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Basic Insurance Concepts And Principles

Before you learn about specific policy types and their provisions, you will need to understand some basic concepts and terms associated with the insurance industry. This chapter discusses concepts that make it easier for you to learn the rest of the material in this course, so it is important for you to master these ideas before moving on to the next chapter.

TERMS TO KNOW

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

A. Insurance (CIC 22)

Educational Objectives:

I.A. Be able to:

1. Identify the definition of insurance (CIC 22);
2. Recognize the definition of risk;
3. Differentiate between a pure risk and a speculative risk;
4. Identify a definition of peril;
5. Identify a definition of hazard;
6. Differentiate between moral, morale, and physical hazard;
7. Identify the definition of the law of large numbers.

II.A.1. Be able to identify examples or definitions of:

a. Life insurance
b. Applicant, policyowner, insured, beneficiary

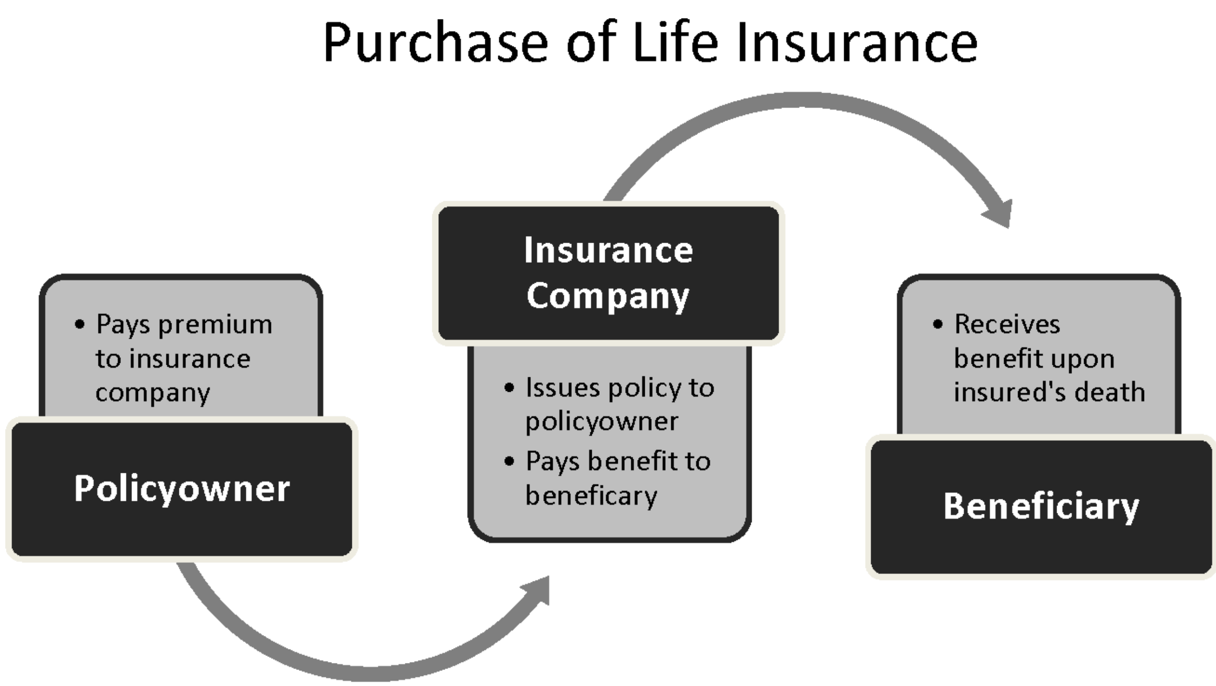
Insurance is a **transfer** of risk of loss from an individual or a business entity to an insurance company, which, in turn, spreads the costs of unexpected losses to many individuals. If there were no insurance mechanism, the cost of a loss would have to be borne solely by the individual who suffered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

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

In the law, a **person** is a legal entity which acts on behalf of itself, accepting legal and civil responsibility for the actions it performs and making contracts in its own name. **Persons** include individual human beings, associations, organizations, corporations, partnerships, and trusts.

As defined by CIC 22, "***insurance** is a contract whereby one undertakes to indemnify another against loss, damage, or liability arising from a contingent or unknown event."*

In broader terms, **insurance** is the legal agreement, or contract, whereby the two parties involved agree to the limits of the indemnification, the circumstances under which it will occur and what things of value (consideration) will be exchanged by the parties to the contract.



B. Definition And Types Of Risk

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

- **Pure risk** refers to situations that can only result in a loss or no change. There is no opportunity for financial gain. Pure risk is the only type of risk that insurance

companies are willing to accept.
- **Speculative risk** involves the opportunity for either loss or gain. An example of speculative risk is gambling. These types of risks are not insurable.

Know This! Only *pure* risks are insurable.

C. Perils And Hazards

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

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

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

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

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

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

A **legal hazard** describes a set of legal or regulatory conditions that affect an insurer's ability to collect premiums that are commensurate with (equal to in value) the exposure to loss that the insurer must bear.

D. Law Of Large Numbers

The basis of insurance is sharing risk among a large pool of people with a similar exposure to loss (a homogeneous group). The **law of large numbers** states that the larger the number of people with a similar exposure to loss, the more predictable actual losses will be. This law forms the basis for statistical prediction of loss upon which insurance rates are calculated.

Example:

When an insurance company issues a policy on a 35-year-old male, the company really has no way of knowing or accurately predicting when he will die. However, the Law of Large Numbers looks at a large group of similar risks – 35-year-old males of similar lifestyles and health conditions – and makes some conclusions based on statistics of past losses. This allows the insurance company to have a general idea about the predicted time of death for this type of insured and to set the premiums accordingly.

Know This! As the number of people in a risk pool increases, future losses become more predictable.

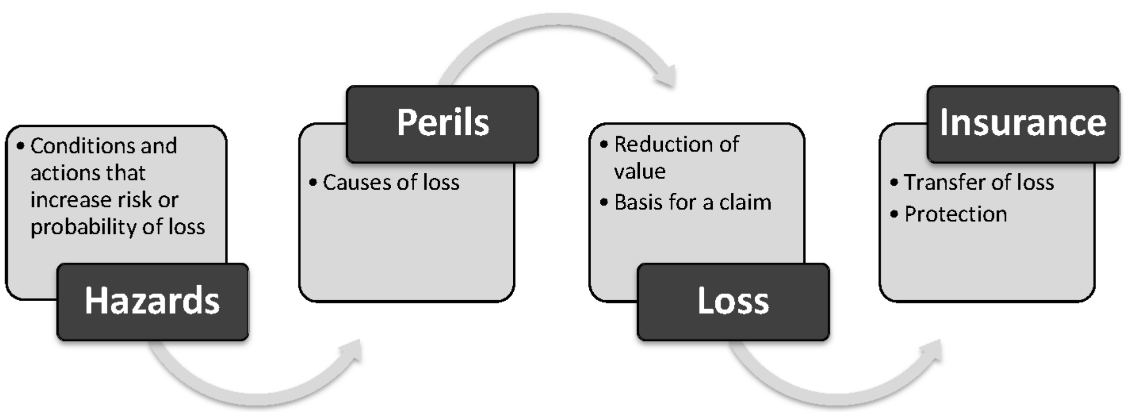
E. Loss Exposure

Educational Objectives:
I.A.8. Be able to identify a definition or the correct usage of the term *loss exposure.*
I.A.9. Be able to identify risk management techniques.
I.A.10. Be able to identify risk situations that present the possibility of a loss.
I.A.15. Be able to identify the meaning of *adverse selection* and *profitable distribution of exposures.*

Exposure is a unit of measure used to determine rates charged for insurance coverage. In life insurance, all of the following factors are considered in determining rates:

- The age of the insured;
- Medical history;
- Occupation; and
- Sex.

A large number of units having the same or similar exposure to loss is known as **homogeneous**. The basis of insurance is sharing risk among the members of a large homogeneous group with similar exposure to loss.



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

A profitable *distribution of exposures* (or spread of risk) exists when poor risks are balanced with preferred risks, with "average" or "standard" risks in the middle. The purpose behind distributing risks in this manner is to protect the insurer from adverse selection. This is one of the key principles of insurance.

F. Adverse Selection

Insurance companies strive to protect themselves from **adverse selection,** the insuring of risks that are more prone to losses than the average risk. Poorer risks tend to seek insurance or file claims to a greater extent than better risks.

To protect themselves from adverse selection, insurance companies have an option to refuse or restrict coverage for bad risks, or charge them a higher rate for insurance coverage.

G. Risk Situations That Present The Possibility Of Loss

In the process of establishing an insurance program, insureds must first identify their exposure to losses, along with the probability of how likely it is that a loss will occur and how "big" the loss might be. Certain risks, because of the severity of the possible loss, will demand attention above others.

For example, an individual who uses power tools to work on avocational woodworking projects is exposed to the possibility of hand injuries. If the individual is a brain surgeon, this would be considered a critical risk of financial loss, since the injury could prevent the person from doing his or her job. If the individual is, however, a radio announcer, the loss of hand function may be deemed a less "important" risk.

Exposures to possible losses should be ranked into appropriate groups and classified in the order of their importance:

- **Critical risks** include all exposures in which the possible losses are of the magnitude that would result in financial ruin to the insured, his or her family, and/or to his or her business;
- **Important risks** include those exposures in which the losses would lead to major changes in the person's desired lifestyle or profession; and
- **Unimportant risks** include those exposures in which the possible losses could be met out of current assets or current income without imposing undue financial strain or lifestyle changes.

In making a decision for establishing an insurance program, it may be wise to apply the following commonsense principles:

- Consider the odds;
- Don't risk more than you can afford to lose; and
- Don't risk a lot for a little.

H. Risk Management Techniques

<u>Educational Objective:</u>
II.A.4. Be able to identify methods of managing risk: avoidance, retention, sharing, reduction, transferring.

1. Sharing

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

2. Transfer

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

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

3. Avoidance

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

4. Retention

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

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

5. Reduction

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

I. Ideally Insurable Risks

Educational Objective:
I.A.11. Be able to recognize the requisites of an ideally insurable risk*.*

Though insurance may be one of the most effective ways to handle risks, not all risks are insurable. As noted earlier, insurers will insure only **pure risks**, or those that involve only the chance of loss with no chance of gain. However, not all pure risks are insurable. Certain characteristics or elements must be present before a pure risk can be insured.

The loss must be due to chance (accidental). In order to be insurable, a risk must involve the chance of loss that is outside the insured's control.

The loss must be definite and measurable. An insurable risk must involve a loss that is definite as to cause, time, place and amount. An insurer must be able to determine how much the benefit will be and when it becomes payable. Since insurance policies are legal contracts, it helps if the conditions are as exact as possible.

The loss must be statistically predictable. This enables insurers to estimate the average frequency and severity of future losses and to set appropriate premium rates. (In life and health insurance, the use of mortality tables and morbidity tables allows the insurer to project losses based on statistics.)

The loss cannot be catastrophic. Insurers typically will not insure risks that will expose them to catastrophic losses. Insurers need to be reasonably certain that the losses will not exceed certain limits. Typically, insurance policies exclude coverage for loss caused by wars or nuclear events because there is no statistical data that allows for the development of rates that would be necessary to cover these events should they occur.

The loss exposure to be insured must involve large homogenous exposure units. There must be a sufficiently large pool to be insured and those in the pool must be grouped into classes with similar risks so the insurer is able to predict losses based upon the **law of large numbers.** This enables insurers to properly predict the average frequency and severity of future losses and to set appropriate premium rates. (In life insurance, the use of mortality tables allows the insurer to project losses based on statistics.)

The insurance must not be mandatory. An insurer must not be required to issue a policy to each applicant applying for coverage. The insurer must have the ability to require that certain underwriting guidelines be met.

J. Insurable Events

<u>Educational Objectives:</u>
I.A.12. Be able to identify the definition of insurable events (CIC 250).
I.A.13. Be able to identify and apply the definition of *insurable interest, the principle of indemnity*, and *utmost good faith.*

According to the California Insurance Code, *"...any contingent or unknown event, whether past or future, which may damnify a person having an insurable interest, or create a liability against him, may be insured against..."* In other words, if a possible future event could result in loss or liability to a person, it may be insurable under the Insurance Code. These insurable events may never occur, but insurance policies can provide protection when those times come.

The more **predictable** a loss becomes, the **more insurable** it becomes. The more **unpredictable** a loss, the **less insurable** it becomes. *For example*, a person cannot be insured against gambling loss or lottery outcomes because they are unpredictable.

The law does not address a limit as to the level of loss that may be insured against; it only specifies the type of event that is insurable. The level of loss to be indemnified is agreed upon by the parties to the insurance contract.

K. Insurable Interest

To purchase insurance, the policyowner must face the possibility of losing money or something of value in the event of loss. This is called **insurable interest**. In life insurance, insurable interest must exist between the policyowner and the insured **at the time of application**; however, once a life insurance policy has been issued, the insurer must pay the policy benefit, whether or not an insurable interest exists.

A valid insurable interest may exist between the policyowner and the insured when the policy is insuring any of the following:

1. Policyowner's own life;
2. The life of a family member (a spouse or a close blood relative); or
3. The life of a business partner, key employee, or someone who has a financial obligation to the policyowner (for example, a debtor has a financial obligation to a creditor, so the creditor has a valid insurance interest in the life of the debtor).

Insurable interest is not required of beneficiaries. Since the beneficiary's well-being is dependent upon the insured, and the beneficiary's life is not the one being insured, the beneficiary does not have to show an insurable interest for a policy to be purchased.

Know This! Insurable interest must exist at the *time of application*.

Know This! The policyowner must have insurable interest in the life of the insured.

L. Indemnity

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

Life and Health Example:

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

Property and Casualty Example:

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

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

M. Utmost Good Faith

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

N. Chapter Recap

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

<table>
<tr><th colspan="2">BASIC INSURANCE CONCEPTS</th></tr>
<tr><td>Insurance</td><td>Transfers the risk of loss from an individual to an insurer
Based on the principle of indemnity
Based on the spreading of risk (risk pooling) and the law of large numbers</td></tr>
<tr><td>Hazards</td><td>Hazards give rise to a peril. There are 3 kinds of hazards:
Physical - physical condition;
Moral - a tendency toward increased risk;
Morale - an indifference to loss</td></tr>
<tr><td>Risk</td><td>Uncertainty regarding financial loss
2 types of risks:
Pure - insurable because it involves a chance of loss only;
Speculative - not insurable because it involves a chance of gain
Methods of handling risk:
Avoidance
Retention
Sharing
Reduction
Transfer</td></tr>
<tr><td>Elements of Insurance Risk</td><td>All of the following elements apply to an insurable risk:
Due to chance: chance of loss beyond insured's control
Definite and measurable: loss must have definite time, place and amount
Predictable: number of losses must be statistically predictable
Not catastrophic: there must be limits that the loss can't exceed
Large exposure: insurer must be able to predict losses based on the law of large numbers
Randomly selected exposure: insurer must have a fair proportion of both good and poor risks</td></tr>
</table>

Insurable Interest	• Must exist at the time of application • Exists when insuring one's own life, the life of a family member, or a business partner or key employee • Not required of beneficiaries