

Module 1 INSURANCE BASICS

Insurance is a social device used to spread the possibility of a financial loss over a large number of similar exposures. This principle is often referred to as the law of large numbers.

Insurance is based on risk-pooling, and the law of large numbers is used to allow the insurer to spread risks over a group of similar risks.

Insurance – the Purpose

The purpose of insurance is to place the insured back to the financial position enjoyed before the loss occurred. This is known as the “principle of indemnity.” The Dictionary of Insurance Terms defines indemnity as “compensation for loss.” You may see the terms **indemnity**, **indemnify** and/or **indemnification** used.

Financial Risk

Risk in any form of insurance can be defined as the uncertainty of a financial loss. **Example:** *A financial risk could be the inability to work and earn a living due to an injury or illness.*

There are two types of recognized financial risks: *Speculative* and *Pure*.

Speculative risks are not insurable because they involve the possibility of both loss and gain. **Example:** *Placing a wager on a sports event would be speculative.*

Pure risks are insurable. Pure risks have only the possibility of loss. **Example:** *A house fire would be a pure loss.*

Risk Management Methods

Risk management is the practice of handling *pure risks*. Managing risk can take various forms. There are five (5) recognized methods of handling risk:

(1) **Risk Avoidance** - This technique simply precludes participation in an activity that would lead to a potential financial loss.

(2) **Risk Assumption** - Whatever the activity, the individual or entity will accept the financial consequences and pay for any losses from its own financial resources.

(3) **Risk Transference** - This is the most effective method of risk management. Generally, *transfer of the risk* involves the person paying a premium to an insurance company in exchange for the company accepting the potential financial loss. However, risk transference does not require the use of insurance.

(4) **Risk Sharing** - This method involves the insured and the insurer each accepting part of the risk. Deductibles and co-insurance are methods of risk retention.

(5) **Risk Reduction** - This technique uses methods to lower the possibility of a loss. **Example:** *The use of seat belts in a car has led to a reduced number of*

fatalities in auto crashes.

Perils & Hazards

A **peril** is defined as the specific event causing a loss. *Examples: Fire, flood, earthquake, explosion, wind, death, and disability are some notable perils.*

A **hazard** is any factor that gives rise to a peril. In insurance, there are three (3) basic types of hazards:

(1) **Physical hazards** are hazards in which the individual characteristics increase the chance of a peril occurring. **Example:** *The improper storage of combustibles would be a physical hazard.*

(2) **Moral hazards** are tendencies people have that could increase risk such as criminal activity or personal habits. **Example:** *Arson would be a moral hazard.*

(3) **Morale hazards** are the tendencies to do things that could cause a loss through an indifferent attitude. **Example:** *The failure to lock doors and windows while away from home would be a morale hazard.*

Requirements of an Insurable Risk (Creating an insurance policy)

Creating viable insurance contracts requires the insurer to follow certain standards determined by law as well as practical business procedures. Insurance companies determine whether the risks would be practical to insure by using the following criteria:

(1) There must be a **large number of similar exposures**. Without a large number of similar exposures, the insuring company cannot accurately predict the potential for or probability of the loss. **For example:** *The more insured persons with similar characteristics such as age, sex, body build, and health, the more accurately the insurance company can predict losses.*

(2) The potential loss must be **significant in scope** or cause an economic hardship for the insured. **For Example:** *A significant financial loss would be the death of a family wage earner.*

(3) The loss must be **measurable or definite**. The amount of loss must be known, and the frequency of an occurrence must be statistically predictable.

(4) The loss must be **accidental in nature** (uncertain, unforeseen, and unintended). The loss cannot be intentional or predictable. **Examples:** *An auto accident is always a possibility when driving a car, but the event would be unintended and unforeseen. Death is a definite, but the time a person will die is not known.*

(5) The loss must be **non-catastrophic in nature**. Insurance companies will not insure events such as floods, nuclear disasters, and war. These events could bring insolvency to the insuring companies because the claims would be too excessive.

Insurers and Place of Domicile (How insurers are defined)

Private insurance companies are categorized according to their place of domicile. They are referred to as:

(1) ***Domestic Insurers***: Insurance companies formed under the laws of and principally domiciled in a particular state. An insurer domiciled in NC would be considered a domestic company.

(2) ***Foreign Insurers***: Insurance companies that have been formed under the laws of and principally domiciled in another state in the United States. An insurer principally domiciled in New York State but doing business in North Carolina would be considered a foreign insurer.