Purpose and Operation of Insurance

Educational Objective (EO)

Describe the purpose and operation of insurance, including risk reduction through pooling and services provided by insurers.

Activity 1 — Describing the Purpose and Operation of Insurance

Questions	**Answers**
1. Why is it important for risk management professionals to understand why insurance works?	
2. What are some of the specialized areas of expertise that is necessary to handle claims?	
3. The operation of insurance relies on [blank.].	
4. This provides a mathematical explanation of the risk reduction that results from pooling.	
5. What is the purpose of insurance?	
6. Under this type of insurance, an insurer has a financial incentive to control claim costs because of its contractual obligation to pay for losses regardless of their severity.	
7. What are the circumstances under which pooling reduces risk?	

Questions	**Answers**
8. Why do insurers provide risk management services?	
9. What are the six characteristics of an ideally insurable loss exposure?	

Answers to Activity 1 — Describing the Purpose and Operation of Insurance

Questions	Answers
1. Why is it important for risk management professionals to understand why insurance works?	To adequately evaluate its effectiveness relative to other risk financing techniques that rely on risk pooling.
2. What are some of the specialized areas of expertise that is necessary to handle claims?	Settling claims, administering claim payments, and preventing fraud.
3. The operation of insurance relies on [blank.].	Pooling
4. This provides a mathematical explanation of the risk reduction that results from pooling.	Law of large numbers
5. What is the purpose of insurance?	To facilitate the spread of hazard risk among those that have similar loss exposures.
6. Under this type of insurance, an insurer has a financial incentive to control claim costs because of its contractual obligation to pay for losses regardless of their severity.	Guaranteed-cost
7. What are the circumstances under which pooling reduces risk?	When the pooled losses are independent (or uncorrelated). Losses are independent if they are not subject to a common cause of loss.
8. Why do insurers provide risk management services?	Because they derive an immediate benefit when their insureds' losses are prevented or reduced.
9. What are the six characteristics of an ideally insurable loss exposure?	• Pure risk • Fortuitous losses • Definite and measurable • Homogenous • Independent and not catastrophic • Affordable

Benefits of Insurance

Activity 1—Describing the Benefits of Insurance

Benefit	Explanation	Example
Pay for losses		
Manage cash flow uncertainty		
Comply with legal requirements		
Promote risk control activity		
Efficient use of insured's resources		
Support for insured's credit		
Source of investment funds		
Reduce social burden		

Answers to Activity 1—Describing the Benefits of Insurance

Benefit	Explanation	Example
Pay for losses	The primary role of insurance is to indemnify (restore to pre-loss status) individuals and organizations for covered losses.	A factory that burns is rebuilt, restoring employment to the workers and a revenue stream to the investors.
Manage cash flow uncertainty	Insurance provides financial compensation when covered losses occur. Therefore, insurance greatly reduces the uncertainty created by many loss exposures.	A family is able to purchase a home with the assurance that their homeowners policy will compensate them for their investment if a loss occurs.
Comply with legal requirements	Insurance can be used both to meet the statutory and contractual requirements of insurance coverage and to provide evidence of financial resources.	All states have laws that require employers to pay for the job-related injuries or illnesses of their employees.
Promote risk control activity	Insurance policies may provide insureds with incentives to undertake risk control activities as a result of policy requirements or premium savings incentives.	Insurance premiums on an office building are reduced when a sprinkler system is installed.
Efficient use of insured's resources	Insurance makes it unnecessary to set aside a large amount of money to pay for the financial consequences of loss exposures that can be insured. This allows that money to be used more efficiently.	A business owner is able to use capital to make investments in equipment rather than holding money in reserve for losses that might occur.
Support for insured's credit	Insurance facilitates loans to individuals and organizations by guaranteeing that the lender will be paid if the collateral for the loan (such as a house or a commercial building) is destroyed or damaged by an insured event, thereby reducing the lender's uncertainty.	When loaning money to a borrower to purchase property, the lender usually acquires a legal interest in that property.
Source of investment funds	The timing of insurer's cash flows, premiums collected up front, and claims paid at a later date enable insurers to invest funds in a variety of investment vehicles.	An insurance company invests in municipal bonds for the construction of community schools and public buildings, which supports job growth and community involvement.
Reduce social burden	Insurance helps to reduce the burden to society of uncompensated	A family breadwinner injured in an auto accident is compensated for

	accident victims.	lost wages by the insurance company rather than by unemployment compensation or other social welfare programs.

Deductibles

Educational Objective (EO)

Describe the types of property and liability deductibles.

Instructions

Activity 1 — Describing Property and Liability Deductibles

Individual Activity Followed by Large Group Discussion

Ask participants to complete the matching activity in **Activity 1— Describing Property and Liability Deductibles**. In this activity, the deductible terms have been defined incorrectly. Participants should match each deductible term with its correct definition.

Debrief:
Review the answers with the class.

Activity 1 — Describing Property and Liability Deductibles

Deductible Term	Definition
1. Per claim deductible	A. A deductible that limits the total amount of losses retained during a year.
2. Percentage deductible	B. A deductible that applies to all damages sustained by any one person or organization as a result of one occurrence.
3. Waiting period deductible	C. A deductible that applies only once to the total of all claims paid arising out of one accident or occurrence.
4. Disappearing deductible	D. A statutory time period in which the injured worker must wait after an injury before benefits can begin.
5. Per accident or per occurrence deductible	E. A deductible that decreases in amount as the amount of loss increases, and disappears entirely to provide full coverage after a loss surpasses a specified amount.
6. Flat deductible	F. A deductible expressed as a percentage of some other amount, such as the amount of insurance, the covered property’s value, or the amount of the loss.
7. Aggregate annual deductible	G. A deductible stated in a specified dollar amount.

Answers to Activity 1 — Describing Property and Liability Deductibles

Deductible Term	Definition
1. Per claim deductible	B. A deductible that applies to all damages sustained by any one person or organization as a result of one occurrence.
2. Percentage deductible	F. A deductible expressed as a percentage of some other amount, such as the amount of insurance, the covered property's value, or the amount of the loss.
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5. Per accident or per occurrence deductible	C. A deductible that applies only once to the total of all claims paid arising out of one accident or occurrence.
6. Flat deductible	G. A deductible stated in a specified dollar amount.
7. Aggregate annual deductible	A. A deductible that limits the total amount of losses retained during a year.

Large Deductible Plans

Educational Objective (EO)

Describe the purpose, operation, advantages, and disadvantages of large deductible plans.

Activity 1—Describing Large Deductible Plans

Questions	Answers
1. What is the purpose of a large deductible plan?	
2. What types of policies use large deductible plans?	
3. What is the advantage for including an aggregate deductible?	
4. What is the difference in operation between large deductible plans and self-insured retention?	
5. What are the two main reasons why reducing the premium reduces costs of risk under a large deductible plan?	

Answers for Activity 1—Describing Large Deductible Plans

Questions	Answers
1. What is the purpose of a large deductible plan?	A large deductible plan is an insurance policy with a per occurrence or per accident deductible of $100,000 or more. Designed to lower premiums for the insured allowing them to assume more of the risk in exchange for a lower premium.
2. What types of policies use large deductible plans?	Large deductible plans are used for workers' compensation, auto liability, and general liability policies. Can also be used in large commercial property policies involving multiple locations.
3. What is the advantage for including an aggregate deductible?	An aggregate deductible caps total deductible payments over a period of time (usually one year).
4. What is the difference in operation between large deductible plans and self-insured retention?	• Large deductible plan—The insurer adjusts and pays all claims for loss, even those below the deductible level, and seeks reimbursement from the insured. • Self-Insured Retention—The insured organization is responsible for adjusting and paying its own losses up to the SIR amount. The insured may have their own adjustment staff or outsource to an independent claim adjusting organization, also known as a Third Party Administrator.
5. What are the two main reasons why reducing the premium reduces costs of risk under a large deductible plan?	• A large deductible plan reduces the state department of insurance charges, such as premium taxes and residual market loadings which are calculated based upon a percentage of premium. • An insurance premium includes charges for the insurer's overhead costs and profit.

Basic Differences: Excess and Umbrella Liability Policies

Educational Objective (EO)

Describe the basic differences between excess liability insurance and umbrella liability insurance.

Instructions

Activity 1—Describing Excess and Umbrella Liability Policies

Individual Activity Followed by Large Group Discussion

If necessary, provide participants with a sheet of paper. Ask participants to write a two-minute paper on the differences between excess and umbrella liability policies. Time participants and tell them to stop writing after two or three minutes have passed.

Alternative: Have participants work in small groups to create a chart comparing Excess vs. Umbrella in terms of Purpose, Broad/narrow, Limits, Defense coverage.

	Excess Liability	**Umbrella Liability**
Purpose		
Broad/narrow coverage		
Limits		
Defense coverage		

Debrief:
Ask for volunteers to read their papers or use discussion questions to engage participants in discussion. Questions you might ask include:

- How does excess liability insurance differ from umbrella liability insurance?
- Give an example of when you would choose excess liability insurance instead of umbrella liability insurance.
- Give an example of when you would choose umbrella liability insurance instead of excess liability insurance