

Ch: 8, An Introduction to Insurance and Risk Management

What Is Risk?

- The chance of loss
- There must be a chance of loss for risk to exist

Understanding Risk

- Pure versus speculative: Insurance vs. business venture risk
- Particular versus fundamental: Individual vs. large group losses
- Financial versus nonfinancial: monetary loss (earnings) vs. pain and suffering
- Probability of loss: likelihood of long term loss
- Actuary: calculates probabilities of risk pools and premiums, UW decides which applicant in which risk pool.
- Law of large numbers: predicted results will reflect actual results as number of exposures increase. Coin toss.

Responses to Pure Risk

- Risk avoidance: Don't sky dive, but can't avoid all of life's risks (plane flights)
- Risk reduction: Bungy jumping instead (from 5' up) or: smoke alarm system
- Risk retention or assumption: active= choosing a deductible; Passive= aware of risk but ignoring it, assumed by default
- Risk transfer: transferring risk to others (insurance)

Insurance

- Risk management tool to deal with financial consequences of pure risks.
- Pooling of unexpected losses
- Transfer of risk to insurance co. for a premium based on predicted losses for pool divided by # of insureds + expenses + profit.

Example

1000 30 year old healthy males each insured for \$100,000 against death in next 12 months. Actuary: 2 are expected to die(\$200,00 in expected death benefits) divided by 1000 in pool, each pays \$200++

Second Yr.: 998 left in pool all age 31--premium must go up.

Self-Insurance

- Self -insurance: large organizations with large cash reserves, control, cash flow, custom benefits
- Protected self-insurance: retain risk to stop loss then insure

Causes of Insured Losses

- Perils: the actual cause-fire, collision
- Hazards: conditions that create likelihood of loss
 - Physical hazard: icy road, gasoline storage
 - Moral hazard: dishonestly increasing chance of loss (arson)

- Morale hazard: indifference to loss- increasing risk- doesn't bother locking the door
- Adverse selection: higher than avg.. risks want coverage the most, increases cost to pool, avg. risks drop out. Underwriter is the gatekeeper.

Insurable Losses

- Insurance versus gambling: reduction in existing risk vs. increase in risk where none existed.
- Requisites for an insurable risk
 - Large number of exposure units must exist
 - accidental losses, measurable, not pose catastrophic risk for insurer

Elements of a Valid Contract

- Offer and acceptance
- Legal competency of all parties
- Legal consideration
- Lawful purpose

Legal Principles of the Insurance Contract

- The principle of indemnity
 - insurance makes insured whole again NOT better than before
- The principle of insurable interest: loss must cause insured financial or emotional hardship
- The principle of utmost good faith: both must be forthright in dealings
 - Warranty insureds' promise to do something (install locks)
 - Representation: statement in application
 - Concealment: not revealing material fact

Important Features of Insurance Contracts

- Exclusions: what is not covered
- Riders and endorsements: modify basic contract
- Valuation of insured losses
 - Replacement cost: new
 - Actual cash value (ACV): depreciated value
 - Agreed-upon value: diamond ring appraisal
 - Deductibles and co-payments: insured's part
 - Coinsurance: formula to determine amt. payable when a PARTIAL loss (80% rule)

Individual Loss Exposures and Insurance Coverages

- Perils that can reduce and/or eliminate the ability to earn income
 - Dying too soon
 - Living too long
 - Disability
- Perils that can destroy or deplete existing assets
 - Damage to property
 - Legal liability for injuries inflicted upon others

Characteristics of Insurance Companies

- Type of ownership
 - Capital stock insurance: owned by stockholders
 - Mutual insurance: owned by policyholders, pays dividends
- Insurance underwriting: protects against adverse selection
- Reinsurance: shares risks among insurance companies by agreement

- Federal and state regulation: helps prevent insolvency, abuses
- NAIC

Selecting an Insurance Company

- Rating agencies
 - A.M. Best
 - Fitch
 - Moody's
 - Standard & Poor's
 - See rating categories