Dearborn™

Insurance Fundamentals

Dearborn Career Development™

RESPONDENTS 14

1

The Role of Insurance in Society

Insurance protects us all against unforeseen events that could cause financial hardship. The protection insurance provides allows us to

- purchase cars;
- purchase homes and businesses; and
- safeguard our families' financial futures.

Overall, insurance is what helps us have peace of mind in an uncertain world.

After completing this chapter, you will be able to

- trace the history of insurance from its origin in China to current times;
- define insurance;
- list and recognize the benefits of insurance; and
- distinguish between the costs and benefits of insurance to society.

HISTORY OF INSURANCE

Origins in China

As important as insurance is to modern society, it is not a new idea. The insurance industry enjoys a long and sometimes colorful history dating back many centuries. The earliest form of insurance occurred when wealthy Chinese merchants along the Yangtze River decided that it was too risky to place all their merchandise on a single vessel and sail it down the river. To reduce their risks, they split the shipment into smaller portions and placed them on several boats. They knew that it was unlikely all the vessels would sink or suffer damage and that if one did sink, the majority of the cargo would reach its destination safely. Although this arrangement was not formally called *insurance,* it was the forerunner of the modern insurance company, which also recognizes the importance of spreading risk.

Lloyd's of London

The more formalized insurance arrangements we are familiar with today actually began at a coffeehouse owned by Edward Lloyd near London. In the late 1600s, wealthy merchants gathered at the coffeehouse to discuss their latest ventures, which often involved overseas shipments, increasingly to the new world. Concerned that they could be devastated financially if an entire shipment was lost, merchants began to make arrangements with each other to share their risks of loss.

When a shipment was scheduled to depart, the owner posted a notice with a complete description of the cargo and vessel at the coffeehouse. Other merchants looked at the description and signed their names beneath with a percentage of the cargo they were willing to pay for if the vessel were lost. When 100 percent of the cargo was insured in this manner, the vessel sailed.

These early merchants became known as *underwriters.* If the voyage was successful, each underwriter received a bonus, or *premium.* If, however, the vessel did not reach its destination, the underwriters made good the loss to the shipper. This, of course, was the beginning of Lloyd's of London, an institution that has continued to operate in much the same way for more than 400 years and after which many of our United States insurance customs and practices are patterned. Lloyd's remains a major participant in the worldwide insurance industry. Lloyd's of London is not an insurance company that sells policies. It is a group of private insurers that underwrite risks they feel are good business proposals submitted to them from customer groups.

Fire Insurance Origins

The U.S. insurance industry owes a great deal of its current structure to Benjamin Franklin, who is less known for instituting U.S. insurance practices than for inventing things. In the late 1700s, as cities grew, citizens were highly concerned about fire damage to homes and other buildings. Franklin convinced worried citizens to contribute to a fund that would pay for a fire brigade to extinguish fires. Each contributor received a *fire mark* plaque to be placed on the front of his or her house.

In the event of a fire, brigades came by looking for the fire mark. When they saw one, they stopped and put out the fire. If, however, a home didn't have one or it named another brigade, they kept going. Although this may not appear to be insurance by today's standards, this kind of arrangement involves many fundamental concepts still used in the modern insurance industry.

DEFINITION OF INSURANCE

Although modern insurance transactions are somewhat different from those used by the river boatmen, the result is the same. The similarities are

- premiums are placed in a fund;
- payment from the fund is made for losses; and
- risks are shared equally.

The characteristics of an insurance transaction are

- pooling of resources;
- accumulation of funds;
- distribution of funds to those who have losses;
- transfer of risk from one person to the group; and
- spread of risk among all members of the group.

Pooling of Resources

When people facing a common risk pool their resources, they create an accumulation of funds from which individual losses can be paid. Such an arrangement transfers risk from the individual to the group because the group shares the cost of the risk among all of its members. All insurance, no matter what type or sold by which company, is a form of this kind of arrangement.

COST AND BENEFITS OF INSURANCE

The products and services the insurance industry provides offer many benefits to society. Today's insurance provides protection by reimbursing people when their property is damaged or they suffer some other loss. Insurance helps individuals and business owners resume their normal standard of living and operations, which also benefits society as a whole.

The primary benefits of insurance include

- payment of losses;
- economic growth;
- credit support;
- loss prevention; and
- peace of mind.

Payment of Losses

If a business burns down and has no means to resume operation, it would mean financial hardship for the owner. But the negative impact would extend beyond the owner and affect

- employees (who now are unemployed);
- those from whom the business purchases raw materials, goods or services (who now must find a new customer); and
- those to whom the business provides goods and services (who now must find another business to fill their needs).

The proceeds of an insurance policy benefit everyone by restoring the insured person or organization to the same financial condition as before the loss and preventing the loss from rippling out and affecting others negatively.

Economic Growth

The insurance industry plays an important role in the nation's economy. It is second only to the commercial banking industry as a source of investment funds because insurance companies invest the billions of the premium dollars they receive annually in a wide range of investments.

Insurance companies use premiums collected from policyholders to

- pay for claims;
- pay for cost of doing business; and
- build cash reserves for future loss payments.

Cash reserves are invested in federal and municipal bonds that are used to build roads, schools and utilities. Reserves are also invested in commercial developments and the stock market. These investments promote economic growth in communities and support the insurance company's requirement of maintaining sufficient capital reserves to pay future losses and earn a profit.

Loss Prevention

Insurance also benefits society by encouraging activities and devices that reduce the amount of losses and their economic impact.

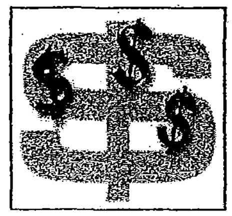
Seat belts and other passive restraints in automobiles significantly reduce the extent of injuries suffered by vehicle occupants involved in auto accidents. Insurance companies were a major force behind requiring seat belts as standard equipment in all vehicles. You may have noticed the "UL Approved" label on an appliance you own. UL stands for *Underwriters Laboratories*, an insurance industry think tank that develops safety standards for items used in residences and businesses.

Insurance agents and risk managers often work with individual and commercial clients to implement loss prevention measures such as security systems, better construction materials or employee disaster evacuation plans. The life insurance industry also educates individuals and businesses on the need to develop financial plans in the event of a premature death of a breadwinner or key executive. Helping clients to eliminate or reduce the amount of loss and human suffering has long been a part of the insurance industry.

Credit Support

Banks and credit institutions rely on insurance to make sure they can recover loans if disaster occurs. Insurance allows borrowers to guarantee creditors that their investment is protected against disasters.

Insurance protects



- the value of property from unforeseen disasters; and
- a client's ability to pay back loans if illness or premature death occurs.

Cost to Society

Despite its benefits, insurance is not without costs. Insurance can *inadvertently* create a situation where losses are more likely to occur. For example, no one would burn down his or her house if he or she had to bear the financial burden. Tempted by the opportunity offered by insurance coverage, unscrupulous people commit arson simply to access policy proceeds. This is an insurance cost because the loss would not have occurred unless the arsonist believed he or she could collect on the policy. In other words, without insurance, arson for profit would not exist.

In a less sinister but equally damaging way, some people aren't as careful to prevent losses when they have insurance. You may have heard someone say, "So what if something happens to my property—that's why I have insurance." They don't cause the loss intentionally, but are indifferent as to whether it occurs. This indifference to loss leads to damage and injury that could have been prevented, and it also is considered a cost of insurance.

Key Point

While insurance provides significant benefits our society depends on, it is not without its costs. In addition to the physical and human resources consumed in the insurance industry, insurance also creates some losses that otherwise would not occur, such as deliberate fires—arson—or needless damage and injury caused by indifference.

SUMMARY

In addition to defining insurance, this chapter introduced you to the concept of insurance by explaining how it originated. You also learned about the benefits and costs of insurance to society.

CHAPTER REVIEW QUESTIONS

1. The U.S. largely influenced the earliest development of insurance.

   A. True

   B. False

2. Antonio and his five closest friends have decided to insure that each member of their exclusive group is assured of a bright future. Antonio is the trustee for the group. All five of Antonio's friends chip in a million dollars to a mutual fund account set up in all six names. Is this arrangement an example of insurance?

   A. Yes

   B. No

3. Which of the following is a cost of insurance to society?

   A. Investments that insurance companies make

   B. Devices that prevent loss

   C. Protection from loss

   D. Indifference to loss

4. The Joneses have a new baby boy. They just purchased life insurance on themselves to provide financial arrangements for his care if either of them were to die prematurely. Select the *primary* type of insurance benefit represented by this example.

   A. Loss payment

   B. Economic growth

   C. Peace of mind

   D. Loss prevention

5. John and Judy are purchasing a new home. They have a significant down payment and stable employment records; however, all the banks they have talked to require proof of insurance for the loan to be approved. Select the *primary* type of insurance benefit represented by this example.

   A. Peace of mind

   B. Loss prevention

   C. Economic growth

   D. Credit support

6. A city is building a new elementary school that was financed with bonds funded in part by the ABC Insurance Company. Select the *primary* type of insurance benefit represented by this example.

   A. Payment of losses

   B. Economic growth

   C. Credit support

   D. Loss prevention

ANSWERS AND RATIONALES TO CHAPTER REVIEW QUESTIONS

1. **B.** Insurance was developed initially among Chinese (and later among English) merchants concerned about lessening risks associated with ocean voyages. The U.S. system of transportation, however, has contributed greatly to the comprehensive insurance structure of today.

2. **B.** This arrangement is not an example of insurance because Antonio did not contribute to and share the risk with his friends. This group did not have a common risk.

3. **D.** The other choices are benefits provided by insurance companies' monetary investments in society and in its preservation.

4. **C.** Life insurance does have an impact on future loss prevention; however, this is primarily an example of the peace of mind insurance provides.

5. **D.** Credit support is the primary insurance benefit in the above example; however, the ability to purchase the insured home will also result in economic growth and peace of mind for the owners.

6. **B.** Economic growth is supported by the investments insurance companies make to maintain and give cash reserves for future loss payments. Often these investments are in federal, state and municipal bonds that stimulate community development and promote economic growth.

2

The Concept of Risk Management

This chapter provides a good background for your study of risk management. After completing this chapter, you will be able to

- define key risk management words and terms;
- discriminate between pure and speculative risk; and
- describe the five most common methods of handling risk.

RISK

Any introduction to insurance requires a clear understanding of the concept of risk. Many insurance professionals use the word *risk* to refer to an insured, a prospect for insurance or to the peril that is being insured. They will say that a particular person or property is a good risk or a bad risk, meaning that they have evaluated the underwriting characteristics of that person or property for a particular insurance policy. This usage differs from the strict insurance definition, which defines risk as the uncertainty regarding financial loss.

Accident vs. Arson

To understand this strict insurance definition of risk, consider what happens when an individual decides to burn down his or her own home. When gasoline is sprayed on the house and a torch is applied, the loss is certain. *The event is purposeful in nature, and no uncertainty exists.* Therefore, there is no risk (in insurance terms) of loss by fire. Conversely, when a house fire is started by faulty electrical circuitry or a lightning strike, the event is sudden and unexpected. Both the owner of the house and the financial institution that holds the mortgage on the house suffer a financial loss. The loss is uncertain and accidental; therefore, a risk exists and the loss is covered by insurance.

Speculative vs. Pure Risk

Risk, as defined by the insurance industry, can be of two kinds: speculative or pure. This distinction is important because, in general, only pure risks are insurable.

Speculative risk involves three possible outcomes: loss, no loss or profit. Investing in the stock market is an example of speculative risk. One might profit when the value of the stock rises, lose when it declines or break even if no change occurs. Speculative risks are not insurable.

Pure risk involves only two possible outcomes: loss or no loss, with no possibility of gain or profit. The risk associated with the chance of being robbed is an example of pure risk. No opportunity for gain exists if the robbery does not occur—only an opportunity for loss if it does. Only pure risks are insurable. A pure risk involves only the chance of loss, never the chance of a gain. Insurance protects against pure risk.

Speculative Risk

Key Point

Speculative risks involve the chance of both loss and gain. Although betting at the racetrack or investing in the stock market are cited frequently as examples of speculative risk, individuals face many decisions every day that entail an element of this type of risk.

Some everyday examples of speculative risk decisions people face include

- remaining in current positions or looking for new jobs;
- remodeling or purchasing a larger home; and
- making only minimum installment payments or completely repaying current debt.

Because the possibility of loss or gain exists in all of the above decisions, the financial outcome is not insurable.

Loss and Exposure

Loss is defined for insurance purposes as unintended, unforeseen damage to property, or the amount the insurance company is obligated to pay because of personal injury. Everyday wear and tear on clothing represents destruction or decline in value; however, for insurance purposes, it is not a loss because it is the expected or intended consequence of wearing the clothes. Smoke damage to clothing caused by a fire in the house, in contrast, would be considered a loss that a person could obtain insurance to offset.

In the context of insurance, *exposure* is the possibility of a loss. It simply means the degree to which a person or property is vulnerable to risk or to the possibility of loss

Insurance

Insurance is a financial device for transferring or shifting risk from an individual or entity to a large group with the same risk. This is accomplished through a contract, the insurance policy, with an insurance company. Under this arrangement, the individual, along with other insureds, pays a sum to the insurance company. In turn, the insurance company agrees to pay an amount of money (reimbursement) to the individual, or on behalf of the individual, if the events described in the policy occur.

Key Point

Insurance is used to indemnify, or restore, a policyholder to a preloss condition. The individual accepts a known cost, the *premium,* in exchange for payment of a large, uncertain financial loss. The insurance company combines, or *pools,* a large number of similar units (homes, autos, businesses, etc.) and thus can predict losses within these units.

The Law of Large Numbers

The mathematical principle of probability is called the *law of large numbers.* In insurance, a prediction must be made from past loss experience or statistical analysis of the number of losses to be expected within a group of exposures. The law of large numbers tells us that actual losses will be more accurate as the number of units of exposure increases.

This principle, known as the *law of large numbers,* states that as the number of observations of an event increase, the closer the predicted outcome will be to the actual outcome. Insurers know, within a very narrow margin, how many homes will be damaged each year by fire, although they do not know which homes will be damaged. This uncertainty introduces risk and makes it possible to insure homes against fire loss.

Assume 1,000 homes in an area are each worth $50,000. Also assume that statistics show that five of these homes can be expected to burn this year. If each of 1,000 homeowners contributes his or her share ($250) of the expected $250,000 loss into a fund at the beginning of the year, an adequate insurance pool will exist to pay for the losses if they occur.

Similarly, an insurer issues policies insuring against the same type of risk to a large number of homeowners. The insurer knows how many homes may be destroyed by fire in a single year, but not which homes will suffer the loss.

Transfer (Other Than Insurance)

Some risks, or loss exposures, may be transferred to another person or entity. For example, a construction contract may *transfer* certain construction risks to a subcontractor, such as when an electrician agrees to hold a general contractor harmless for certain injuries that occur at the job site while the electrician performs his or her harmless duties.

Insurance is the most prominent device for transferring risk; however, there are noninsurance transfer options that are effective for some risks. Examples of noninsurance risk transfers include

CHAPTER REVIEW QUESTIONS

1. Choose the appropriate risk management technique for this example: Protection for homes and autos.

   A. Retention
   B. Transfer (other than insurance)
   C. Loss control
   D. Insurance

2. Choose the appropriate risk management technique for this example: Regularly replacing batteries in home smoke detectors.

   A. Avoidance
   B. Retention
   C. Loss control
   D. Insurance

3. Choose the appropriate risk management technique for this example: Window glass breakage.

   A. Avoidance
   B. Retention
   C. Loss control
   D. Insurance

4. Choose the appropriate risk management technique for this example: Formation of a corporation to limit personal liability.

   A. Retention
   B. Transfer
   C. Loss control
   D. Insurance

5. Uncertainty regarding financial loss is the definition of

   A. insurance
   B. risk
   C. hazard
   D. peril

6. Which of the following is a pure risk situation?

   A. A car is damaged by vandalism.
   B. A tornado destroys a business.
   C. A fire caused by lightning damages a home.
   D. All of the above

7. Choose the appropriate risk-management technique for this example: Selling fireworks as a home-based business.

   A. Avoidance
   B. Retention
   C. Loss control
   D. Insurance

ANSWERS AND RATIONALES TO CHAPTER REVIEW QUESTIONS

1. **D.** Insurance is an affordable way of managing risk by spreading it among a sufficiently large number of similar exposures.

2. **C.** Installing and maintaining smoke detectors is a loss control technique for reducing the potential damage from a fire.

3. **B.** The individual can retain lesser exposures, such as glass breakage, without extreme financial strain and reduce premium expense with the use of a *deductible*.

4. **B.** By forming a legal corporation, shareholders transfer the risk to the corporations.

5. **B.** The insurance industry defines risk as the uncertainty regarding financial loss.

6. **D.** These are all loss/no loss situations and, therefore, can be classified as pure risks, which are insurable.

7. **A.** As a general rule, a risk should be avoided when it is greater than the possible gain involved.

3

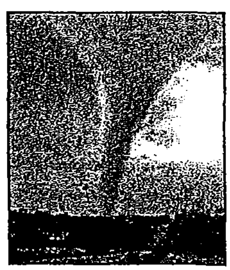
Fundamental Insurance Concepts

In this chapter, we'll review some fundamental insurance concepts that will give you a good foundation for the rest of the course.

After completing this chapter, you will be able to

- define losses, perils and hazards;
- describe common loss exposures;
- explain the requirements of an insurable risk; and
- distinguish between insurable interest and the principle of indemnity.

PERILS AND CAUSES OF LOSS



Many people use the term *loss, peril* and *hazard* synonymously. However, the meanings of these words as used in insurance are quite different and should be carefully distinguished. As we discussed in the last chapter, in insurance, a *loss* is defined as an unintended, unforeseen reduction or destruction of financial or economic value to an individual, organization or object caused by an accidental event. For example, the market value of an automobile decreases as it ages. Although depreciation represents a decline in the auto's economic value, it is not unforeseen, and, therefore, it does not represent a loss in an insurance sense. On the other hand, the destruction of an auto by a tornado is unintended and unforeseen and is, therefore, considered a loss.

Common Loss Exposures

The probability that an event will occur is called a chance of loss or an *exposure* to loss. Listed below are the most common exposures to loss are

- personal;
- property; and
- liability.

Personal Losses

Illness, injury and premature death are all examples of personal loss exposures.

Property Losses

Car accidents, house fires and storm damage to businesses are examples of property loss. Property loss involves the destruction of personal or commercial property.

Liability Losses

Liability loss exposure means the potential to become legally responsible for injuries of others or damages to someone else's property. For example, if your dog bites a small child, you may be liable for the child's injuries. Likewise, if you have a car accident and are held at fault, you may be required to pay for any injuries or damages that result.

Direct and Indirect Losses

Losses can be classified as either direct or indirect, with insurance policies designed to cover either or both types of loss.

Direct loss refers to actual physical loss, destruction or damage to property—for instance, the loss caused by a fire as well as other damage for which the fire was the proximate cause, such as water damage from putting out the fire.

Indirect loss is a financial loss incurred as a result of direct damage to property. For a business, this includes loss of profits, rent and continuing or extra expenses necessary to keep the business operating after a direct loss. In the case of a personal dwelling, indirect loss involves the possible loss of rent from a rental unit in the dwelling or the extra expenses the homeowner incurs from living in a motel while his or her home is being repaired after a direct loss.

Proximate Cause

Proximate cause is the uninterrupted sequence of events that produces a loss due to negligence, injury or damage. In other words, there is an unbroken chain of cause and effect between the occurrence of an insurance peril and the damage to property.

Suppose a fire in one part of a building caused damage to wiring that in turn caused a short circuit. The short circuit then caused damage to machinery in another part of the building. In this example, fire was the proximate cause of damage to the machinery.

The old story of Mrs. O'Leary and her famous cow that caused the Great Chicago Fire is still a classic example of proximate cause. The cause (cow kicking over the lantern) that sets in motion an unbroken chain of events leading to a loss (fire damage) is considered the proximate cause of the loss.

Peril

Peril is the insurance term for the actual cause of a loss. Perils are identified or referred to in the policy. Perils include such events as fire, wind, hail, collision with another car and the like. A *named peril policy* provides coverage only if a loss is caused by one of the perils specifically named or identified in the policy, such as fire, wind or hail. If a peril is not listed, it is not covered. Policies also can exclude perils only under certain conditions or cover them only under certain conditions.

For example, vandalism is a covered cause of loss in most property insurance policies. However, coverage for vandalism often is excluded when a building has been vacant for more than 60 days preceding the loss.

The insuring agreement of an *open perils* policy is stated in very broad terms--the policy provides coverage for risks of direct physical loss or damage *except* from those causes of loss specifically excluded, such as intentional losses, earthquake and the like. In other words, open perils policies define coverage in part by the policy exclusions.

Key Point

The term *all risk* should not be used in any written or oral communication with an insured. This has become insurance industry shorthand for an open perils or a special form policy, but the term can be misleading to a policyholder who might expect his or her policy to cover *every* type of loss situation.

Hazards

Four types of hazards promote loss:

- physical hazard;
- moral hazard;
- legal hazard; and
- morale hazard.

Physical

This is a characteristic of a loss exposure or physical object that increases the chance or degree of loss. Examples of physical hazards include

- a broken step;
- a wooden building located far from a fire department; or
- a sports car driven by a reckless young driver.

Moral

This factor relates to the honesty of the individual who is insured and to conditions that encourage an insured to cause losses for his or her own benefit. The existence of moral hazard increases both the chance and degree of loss because it is often difficult for the insurer to see and correct in advance. Examples of moral hazard include

- arson for profit; or
- embezzlement.

Morale

An attitude of carelessness or lack of concern on the part of the insured that increases the chance that a loss will occur is also a morale hazard. Examples of this type hazard morale include

- leaving doors unlocked;
- carelessly handling smoking materials; or
- storing oily rags near a fire source.

Legal

The legislation created and enforced by legislative, judicial and administrative agencies creates legal obligations and potential liability for an individual or entity. A legal hazard exists when an individual or entity is susceptible to legal action resulting from the enforcement of such legislation.

The courts, for example, apply the doctrine of *absolute* or *strict liability* to a party engaged in an extra-hazardous pursuit, even if the person involved in the activity has not performed negligently. Anyone who possesses, stores, maintains or transports a dangerous instrumentality or device is absolutely liable for any injury or damage caused by that instrument, regardless of the presence of due care.

For example, assume a person keeps an undomesticated animal, such as a mountain lion, as a pet. The owner installs a 20-foot fence around the backyard and posts signs warning trespassers that a wild animal is present. The courts will likely find the owner absolutely liable for any injury or damage that the animal may cause, even though the owner took precautions to prevent such occurrences. The owner of the mountain lion has subjected his or her neighbors to abnormal risk by bringing a wild animal into the neighborhood.

REQUIREMENTS OF AN INSURABLE RISK

Not all risks and loss exposures are insurable. Insurance companies generally are unwilling to insure unusual risks or those that represent a potential for catastrophic loss. Certain requirements must be met for a risk to be insurable from a company's point of view. To be insurable, a risk must meet the following general requirements:

- large enough to cause economic hardship yet feasible to insure;
- not excessively catastrophic; and
- unintentional and accidental.

Economic Hardship Losses

When an individual purchases an insurance policy, he or she transfers the risk of economic loss to an insurance company. Although people might wish to transfer all of their chances of loss to the insurer, insurance companies are not interested in assuming every risk inherent in a person's everyday life. The potential losses insurance covers must be large enough to warrant the insurer's time, effort and expense to provide insurance against the occurrence. Thus, the potential loss must be large enough to cause an economic hardship for the insured, yet the cost of insuring the risk must be economically feasible.

Most insurance policies do not provide coverage for small losses, such as an injury to a household pet, that insureds can usually afford to pay themselves. To this end, many insurance policies include a *deductible* provision, which specifies that, in return for a reduced premium, the insured will assume losses below a specified amount, perhaps $100 or more.

Individually Random Losses

To be insurable, losses must be individually random. The risk is not likely to result in repeated catastrophic losses, either to the same insured or to a significant number of similar insureds at the same time.

Assume that several houses are built along the banks of a river that overflows its banks almost every year. When the floods begin, the homeowners must evacuate their homes and move to another location until the flood waters subside. Most of these homeowners have an average loss of $15,000 each time the river overflows. Because there is a significant chance that the insurance company would lose a great deal of money insuring these house for flood damage, most homeowners insurance policies exclude the *peril* of flood. Certain natural disasters that can cause widespread disaster may appear to be uninsurable. However, coverage can be purchased through certain specialty insurers or particular government programs.

Fortuitous or Accidental Losses

The loss must be fortuitous or accidental, meaning to be insurable, losses must be accidental and unintentional from the insurer's standpoint. Individuals covered by insurance contracts should not benefit financially from the occurrence of an event insured against. Neither can they intentionally cause a loss to recover from an insurance company.

INSURABLE INTEREST AND INDEMNITY

Once a company has determined that a risk is unintentional, significant in size to cause economic hardship, not excessively catastrophic and feasible to insure, it next must determine if the client has an insurable interest. *Insurable interest* means having a relationship to property such that a loss of or damage to the property results in a financial loss to an individual or organization.

Such an interest generally comes about through

- owning property;
- having a relationship with the named insured;
- holding a mortgage or lien on property; or
- having care, custody or control of other people's property.

Key Point

Insurable interest is a relationship between a person and a property such that, if a loss occurs, the person is harmed financially. An insurable interest must exist at the time of the loss for payment to be made.

Generally, state law requires that the insurance buyer, as well as other insureds on the contract, have an insurable interest at the time of application for the insurance policy and at the time of a loss (claim). However, insurable interest need not be maintained throughout the life of the contract. For example, a loan can be paid off, extinguishing the lender's interest. The policy does not have to be cancelled nor the name of the lender removed, but it will not receive any benefits under the policy because its insurable interest has ended.

The Principle of Indemnity

One of the foundations upon which the property and casualty industry is built is the principle of indemnity. This is similar to insurable interest, but rather than defining under what circumstances a policyholder can collect on an insurance policy, the *principle of indemnity* determines how much he or she can collect.

Under this rule, insurance policies are considered to be contracts of indemnity, meaning they are designed to put someone back in the same general financial condition he or she was in before the loss. In other words, a person should not be able to profit by collecting on insurance. The elimination of gain also supports the idea that insurance is designed to insure only pure risk situations.

SUMMARY

This chapter provided information on the basic terms and concepts you'll need to know to complete the rest of the course.

CHAPTER REVIEW QUESTIONS

1. Arson is an example of which of the following?
   A. Physical hazard
   B. Moral hazard
   C. Legal hazard
   D. Morale hazard

2. A hole in a walkway is an example of which of the following?
   A. Physical hazard
   B. Moral hazard
   C. Legal hazard
   D. Morale hazard

3. A firecracker is an example of which of the following?
   A. Physical hazard
   B. Moral hazard
   C. Legal hazard
   D. Morale hazard

4. Which of the following is NOT an example of a hazard?
   A. Oily rags stacked in a corner of a building
   B. Homeowners' carelessness because he has insurance
   C. Fire that destroys personal property in a building
   D. Insured who sets fire to his or her own building

5. To be insurable from an insurance company's standpoint, which of the following NOT true?
   A. Losses must be intentional.
   B. Losses must be accidental.
   C. Losses must be large enough to create economic hardship.
   D. Insuring the risk must be economically feasible.

6. Storing gasoline next to a natural gas heater is an example of which of the following?
   A. Physical hazard
   B. Moral hazard
   C. Legal hazard
   D. Morale hazard

7. Which of the following statements describes the characteristics of an insurable pure risk?
   A. The loss must be fortuitous or accidental.
   B. The risk is not likely to result in repeated catastrophic losses, either to the same insured or to a significant number of similar insureds at the same time.
   C. The potential loss must be large enough to cause an economic hardship for the insured, yet the cost of insuring the risk must be economically feasible.
   D. All of the above

8. To have an insurable interest in property, the insured must
   A. have some relationship to the property at the time of loss
   B. have had a past financial relationship to the property
   C. be the sole owner of the property
   D. be the person who purchases insurance on the property

ANSWERS AND RATIONALES TO CHAPTER REVIEW QUESTIONS

1. **B.** Arson is a classic example of a moral hazard in which an insured causes loss for his or her own benefit. Although arson is a illegal, arson is a conscious choice based on a moral decision.

2. **A.** A hole in a walkway is an example of a physical hazard because its presence increases the chance of someone tripping over it.

3. **C.** Anyone who possesses, stores, maintains or transports a dangerous instrumentality or device is liable for any injury or damage caused by that instrument, regardless of the presence or absence of due care.

4. **C.** Fire is a cause of loss or peril, not a hazard.

5. **A.** To be insurable, losses must not be excessively catastrophic or intentional; in fact, they must be accidental from the insured's standpoint.

6. **D.** Storing gasoline next to a natural gas heater is an example of carelessness and lack of concern that increases the chance of a loss.

7. **D.** All three statements taken together describe the aspects of risk that an insurer must consider.

8. **A.** Property and casualty insurance requires that an insurable interest be present at the time a loss occurs.