using an alternate method of risk management.

- The risk of loss must be **definite** as to time and place, and difficult to counterfeit or falsify. Death is probably the best example of a definite loss.
- The risk must be **unexpected**. In fact, as we mentioned earlier, if the results are expected, it does not qualify as a risk. The risk of a train wreck could be insured, while the risk that your suitcase will eventually wear out is not really a risk at all and, therefore, is not insurable.
- The risk must be large enough to create a **financial hardship** for the individual involved. A financially insignificant risk, such as the chance that you might lose a pair of inexpensive sunglasses, is not insurable.
- The loss must be **calculable**. In addition to requiring adequately “large” risks, only risks for which the cost of loss is calculable may be insured. Risks that involve loss that can’t be assigned a financial value are uninsurable.
- The cost of the insurance must be **“affordable”** to the insured. If the risk is so severe that it requires the insurance company to charge prohibitively high premiums to accumulate enough money to pay losses, it is not an insurable risk. Even if the person purchasing the insurance could afford to pay it, the cost should be only a fraction of the value of the item itself.
- There must be a **large number of persons with a similar potential loss available for the insurance so that overall, losses become predictable**. The law of large numbers applies here. To accumulate adequate funds to

pay losses, the insurance company must be able to predict losses. Accurate predictions are possible only when there are sufficient numbers of potential insureds with a similar chance of loss.

- The loss **must not happen to a large number of insureds at the same time**. While insurance companies do want to insure a large number of persons, if a great number of these insureds were to suffer a loss at the same time, it would be catastrophic for the insurance company.

For instance, suppose an insurance company were to insure every home in a single town. A rapidly spreading fire could destroy the entire town. So instead of insuring every person in a single town, a company will want to insure several people in many towns. This is known as **spread of risk**. The greater the spread of risk, the less likely that there will be a catastrophic loss for the insurance company.

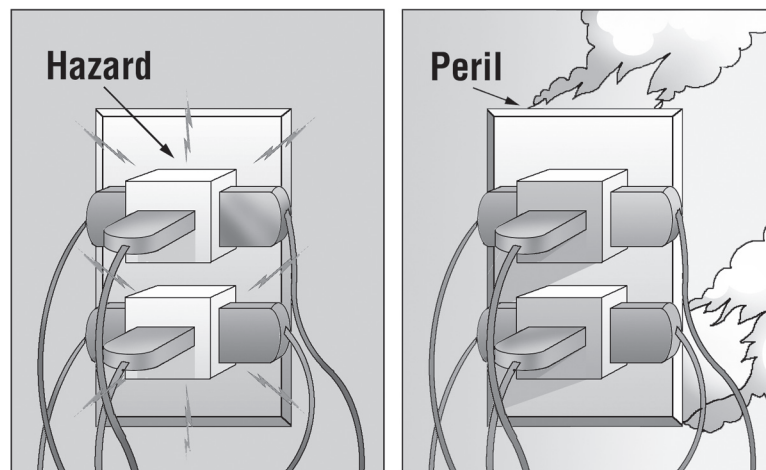
OTHER INSURANCE TERMS

Peril

You've learned that risk is the uncertainty of loss. A **peril** is the **cause of loss**. Fire and collision are both examples of perils.

Hazard

Now that you understand the difference between risk and peril, let's discuss another important term: hazard. A **hazard** is **anything that increases the chance of loss**.



Suppose Georgia was injured when a furnace exploded as the result of a poorly tightened gas connection. The peril was explosion; the hazard was a poorly tightened gas connection.

Physical, Morale and Moral Hazards

There are three different types of hazards.

A **physical hazard** is a hazard that arises from the condition, occupancy or use of the property itself. An example of a physical hazard is a skateboard left on the porch steps.

The second type of hazard is called a **morale hazard**. This means that an individual, through carelessness or by irresponsible actions, can increase the possibility for a loss. An example of a morale hazard is a person who drives a car carelessly because he knows a loss will be insured if an accident occurs.

The third type of hazard, closely related to the morale hazard, is the **moral hazard**. A moral hazard means that a person might create a loss situation on purpose just to collect from the insurance company. An example of a moral hazard is a prearranged, faked theft of an older vehicle so the owner could collect the insurance money and buy something new.

Exercise

Read through the examples that follow and mark each as a physical, morale or moral hazard.

- A. Jerry is having serious business difficulties. He plans to burn down the building in which his business operates so he can collect on the insurance. _____
- B. Bill leaves his car unlocked whenever he goes shopping. He figures that the car is insured and there is no reason to worry. _____
- C. The Starfire Equipment Company, which is occupied in a very old building, has had several serious fires in the last two years. An inspector says that a worn-out furnace may have caused the fires. _____

Answers: A. Moral; B. Morale; C. Physical