

SECTION 2

General Insurance Concepts

CONCEPTS

Insurance is a social device for spreading the chance of financial loss among a large number of people. By purchasing insurance, a person shares risk with a group of others, reducing the individual potential for disastrous consequences.

The insurance company, or insurer, receives relatively small amounts of money, referred to as premium, from each of the large number of people buying insurance. A large, uncertain loss is traded in this way for a small, certain loss, the premium.

The agreement between the insurer and the insured, the person who is covered by the insurance, is established in a legal document referred to as a contract of insurance, or a policy. The insurer promises to pay the insured according to the terms of the policy if a loss occurs. Loss is defined as reduction in the value of an asset. To be paid for a loss, the insured must notify the insurer by making a claim.

Risk is the possibility (uncertainty) that a loss might occur and is the reason that people buy insurance. If a certain event happens -- accident, sickness, or death -- loss occurs. Insurance is designed to provide for such losses, while not providing the insured with the possibility of gain from the accident, sickness, or death.

Speculative risk (such as gambling) creates a risk situation and offers the opportunity for gain as well as the possibility of loss. It is this type of risk that insurance won't cover.

Pure risk is the type of risk that insurers accept. With pure risk, there is the possibility that a certain event will occur, for example, accident or sickness. However, it is the purpose of insurance to restore the insured to his or her original position, not to provide a person with the opportunity of making a profit on an accident or sickness.

ELEMENTS OF INSURABLE RISK

Risk managers evaluate risks for loss frequency (probability of loss), severity, and potential dollar losses over time. Once the loss exposures are identified and analyzed, the best techniques for dealing with them must be examined.

There are four ways to manage risk. A risk may be retained, avoided, reduced, or transferred. A risk is retained when a person decides to assume financial responsibility for certain events. The deductible amount on a health insurance policy may be seen as a way the insured retains some portion of the risk.



In addition, his premium is reduced because of this assumption of risk. To avoid a risk, a person might stay home rather than drive somewhere. A risk is reduced when a person practices living a healthier lifestyle, thereby reducing the chance of major illness.

A risk may be transferred in two ways. If someone's negligence causes an injury, the person injured could sue the negligent party, transferring the burden of the risk to the negligent party.

The second method for transferring risk is accomplished through the use of insurance. The risk of loss is transferred to the insurance company. However, unlike the first instance of risk transfer, the entire burden is not merely transferred to one party, it is shared among a number of insureds who share the same chance and uncertainty of an event occurring. The characteristics for determining which group of individuals share a common risk are such things as age, sex, and occupation.

Insurance companies predict the potential losses of a large group by studying the past experiences of the group using the mathematical principles of probability and statistics. Looking at groups of individuals, rather than the individuals themselves, to make predictions is called the pooling concept and is an accurate way of predicting potential losses.

LAW OF LARGE NUMBERS

The law of large numbers allows an insurance company to predict the expected losses of a group. The basic principle of this law is that the larger the number of separate risks of a like nature combined into one group, the more predictable the number of future losses of that group within a given time period. For the law of large numbers to operate, it is essential that a large number of exposure units be combined. The exposure unit in life and health insurance is the economic value of the individual person's life. In property and casualty insurance, it is the car, home, or other item to be insured. Insurance companies can only predict the number of losses expected for a group, not for each individual.

If large enough numbers of exposure units are combined, the degree of error in predicting future losses decreases as the number of individual exposure units in a group increases. The larger the group, the more closely the predicted experience will approach the actual loss experience.

Insurance companies collect premiums to cover expenses, profits, and the cost of expected losses. The expected losses are based upon the past experience of the average risk. The fact that some people never experience an automobile accident or that some live well beyond their life expectancy is immaterial, for they are balanced by other people who are involved in accidents or die prematurely. Those insureds who suffer loss are compensated, while many other insureds do not experience sizable losses.

INSURABLE INTEREST

Individuals may not be able to purchase any kind of insurance they desire. To be insurable, a risk must involve the possibility of loss only, and not gain, and the applicant must have a legitimate interest in the preservation of the life or property insured. This requirement is called insurable interest.

A person is presumed to have an insurable interest in his or her own life. An individual is also considered to have an insurable interest in the life of a close relative or a spouse. Insurable interest can also be based on a financial loss that will take place if an insured individual dies. An example is two partners in a business, each of whom brings substantial expertise to that business. If one partner should die, the business could fail, resulting in a loss to the other partner.

For life insurance, insurable interest must exist at the time of the application for insurance, but it need not exist at the time of the insured's death. For property and casualty insurance, insurable interest must exist at the time of loss.

INSURABLE RISKS

An insurance company must be able to predict future losses accurately. Also, the company must deal only with insurable risks. Not all risks are insurable, and it is important to outline those risks to which insurance concepts can be properly applied.

Large Number of Homogeneous Units: The expected loss experience of a group of exposure units cannot be predicted with any certainty unless there is a large number of exposure units in that group. Risks are not considered insurable unless the insurance company has a large enough number of similar risks and knows enough about its previous loss experience to be able to predict the future reliably.

Loss Must Be Ascertainable: Since the purpose of insurance is to reduce or eliminate the uncertainty of economic loss, it is essential that the insured's economic loss be ascertainable. In other words, the insurer must be able to place a monetary value on the loss. In life insurance, monetary value is placed on the insured's income-earning capacity. It is especially difficult to determine economic loss under health insurance. For this reason, economic loss is measured by lost wages or by actual medical expenses incurred. The potential loss must be measurable so that both parties can agree on the precise amount payable in the event the loss occurs.

Loss Must Be Uncertain: Since the purpose of insurance is to reduce or eliminate uncertainty, it is obviously not in the public interest to permit the writing of insurance for intentional acts, such as a person committing suicide two days after purchasing an insurance policy. Uncertainty arises out of NOT knowing what is going to happen, or being unable to predict what is going to happen to the individual exposure unit. If insurance is provided for other than uncertain losses, the element of chance is not a factor. Nor is there any element of uncertainty in losses occasioned by natural wear and tear or deterioration, depreciation, or defects in property covered under insurance. Losses are expected in these situations, therefore such losses would not be uncertain.

Economic Hardship: The nature of the loss must be such that an economic hardship would occur should the loss occur. There would be little point in obtaining insurance to cover occurrences so minor that a loss would not produce economic hardship. For example, if a person loses one day's pay because of an injury, a loss occurs, but it is not significant enough to be covered by insurance.

The nature of the loss must be such that it is worthwhile to incur the premium cost to cover potential loss. It must be economically feasible to insure. A comparison of the potential loss with the cost of premium is a major consideration to the insurance buyer.

Exclusion of Catastrophic Perils: While the ability to predict future losses with a reasonable degree of accuracy is critical to the insuring function, certain types of perils do not lend themselves to prediction. Such perils, when they cause losses, do not establish a pattern of predictability that can be relied upon for future predictions of anticipated loss. These perils are usually excluded from coverage. Examples of excluded catastrophic perils are war, nuclear risk and floods.



PRINCIPLE OF INDEMNITY

The principle of indemnity restores the insured person, in whole or in part, to the condition he or she enjoyed prior to the loss. Restoration may take the form of payment, repair, or replacement.

In life and health insurance, the principle of indemnity takes on a different meaning because value cannot be placed on a human life. With respect to life insurance, the "value" is assigned not to the person's life, but to the person's potential earning power. The intent of a life-insurance policy is to allow the family to continue financially as if the principal breadwinner were still alive.

INSURERS

Types of Insurers: Insurance is provided to the public by three major sources: private commercial insurers, private commercial service organizations, and the United States Government. Other types of private insurers include reciprocals, fraternal insurers, Lloyd's of London, and re-insurers.

1. *Stock Insurers:* A stock insurance company, like other stock companies, consists of stockholders who own shares in the company. The individual stockholder provides capital for the insurer. In return, they share in any profits and any losses. Management control rests with the Board of Directors, selected by the stockholders. The Board of Directors elects the officers who conduct the daily operations of the business.
2. *Mutual Insurers:* In a mutual company, there are no stockholders. In a mutual company, ownership rests with the policyholders. They vote for a Board of Directors, which in turn elects or appoints the officers to operate the company. Funds not paid out after paying claims and not used in paying for other costs of operation may be returned to the policyholders in the form of policy dividends. Dividends from a mutual may never be guaranteed and are not taxable.
3. *Nonprofit Service Organization:* Service insurers are unique to the health insurance field, and technically they are not insurers. They are organizations providing prepaid plans for hospital, medical, and surgical expenses. They do not provide cash benefits to the plan subscriber, but instead pay the provider of medical services directly to the extent covered in the contract. Best known of the service insurers are the various Health Maintenance Organizations or HMOs.
4. *Reciprocal Insurers:* Reciprocal insurers are unincorporated groups of people providing insurance for one another through individual indemnity agreements. Each individual who is a member of the reciprocal is known as a subscriber. Administration, underwriting, sales promotion, and claims handling for the reciprocal insurance is handled by an attorney-in-fact.
5. *Fraternal Insurers:* Fraternal benefit societies are primarily life insurance carriers that exist as social organizations and usually engage in charitable and benevolent activities. Fraternal insurers are distinguished by the fact that their membership is usually drawn from those who are also members of a lodge or fraternal organization. One characteristic of fraternal life insurance is the open contract, which allows fraternal insurers to assess their policyholders in times of financial difficulty.
6. *Reinsurance:* Reinsurance is a form of insurance between insurers. It occurs when an insurer (the re-insurer) agrees to accept all or a portion of a risk covered by another insurer.

Companies often use reinsurance to reduce the risk of a catastrophic loss. Insurance against loss by earthquakes and aviation accidents might not be available if a single carrier had to assume all

of the risk. Reinsurance makes it possible for a carrier to issue a policy and then share the risk with a larger insurer or a group of insurers.

Reinsurance may be written on an excess of loss basis, which means the re-insurer will pay only the portion of loss that exceeds a threshold, or on a quota share basis, which means that the insurers will share loss on a pro rata or fixed-percentage basis.

7. *Captive Insurers:* Captive insurers are formed to serve the insurance needs of their stockholders while avoiding the uncertainties related to commercial insurance availability and costs. A captive insurer's stock is controlled by one interest or a group of related interests who have direct involvement and influence over the company's operations. For example, an association of self insured corporations may purchase reinsurance from a captive insurer that they control. Most captive insurers are non-admitted alien corporations.
8. *Excess and Surplus Lines:* Occasionally, it may be difficult to place a risk in the normal marketplace. If the risk is very large or unusual in nature, typical carriers may be unwilling to assume it. For some special risks, the only market may be with specialty carriers. Such business must be placed through a licensed excess or surplus lines broker, who will attempt to place it with an unauthorized carrier located in another state or out of the country (such as Lloyd's of London).
9. *Government Insurers:* The federal government provides life and health insurance through various sources. The federal government has offered a variety of military life insurance plans as well as Medicare for seniors, which is part of Social Security.

Because private insurance policies exclude catastrophic risks, the federal government has stepped in to provide National Flood Insurance, Federal Crime Insurance, Federal Crop Insurance, and insurance on mortgage loans. At the state level, governments are involved in providing unemployment insurance, Workers' Compensation programs and secondary-injury funds, and state-run medical-expense insurance plans.

Federal, state, and local governments provide social insurance to a segment of the population who would otherwise be without disability income, retirement income or medical care.

Domestic, Foreign, and Alien Insurers: An insurer is defined not only by its corporate status, but also by its locality, or "domicile of incorporation." If an insurer is incorporated under the laws of the state in which it conducts business, that insurer is considered a domestic insurer. If an insurer conducts business in a state where it is not resident, the insurer is considered a foreign insurer. If an insurer is incorporated in a country other than the United States, it is considered an alien insurer.

Therefore, an insurer incorporated in California and conducting business in California is considered a domestic insurer. This same California-based insurer conducting business in Colorado would be considered a foreign insurer there. An insurer incorporated in Canada and conducting business anywhere in the United States or its territories is an alien insurer.

Authorized vs. Unauthorized Insurers: Before an insurance company can conduct business it must, by law, receive the authority to do so. Insurance statutes require a company to secure a license from the Department of Insurance to sell insurance in a particular state. Once the insurer receives the license, it is considered "admitted" into the state as a legal insurer, and is "authorized" to transact the business of insurance. This licensing power is used to regulate company activities. Licenses may be issued to domestic companies, foreign companies, or alien companies.



FINANCIAL STATUS (INDEPENDENT RATING SERVICES)

In today's market, no matter what the type of insurance company, producers and clients are very concerned about financial stability. To determine the financial strength of a prospective carrier, producers and clients often turn to independent rating services such as Best's Guide, Standard & Poor's, and Moody's. These private publications may be purchased direct from the publishers or are available at most larger libraries. They rate insurance companies according to the amount of financial reserves the company has available to pay future claims and other liabilities, such as cash surrenders.

MARKETING SYSTEMS

Insurance companies market their products generally by using producers to sell their products or by selling directly through mass marketing. The majority of policies are sold through producers.

Companies that sell through producers vary by whether their producers are their employees or independent businesspersons, and by who owns the policy expirations.

Independent insurance producers sell the insurance products of several companies and work for themselves or for other producers. They sell their clients the policies that fit the clients' needs best among the many insurers they represent, and are paid a commission for each sale. The independent producer owns the expirations of the policies sold, meaning that that individual may place that business with another insurer upon renewal if it is in the best interest of the client.

Exclusive or captive producers represent only one company, and may be paid a salary or compensated by commissions. Exclusive producers do not own the policy expirations. If the exclusive producer has a group of producers working for him, the employing producer then becomes a managing general agent. The managing general agent is paid by an overriding commission; which is in addition to the commission paid to the soliciting producer.

Managing General Agents (MGAs) may be required to obtain an MGA license from the state Department of Insurance. MGAs may be independent, representing several insurance companies, or they may have an exclusive agreement with just one carrier.

Direct writing companies pay salaries to employees whose job function is to sell their company's insurance products. In this case, the insurance company owns the expirations and the producers' business.

The franchise marketing system provides coverage to employees of small firms or to members of associations. Unlike group policies, in which benefits are standard for classes of individuals, persons insured under the franchise method receive individual policies that vary according to the individuals' needs.

Franchise plans are attractive to employers who do not, according to the laws of their state, meet the qualifications for a "true group." They allow the employers to offer individual insurance to their employees at a lower premium than for insurance purchased on an individual basis. Premiums may be deducted from the individual's paycheck.

Non-insurance sponsors are being used more and more. The most common are banks and companies that issue credit cards. This marketing system reaches a select group of individuals who have a history of periodic payments. Usually the sponsor is responsible for the billing of premium, which is added to the billing statement or deducted from checking accounts. Vending-machine sales usually consist of travel-

accident policies sold from coin-operated machines at airports. A large amount of coverage is available at low premiums. The coverage is good only for the duration of a single trip and usually covers accidental death only.

PRODUCERS

Life and health insurance producers (or agents) generally do not have the authority to issue or modify insurance contracts. Customarily, life and health insurance producers are authorized to solicit, receive, and forward applications for the contracts written by their companies. The producer may receive the first premium due with the application, but usually not subsequent premiums, except in industrial life insurance. The insurance company approves and issues the contract after receiving the application and premium from the applicant through the producer. Life and health producers usually cannot bind coverage.

Property and Casualty producers appointed by property and casualty insurance companies generally are granted more authority. These producers may bind or commit their companies by oral or written agreement. They sometimes inspect risks for the insurance company and collect premiums due. Producers may also be licensed as brokers, especially in the area of Surplus Lines.

Since most Surplus Lines insurers, such as Lloyds of London, are “unauthorized”, they must conduct their business locally through a licensed representative known as a Surplus Lines Broker. Generally, Surplus Lines Brokers must first be licensed as Insurance Producers and are required to post a “license” bond with the state, since they are responsible for the collection of premium taxes on the Surplus coverages they place.

An understanding of the Law of Agency is important, as an insurance company, like other companies, must act through producers.

Agency is a relationship in which one person is authorized to represent and act for another person or for a corporation. Although a corporation is a legal “person,” it cannot act for itself, so it must act through producers. A producer is a person authorized to act on behalf of another person, who is called the principal. When one is empowered to act as a producer for a principal, she is legally assumed to be the principal in matters covered by the grant of agency. Contracts made by the producer are the contracts of the principal. Payment to the producer, within the scope of her authority, is payment to the principal. The knowledge of the producer is assumed to be the knowledge of the principal. The authority of a producer is of three types: express, implied, and apparent.

Express authority is an explicit, definite agreement. It is the authority the principal gives the producer as set forth in his/her contract. It is very important for a producer to know the limitations of the contract and to operate within its limits. To do otherwise could place the producer in a position of personal liability for Errors and Omissions (E&O). The producer’s actions and knowledge are binding on the insurance company, so he/she must be alert to the consequences of his/her actions and words.

Implied authority is not expressly granted under an agency contract, but it is actual authority that the producer has to transact the principal's business in accordance with general business practices. For example, if a producer's contract does not give her the express authority of collecting and submitting premium, but the producer does so on a regular basis and the company accepts the premium, then the producer is said to have implied authority. That is, it is a general business practice to collect premium, and by accepting the premium from the producer, the company has implied that the producer has the authority to conduct this practice.



Apparent authority is the authority a producer seems to have because of certain actions taken on his part. This action may mislead applicants or insureds, causing them to believe the producer has authority that he does not, in fact, have. The principal adds to this impression by acting in a manner that reinforces the impression of authority. For instance, a producer's contract usually does not grant him the authority to reinstate a lapsed policy by accepting past due premiums. If, in the past, the company has allowed the producer to accept late premiums for that purpose, a court would probably hold that the policyholder had the right to assume that the producer's acceptance of premium was within the scope of his authority.

All premiums received by a producer are funds received and held in trust. The producer must account for and pay the correct amount to the insured, insurer, or other producer entitled to the money.

A producer has a fiduciary duty to the insured or applicant. A fiduciary relationship is developed when a person relies on, or places confidence, faith, or trust in, another person's action or advice. A producer, as a "fiduciary," has accepted the obligation of acting in the insured's best interest. To do this, the producer must become familiar with not only the features of the various policies that she sells to the public, but also the many uses to which these policies can be put. The producer must also explain the features of each policy, including its provisions, riders, exclusions, and all possible options to the client.

The producer also owes certain general responsibilities to the company. First, a producer owes the duty of loyalty. Second, the producer owes a duty to obey the company and to perform in accordance with instructions given by the company. If the producer violates the instructions and causes the company a loss, he may be liable to the company for any breach of duty.

Third, a producer has a duty to act with that degree of care that a reasonable person would exercise under comparable circumstances. Fourth, a producer must account for all property or money belonging to the company that comes into the producer's possession. Fifth, a producer is required to inform his company of all facts that are pertinent to the agency relationship in order that the company will be best protected.

Since a producer acts in the place of his company, the act of the producer is, under the eyes of the law, considered to be the act of the company. Each producer should stress to a potential insured the importance of filling out the insurance application completely and honestly. The signed application often becomes a part of the policy and statements made therein may invalidate the insurance contract if they are not true.

Once the insurance company is satisfied that the applicant is a good candidate for insurance, and agreement has been reached as to coverage and premium, the policy will be delivered to the producer. It is important to remember that coverage usually does not begin until the policy is delivered to the insured by the producer, except when binding receipts are used.

Errors and Omissions (E&O) insurance is needed by professionals who give advice to their clients. It covers negligence, error, or omission by the insurer or the producer who is the insurer's representative. E&O policies protect producers from financial losses they might suffer if insureds sue to recover for their financial loss due to a producer giving them incorrect advice (error) or not informing them of an important issue (omission).

E&O policies cover only losses due to negligence, error or omission. For example, a producer can be sued if he/she replaces an existing policy and fails to mention that the probationary period starts over. E&O policies usually have a high deductible that provides an added incentive for a producer to minimize his errors. E&O policies do not cover embezzlement or filing of false financial statements or bodily-injury or property-damage liability.

CONTRACTS

Insurance policies are contracts. In order to be enforceable in court, they must contain four essential elements, often given the acronym “COAL”:

Consideration: The exchange of something of value between the parties. The client pays the premium and the insurance company promises to provide coverage. The consideration given between parties does not necessarily have to be equal.

Offer: This must be clearly communicated. Usually, the offer is made by the client when he completes and signs the application and writes out his check for the first premium payment.

Acceptance of the Offer: This is usually done when the underwriter approves the application and issues the policy for delivery.

Legal Purpose and Legal Capacity: Contracts for illegal purposes are unenforceable in court, and, of course, all parties to a contract must be competent to contract, meaning they must be of age, of sound mind, and not under the influence of drugs or alcohol.

Since insurance contracts are unique because the client must buy them as written without any chance to modify or clarify the contract language, the Doctrine of Adhesion states that if the insurance contract language is vague or unclear, any ambiguity will be construed in favor of the insured, since that person had no chance to change it when she bought it. This is why insurance companies don't like to go to court, since they usually lose!

Of course, insurance companies issue most policies based on the answers contained in the application, which are considered to be representations, or the truth to the best of the client's knowledge. If everyone lied, the insurance industry would not be able to function. It is based on the Doctrine of Utmost Good Faith, which applies to all parties involved, including the applicant, the producer, and the insurer.

The legal doctrine of Waiver and Estoppel also relates directly to the responsibilities of insurance producers. Waiver is defined as the voluntary giving up of a known right. Once given up, it cannot be used as a defense in court. In other words, once a waiver of a known right has occurred, the party waiving those rights is stopped from asserting that right in the future. This is known as the Doctrine of Estoppel.

Of course, some clients do make misrepresentations on applications or attempt to conceal material facts from the producer and underwriter. Concealment is defined as the deliberate omission of a material fact. Fraud is defined as a deliberate attempt to deceive the producer or insurance company. Either could cause the policy or claim to be voided by the insurance company. However, since fraud is very hard to prove, most insurance companies are reluctant to use it as a defense, since if they fail to prove it, the other party may sue the insurance company for libel or slander and will probably win.

A Warranty is defined as an absolute guarantee of truth, and if written, such statements are usually required to be notarized. Life insurance companies usually don't ask the client to make any warranties on the application. Instead, the applicant is expected to furnish representations, which is the truth to the best of his/her knowledge. When the application is attached at policy issue, representations become part of the contract.



However, on some Property & Casualty policies, the insured may be entitled to a premium discount if they “warrant” that they have installed certain safeguards, such as a burglar alarm or a sprinkler system. Breach of this type of warranty may void coverage.

Insurance contracts are also unilateral, in that only one party to the contract, the insurer, makes an enforceable promise to pay a covered claim if the premium has been paid.

Personal contracts of insurance are also aleatory, in that the outcome depends upon chance. Further, the consideration exchanged need not be equal. The insured may pay a premium, but never have a claim.

To help identify individual “loss exposures,” producers should be able to identify the various hazards that increase the insurer’s risk, or chance of loss. There are three types of hazards: 1) a “moral” hazard, which is presented by a dishonest client; 2) a “morale” hazard, which is presented by a careless client; and 3) a “physical” hazard, such as a dangerous occupation or hobby.

Life insurance policies are “valued” contracts, that pay the agreed policy limit to your beneficiary upon your death. If the insurer won’t pay, the beneficiary could sue the insurer for “breach of contract.”

However, most Health Insurance policies follow the Principle of Indemnity, which states that the purpose of insurance is to restore the insured financially. Such policies will pay the amount of the claim or the policy limit, whichever is less. No profit is allowed.