

A full-page photograph of two rock climbers against a clear blue sky. One climber, wearing a red shirt and blue pants, is on a rock ledge on the left, reaching out with a blue rope. The other climber, wearing a yellow shirt and dark pants, is hanging from the rope below, reaching up. Both are wearing safety harnesses and helmets.

FIFTH EDITION

PRINCIPLES
OF
RISK MANAGEMENT
AND
INSURANCE

GEORGE E.
REJDA



CAREER BROCHURE AND FREE
STUDY GUIDE CHAPTER INSIDE!

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**Principles of Risk Management and Insurance,
Fifth Edition**

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Preface

On February 26, 1993, the World Trade Center was bombed. On January 4, 1994, an attacker leapt from a crowd of spectators and assaulted Olympic figure-skating contender Nancy Kerrigan. On January 17, 1994, an earthquake roused a sleeping Los Angeles, only months after fires devastated the Los Angeles landscape and looters ravaged small businesses in the aftermath of race rioting. In the last few years, the mighty Mississippi River flooded much of its central plains valley, and Hurricanes Andrew and Hugo devastated the Gulf Coast and the Eastern Seaboard. And those are some headlines receiving international attention. To say that a lot has happened since publication of the previous edition of *Risk Management and Insurance* might be an understatement.

Occupancy of the World Trade Center is up, Nancy Kerrigan went on to win a silver medal, Los Angeles survived the race riots and acts of nature, and the rest of the nation is rebuilding. The fifth edition of this text explains how recovery from such physical disasters is possible. More important, it examines the process of analyzing and planning for such risks and others, at both personal and business levels. Like earlier editions, the book suits the beginning undergraduate course in principles of risk management and insurance with no prerequisites. Thoroughly revised and updated, the fifth edition provides complete and current coverage of major areas in risk management and insurance, including basic concepts of risk and insurance, risk management, legal principles, property and liability insurance, life and health insurance, employee benefits, social insurance, functional and financial operations of insur-

ers, insurance regulation, and current public policy issues, especially those affecting consumers.

As with previous editions, the fifth edition leans toward the insurance consumer and blends basic insurance principles with consumer considerations. Further, it addresses personal risk management and financial planning issues so that students of insurance can apply basic insurance concepts immediately to their own lives.

MAJOR CHANGES IN THE FIFTH EDITION

1. Streamlined text. Instructors requested a shorter, more streamlined text and made many excellent suggestions on how to achieve such brevity. Through keen editing and judicious rewriting, I have carefully pruned detail in both content and boxes to reduce the text's overall length without sacrificing its usefulness as an insurance resource for years to come.

2. Clarity in writing. Insurance as a subject can intimidate some students if set forth in a disjointed or abstract way. Since readability continues to be crucial, I persist in presenting concepts clearly and directly, for the most user-friendly of texts.

3. New "Insight" boxes. Instructors and students alike enthusiastically endorsed the "Insight" boxes in each chapter of the previous edition. Because "Insights" are such powerful learning tools with their real-world applications of the principles at hand, I replaced virtually all "Insights" with concise, exciting new ones. Readers should look for these grabbers, and then some, throughout the text:

- What Your Mother Didn't Tell You About the Automobile Liability Risk
- What's Required to Set Up a Captive Insurer?
- Are You Insured When You Drive Another Person's Car?
- Personal Injury Lawsuits by Students Are Endangering University Budgets
- How to Cut Your Homeowners Premium
- In California, Insurance Policies Burn Taxpayers
- When the Insurer Totals Your Car
- Protecting Yourself from the Other Guy
- Policy Offered for Sexual Harassment Defense
- What Happens If Stolen Property Is Recovered?
- An Employer's Nightmare: Hiring Dishonest Employees
- Is This Death a Suicide?
- Seven Common Mistakes in Estate Planning
- Consumers Squeezed as Insurers Dispute "Usual and Customary" Medical Fees
- Ignorant of Retirement Nest Egg? Watch Out!
- New Futures Contracts Let Insurers Hedge Against Catastrophic Disasters
- What Happens If Your Insurance Company Becomes Insolvent?

4. Current issues and up-to-date coverage.

Readers will find in-depth analyses of current issues throughout the text: health-care reform, new approaches to reduce insurer insolvency, the new risk-based capital requirements for life and health insurers, current status of the McCarran-Ferguson Act, banks and other financial intermediaries entering and fiercely competing in the insurance industry, and rebates of insurance premiums. Many citations feature recent copyright dates.

The text's endpapers contain tables, charts, and graphs of insurance expenditures and data on matters of life and death, natural disaster and man-made disorder, and motor vehicle usage. Instructors can

use this information for classroom discussion or for comparison throughout the course, and students can get ideas for future research and presentation.

5. Revised beginning- and end-of-chapter material. Chapter introductions more immediately grab reader attention and invite students to learn with key terms and concepts on the first page. A list of student learning objectives launches each chapter so that students know exactly what they need to master before they move on; content summaries, review questions, and questions for discussion all support these objectives at the end of each chapter.

6. New case applications. Many instructors asked for a learning tool that would enable them to give students hands-on experience with insurance. In response, I added a mini-case at the end of each chapter so that students could have a crack at developing critical analytical skills and reasoning through tough insurance problems.

7. Technical accuracy. As in past editions, numerous insurance specialists and technical experts reviewed the revised manuscript for technical accuracy, especially in areas where changes have occurred rapidly or dramatically. Once again, instructors can rely on the fifth edition for the most technically accurate and up-to-date information available.

8. Student Resource Guide to Insurance. A new student resource guide replaces the traditional study guide as an optional student learning and planning aid. The resource guide, described in more detail later in the preface, supports the textbook's greater emphasis on personal risk management and insurance program planning.

CONTENT CHANGES

1. Risk of old age. The introduction to risk associated with old age in Chapter 1 now reflects the current income and net worth position of the elderly.

2. Taxation of captives. Chapter 3, "Risk Management," now includes the current taxation of captive insurers based on recent court cases.

3. The liability risk. Chapter 6, "The Liability Risk," is now more logically positioned in Part

Three, “Personal Property and Liability Risks,” and more thoroughly details the subject matter.

4. Homeowners insurance. Reviewers asked for a reduction in the number of details on the contractual provisions in the homeowners policy. The appendix to Chapter 8, “Homeowners Insurance—Section II,” includes a convenient new worksheet for determining the amount of homeowners insurance to purchase.

5. Insurance on rental cars. Those planning a vacation or aspiring to a job with much business travel should appreciate the new “Insight” box in Chapter 10, “Automobile Insurance,” which should clarify the confusion surrounding the current status of insurance on rental cars.

6. Automobile insurance. Chapter 10 discusses the new 1994 Personal Auto Policy. Chapter 11 is retitled “Automobile Insurance and Society” to reflect more accurately the chapter contents.

7. New edition of the commercial general liability policy (CGL). Chapter 13, “Commercial Liability Insurance,” discusses the latest 1992 edition of the CGL policy drafted by the Insurance Services Office.

8. Federal crime insurance. Chapter 14, “Crime Insurance and Surety Bonds,” now explores the latest version of the federal crime insurance policy for business firms.

9. Investment performance of variable universal life insurance. Chapter 16, “Types of Life Insurance and Annuities,” illustrates the total returns for variable life insurance by type of account. It also shows annual expense ratios, which are extremely important in determining long-run total returns.

10. Investment performance of variable annuities. Chapter 16 also examines the total returns of variable annuities by type of account, as well as the annual expense rates of variable annuities and their impact on total returns.

11. Yearly rate-of-return on life insurance. Chapter 18, “Buying Life Insurance,” now presents Professor Joseph M. Belth’s simplified method for determining the yearly rate of return on life insurance policies.

12. Rating controversy. Chapter 18 also sorts through the confusion about the grades that rating

agencies give to life and health insurers and looks at what these ratings really mean to consumers.

13. Health-care crisis in the United States. Chapter 20, “Individual Health Insurance,” explores the nature and causes of the health-care crisis in the United States.

14. Health-care reform proposals. Chapter 22, “Employee Benefits: Retirement Plans,” overviews the various health-care reform proposals introduced in Congress as of the date of textbook publication. If enacted into law, health-care reform will profoundly alter both individual and group health insurance.

15. Retirement plans. Chapter 22 also shows how current tax law affects qualified pension plans, Section 401(k) plans, individual retirement plans (IRAs), and other retirement plans.

16. Social Security. Chapter 23, “Social Insurance,” investigates the important and timely issue of whether young people receive their money’s worth under Social Security. To ensure the highest level of accuracy, Robert J. Myers, former chief actuary of the Social Security Administration, examined this chapter closely.

17. Workers compensation financial crisis. Chapter 23 also analyzes the current workers compensation financial crisis in the United States.

18. Risk-based capital requirements. Chapter 27, “Government Regulation of Insurance,” discusses the new National Association of Insurance Commissioners risk-based capital requirements, established to reduce insurer insolvency. Life and health insurers will now be graded on how much capital they have to support the riskiness of their investments and business operations.

SUPPLEMENTS

Instructor’s Manual with Test Bank and Transparency Masters. Prepared by George E. Rejda and Burton T. Beam, Jr., The American College. Designed to reduce new course start-up costs and to give seasoned instructors some fresh ideas, this comprehensive manual contains teaching notes, lecture outlines, answers to all text questions

for discussion and review, approximately 675 multiple-choice test items, and a set of transparency masters that illustrate the text's most important points.

TestMaster Computerized Testing System.

This computerized version of the test bank helps instructors to construct tests quickly and easily. Instructors can choose existing test items randomly by chapter, question type, and quantity, or manually by specific item number. The TestMaster program allows instructors to edit test items or add their own questions; print tests in several formats; and incorporate graphs, charts, and tables. Available at no additional cost to adopters of the text; for use with IBM-PC and compatibles.

Student Resource Guide to Insurance.

Prepared by Michael J. McNamara, The University of Memphis. *Sample pages appear at the end of the preface.* This new study tool and planning aid replaces the traditional study guide. It contains exercises that should enable students to apply the various concepts to their own personal insurance programs and to possible careers in the insurance industry. The introductory section to the student summarizes the features and the benefits of the guide, and how to use the guide effectively as a learning device. Each chapter features practice test items such as those objective items found in the test bank, as well as alternative testing items to support various teaching and testing styles; learning goals organized and summarized by the objectives listed at the start of every text chapter; key terms—related exercise; worksheets where appropriate for calculations to support end-of-chapter mini-cases and to facilitate steps in analysis and planning; and step-by-step demonstration problems with rationales for each step, where appropriate for key calculations and decisions covered in each chapter. Solutions to all questions are found at the end of every chapter for quick reference and self-testing. End-of-text appendices include a set of insurance planning worksheets to help students effectively use insurance coverage as part of their personal risk management programs, a comprehensive list of insurance and service organizations operating in the United States today, and an up-to-date guide to all state insurance commissioners currently in office. Interested students should browse through the sample pages of manual found at the end of this preface.

ACKNOWLEDGMENTS

As I have stated in earlier editions, a market-leading textbook is never written in isolation from its market. I owe an enormous intellectual debt to nationally known insurance scholars and academicians for their kind and gracious assistance. Numerous insurance educators have taken time out of their busy professional schedules to review part or all of the fifth edition, to contribute supplementary materials, or to offer valuable suggestions and comments. They include the following:

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Burton Beam, Jr., Mike McNamara, and Evelyn
Rice. Finally, the fundamental objective underlying
the fifth edition is the same as earlier editions—I
have attempted to write an intellectually stimulat-
ing textbook from which students can learn and
professors can teach.

GEORGE E. REJDA, Ph.D., CLU
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Chapter 11

Automobile Insurance and Society

Chapter Overview

How to compensate innocent motorists who have been injured in an automobile accident is an important issue for society. Private insurers are not anxious to insure high-risk drivers, while it is in society's interest that all motorists be financially responsible for the injuries and property damage they may cause. This chapter examines a number of issues related to automobile insurance and society. Four major topics are addressed. First, approaches that are used to compensate innocent automobile accident victims are discussed. Second, no-fault insurance as an alternative to the traditional tort liability system is explored. Third, methods of providing automobile insurance to high-risk drivers are examined. Finally, automobile insurance rating factors are examined and suggestions are offered for consumers who purchase auto insurance.

Learning Objectives

After studying this chapter you should be able to:

- Describe the various approaches for compensating innocent automobile accident victims.
- Explain the meaning of no-fault automobile insurance laws and the arguments for and against such laws.
- Identify the methods for providing automobile insurance to high-risk drivers.
- Identify the major factors that determine the cost of automobile insurance.
- Explain the rules that should be followed when shopping for automobile insurance.
- Define the following:

Add-on plan
Automobile insurance plan
Compulsory insurance law
Essential services expenses
Financial responsibility law
Good student discount
Joint underwriting association (JUA)
Maryland Automobile
Insurance Fund
Modified no-fault plan
Monetary threshold
Multi-car discount
No-fault automobile insurance

Optional deductibles
Optional no-fault benefits
Pure no-fault plan
Rating factors
Reinsurance facility (pool)
Safe driver plans
Servicing insurer
Shared (residual) market
Specialty automobile insurers
Survivors' loss benefits
Uninsured motorists coverage
Unsatisfied judgment fund
Verbal threshold

Sample pages from the **Student Resource Guide to Insurance**: To help students succeed in the course, each chapter of the **Resource Guide** opens with an overview, a checklist of learning objectives for personal goal setting, a list of key concepts and terms for quick review, and a topical outline for taking class notes during lectures.

B. Compulsory Insurance Laws

C. Unsatisfied Judgment Funds

D. Uninsured Motorists Coverage

E. No-Fault Automobile Insurance

II. Automobile Insurance for High-Risk Drivers

A. Automobile Insurance Plans

B. Joint Underwriting Associations

C. Reinsurance Facility

D. Maryland Automobile Insurance Fund

E. Specialty Automobile Insurers

True-False Questions

Circle the **T** if the statement is true, the **F** if the statement is false. Explain to yourself why a statement is false.

- T F** 1. Adequate physical damage coverage for your auto is the most important consideration in automobile insurance.
- T F** 2. Some insurance companies specialize in insuring motorists with poor driving records.
- T F** 3. No-fault insurance typically provides benefits for essential services expenses.
- T F** 4. If you double the amount of liability insurance you carry under your PAP, the premium for your liability insurance will double.
- T F** 5. Compulsory insurance is the only fool-proof method of assuring that innocent victims of auto accidents receive compensation.
- T F** 6. Carrying limits of automobile liability responsibility limits assures that innocent victims of auto accidents receive compensation.
- T F** 7. Under an add-on no-fault driver.
- T F** 8. An insured who owns two cars is insured by the same policy as an insured who owns one car.
- T F** 9. Under state financial responsibility laws, an insured is responsible until after a conviction for certain offenses.
- T F** 10. High-risk drivers are assigned to a separate class of insurance associations.

150 • Part Three Personal Property and Liability Risks

Multiple Choice Questions

Circle the letter that corresponds to the **BEST** answer.

1. In a certain state, all high-risk automobile insurance business is placed in a common pool, and each auto insurer operating in the state pays its pro rata share of pool losses and expenses based upon their proportion of automobile insurance coverage written in the state. Such a plan is called a(n):
 - a. joint underwriting association
 - b. reinsurance facility
 - c. specialty automobile insurer
 - d. automobile insurance plan
2. What statement(s) is(are) true with regard to pure no-fault automobile insurance?
 - I. Under pure no-fault insurance, after an automobile accident involving bodily injury, each party collects from his or her own insurer regardless of fault.
 - II. Most states that have adopted no-fault plans use the pure no-fault form of no-fault.
 - a. I only
 - b. II only
 - c. both I and II
 - d. neither I nor II
3. A number of states have established special funds for compensating innocent accident victims who have exhausted all other means of recovery. These funds are called:
 - a. joint underwriting associations
 - b. unsatisfied judgment funds
 - c. a reinsurance facility
 - d. automobile insurance plans
4. All of the following are approaches for protecting innocent victims of automobile accidents **EXCEPT**:
 - a. uninsured motorist coverage
 - b. no-fault automobile insurance
 - c. financial responsibility laws
 - d. higher deductibles on collision coverage
5. Parker lives in a state that has a no-fault automobile insurance law. If Parker is injured in an accident, he has the right to sue a negligent driver if his bodily injury claim exceeds a certain dollar threshold. What type of no-fault plan is used in Parker's state?
 - a. tort liability
 - b. pure no-fault
 - c. modified no-fault
 - d. add-on no-fault

Sample pages from the **Resource Guide**: Multiple-choice and true/false questions, along with answer keys for immediate feedback, are patterned after the objective items in the test bank to simulate a real testing experience.

Short Answer Questions

1. What approaches are available for compensating automobile accident victims?
2. Under what circumstances are drivers typically required to demonstrate proof of financial responsibility under state financial responsibility laws?
3. What are the advantages and shortcomings of financial responsibility laws?
4. What are the advantages and disadvantages of compulsory automobile insurance?

Sample pages from the **Resource Guide**: Short answer questions with solutions also help students prepare for exams. (Not shown are the Problem Sets with step-by-step solutions for those chapters covering the more challenging quantitative aspects of insurance.)

Solutions to Chapter 11

Short Answer Questions

1. There are a number of approaches available for compensating automobile accident victims. These approaches include: financial responsibility laws, compulsory insurance laws, unsatisfied judgment funds, uninsured motorists coverage, and no-fault automobile insurance.
2. Proof of financial responsibility is typically required under the following circumstances: after an accident involving bodily injury or property damage over a certain amount, failure to pay a final judgment resulting from an automobile accident, and conviction for certain offenses, such as driving while intoxicated or reckless driving.
3. On the positive side, compulsory automobile insurance laws are considered superior to financial responsibility laws because they provide a stronger guarantee of protection to the public. Advocates argue that there are fewer uninsured vehicles in states with compulsory insurance than in states with financial responsibility laws.

Critics of compulsory insurance point out a number of defects: the number of uninsured vehicles may not be reduced by compulsory insurance laws, compulsory laws do not provide complete protection, payment to all injured persons is not guaranteed, and compulsory laws do not prevent or reduce the number of automobile accidents.

4. The advantages of uninsured motorists coverage include: some level of protection against uninsured drivers, the coverage is relatively inexpensive, and settlement is faster and more efficient if you collect under uninsured motorists coverage than collecting under tort liability. Uninsured motorists coverage also has some defects as a method of compensating injured automobile accident victims. These disadvantages include: inadequate limits, the injured person must establish that the uninsured motorist is legally liable for the accident, and in some states property damage is not covered under uninsured motorist coverage.
5. One type of no-fault is pure no-fault. Under a pure no-fault plan, the injured person cannot sue the other driver regardless of the seriousness of the claim and no payments are made for pain and suffering. The only source of recovery is from your own insurer. No states have enacted pure no-fault statutes.

A second type of no-fault plan is modified no-fault. Under a modified no-fault plan, an injured person is permitted to sue the other driver if their bodily injury claim exceeds a dollar or verbal threshold. Otherwise, the accident victim collects from his or her insurer only.

The third type of no-fault, an add-on plan, pays benefits to an accident victim without regard to fault. However, the injured person still has the right to sue the negligent driver who caused the accident. These plans are called add-on because in addition to collecting from an insured's own insurer, the accident victim also has the right to sue the negligent driver who caused the accident.

Case Applications

Case 1

Granite Auto Insurance Company is a recently-formed auto insurer. Rod Williams, President of Granite, hired Shawn Boyle, chairman of the Math Department at State University, to be in charge of ratemaking. Using what he considered relevant rating factors, Shawn calculated net premiums. Then he added an allowance to the net premiums to cover expenses. When he explained the premium calculation to Rod Williams, Rod said, "Of course you still need to allow for losses in the residual market. One of the states where we operate has an automobile insurance plan and the other has a joint underwriting association." Not wanting to appear uninformed, Shawn said, "Yes, of course." Shawn has no idea what Rod Williams meant and has asked you for an explanation. What would you tell Shawn?

Case 2

Betty is an underwriter at Last Resort Insurance Company, an insurer specializing in insuring high-risk drivers. Last Resort has Last year Last Resort experience two largest automobile insurance million dollars to shore up Last R

- a. How will Betty's job as a underwriter at an auto insurer that does not

- b. Why would the two largest a

WORKSHEET A-2

Do you have adequate car insurance?

Maybe, or maybe not. Perhaps you have adequate coverage but it costs almost as much as your tuition. If you drive a car (even if you don't own one), then you should be aware of the various coverages of the personal auto policy (PAP). Although many PAPs are similar, there are differences. To get the best affordable coverage, you should compare the policies and costs of different companies before buying or renewing. This exercise asks you to research and compare the coverages and costs for automobile insurance for three companies. Contact two insurance agents to obtain the information requested below.

DATE _____

The insurance agent may ask you the following questions. Before you call, you should have this information handy:

1. Car: (year, make, model, engine size) _____
2. Driver: Age _____ Sex: ☐ F ☐ M Full- or part-time driver? ☐ Full-time ☐ Part-time
Number of accidents/ traffic violations within the last three years: _____
Driver's education course completed? ☐ yes ☐ no
3. Car usage: Number of miles driven each way to work/school _____
Total miles driven a year _____

Your Current Needs	Company A	Company B
Company name, address, phone Name of agent/contact		
Policy length: <input type="checkbox"/> 6 months <input type="checkbox"/> 1 year		
Coverage: Bodily injury Liability <input type="checkbox"/> per person \$ _____ <input type="checkbox"/> per accident \$ _____	Annual Premium \$ _____	Annual Premium \$ _____
Property Damage Liability (per accident)	\$ _____	\$ _____
Collision deductible \$ _____	\$ _____	\$ _____
Deductible \$ _____	\$ _____	\$ _____
Medical payments (per person) \$ _____	\$ _____	\$ _____
Uninsured Motorists Liability per person \$ _____ per accident \$ _____	\$ _____	\$ _____
Other types of coverage: _____	\$ _____	\$ _____
Service charges/fees	\$ _____	\$ _____
Annual Premium	\$ _____	\$ _____

Sample pages from the Resource Guide:

Students will find two cases per chapter like those in the main text, plus an appendix of insurance planning worksheets for launching successful personal risk management programs. (Not shown are the consumer-oriented brochures from the Insurance Information Institute packaged free of charge with the **Guide**.)

Brief Contents

Detailed Contents ix

Preface xvii

PART ONE

Basic Concepts in Risk Management and Insurance 2

- ➊ Nature and Treatment of Risk 4
- ➋ Insurance and Risk 20
- ➌ Risk Management 37

PART TWO

Legal Principles in Risk and Insurance 56

- ➍ Fundamental Legal Principles 58
- ➎ Analysis of Insurance Contracts 77

PART THREE

Personal Property and Liability Risks 94

- ➏ The Liability Risk 96
- ➐ Homeowners Insurance, Section I 116
- ➑ Homeowners Insurance, Section II 143

- 9 Other Personal Property and Liability Insurance Coverages 164
- 10 Automobile Insurance 183
- 11 Automobile Insurance and Society 208

PART FOUR

Commercial Property and Liability Risks 230

- 12 Commercial Property Insurance 232
- 13 Commercial Liability Insurance 257
- 14 Crime Insurance and Surety Bonds 285

PART FIVE

Life and Health Risks 300

- 15 Fundamentals of Life Insurance 302
- 16 Types of Life Insurance and Annuities 319
- 17 Life Insurance Contractual Provisions 354
- 18 Buying Life Insurance 378
- 19 Life Insurance Planning and Estate Planning 399
- 20 Individual Health Insurance 417
- 21 Employee Benefits: Group Life and Health Insurance 440
- 22 Employee Benefits: Retirement Plans 464
- 23 Social Insurance 486

PART SIX

The Insurance Industry 518

- 24** Types of Insurers and Marketing Systems 520
- 25** Insurance Company Operations 536
- 26** Insurance Pricing 559
- 27** Government Regulation of Insurance 579

APPENDIX A

The Law of Large Numbers and Some Elementary Statistical Concepts in Risk and Insurance A-1

APPENDIX B

Homeowners 3 (Special Form) B-1

APPENDIX C

Personal Auto Policy C-1

APPENDIX D

Whole Life Policy D-1

APPENDIX E

Universal Life Policy E-1

Glossary G-1

Index I-1

Detailed Contents

Preface xvii

PART ONE

Basic Concepts in Risk Management and Insurance 2

CHAPTER 1 Nature and Treatment of Risk 4

What Is Risk? 5
Chance of Loss 6
Peril and Hazard 7
Basic Categories of Risk 8
Types of Pure Risk 10
Burden of Risk on Society 13
Methods of Handling Risk 14

Case Application 18

*Insight 1.1: Federal Flood Insurance Covers Few
Midwest Losses 9*

*Insight 1.2: What Your Mother Didn't Tell You
About the Automobile Liability Risk 13*

CHAPTER 2 Insurance and Risk 20

Definition of Insurance 21
Basic Characteristics of Insurance 21

Requirements of an Insurable Risk 23
Two Applications: The Risks of Fire and
Unemployment 25
Adverse Selection and Insurance 25
Insurance and Gambling Compared 26
Insurance and Speculation Compared 26
Types of Insurance 27
Benefits of Insurance to Society 29
Costs of Insurance to Society 32

Case Application 35

*Insight 2.1: Social Investments of Life and Health
Insurers 31*

Insight 2.2: Faked Auto Accidents Claim Billions 33

CHAPTER 3 Risk Management 37

Risk Management 38
The Risk Management Process 39
Identifying Potential Losses 39
Evaluating Potential Losses 41
Selecting the Appropriate Technique for Treating
Loss Exposures 41
Implementing the Risk Management Program 49

Case Application 53

*Insight 3.1: Greater Global Role Seen for Risk
Managers 40*

*Insight 3.2: What's Required to Set Up a Captive
Insurer? 43*

*Insight 3.3: The Self-Insurance Solution to the
Workers Compensation Crisis 45*

*Insight 3.4: Risk Management Effect on Profit
Called 5 Percent 50*

PART TWO

Legal Principles in Risk and Insurance 56

CHAPTER 4 Fundamental Legal Principles 58

Principle of Indemnity 59
Principle of Insurable Interest 61
Principle of Subrogation 63
Purposes of Subrogation 64
Principle of Utmost Good Faith 66
Requirements of an Insurance Contract 68
Distinct Legal Characteristics of Insurance
Contracts 69
Law and the Insurance Agent 71

Case Application 74

*Insight 4.1: No Insurable Interest at Time of Death:
Can the Beneficiary Collect on a Life Insurance
Policy? 63*
*Insight 4.2: Subrogation: When the Other Guy
Won't Pay 65*
*Insight 4.3: Misrepresentation of Material Facts
Allows Insurer to Deny Liability 67*

CHAPTER 5 Analysis of Insurance Contracts 77

Basic Parts of an Insurance Contract 78
Definition of the Insured 81
Endorsements and Riders 81
Deductibles 83
Coinsurance 85
Other-Insurance Provisions 87

Case Application 91

*Insight 5.1: Are You Insured When You Drive
Another Person's Car? 82*

PART THREE

Personal Property and Liability Risks 94

CHAPTER 6 The Liability Risk 96

Basis of Legal Liability 97
Law of Negligence 98
Imputed Negligence 100
Res Ipsa Loquitur 100
Specific Applications of the Law of Negligence 100
Special Tort Liability Problems 103
Reforming the Civil Justice System 109

Case Application 114

*Insight 6.1: Idea of No-Fault in Medical Cases
Gains Support 106*
*Insight 6.2: Personal Injury Lawsuits by Students
Are Endangering University Budgets 108*
*Insight 6.3: Stockholders File Majority of Directors
and Officers Liability Suits 110*
*Insight 6.4: Increased Costs of Litigation Are Crippling
American Firms in the Global Markets 111*

CHAPTER 7 Homeowners Insurance, Section I 116

Package Policy 117
1991 Homeowners Program 117
Analysis of Homeowners 3 Policy (Special Form) 119
Section I Coverages 122
Section I Perils Insured Against 127
Section I Exclusions 130
Section I Conditions 132
Section I and II Conditions 135
Section I Endorsements 137

Case Application 140

*Insight 7.1: Renters Also Need Homeowners
Insurance 119*
*Insight 7.2: An Inventory of Your Property Is Highly
Advisable 133*

Insight 7.3: Property Owners Need to Consider the Big Gap Between Replacement Cost and Actual Cash Value 138

CHAPTER 8

Homeowners Insurance, Section II 143

Personal Liability Insurance 144
 Section II Exclusions 146
 Section II Additional Coverages 151
 Endorsements to Section II Coverages 152
 Shopping for Homeowners Insurance 153

Case Application 158

Insight 8.1: Are You Insured If You Run a Business Out of Your Home? 148

Insight 8.2: How to Cut Your Homeowners Premium 157

APPENDIX: Worksheet: How Much Coverage Do You Need? 160

CHAPTER 9

Other Personal Property and Liability Insurance Coverages 164

Dwelling 89 Insurance Program 165
 Mobile-Home Insurance 166
 Inland Marine Floaters 166
 Insurance on Pleasure Boats 168
 Federal Property Insurance Programs 169
 Title Insurance 174
 Personal Umbrella Policy 176

Case Application 180

Insight 9.1: Federal Flood Insurance Out of Funds 171

Insight 9.2: In California, Insurance Policies Burn Taxpayers 172

Insight 9.3: Tips on Title Insurance 175

Insight 9.4: Examples of Personal Liability Claims 178

CHAPTER 10

Automobile Insurance 183

Overview of Personal Auto Policy 184
 Part A: Liability Coverage 184

Part B: Medical Payments Coverage 189
 Part C: Uninsured Motorists Coverage 191
 Part D: Coverage for Damage to Your Auto 193
 Part E: Duties After an Accident or Loss 201
 Part F: General Provisions 202
 Insuring Motorcycles and Other Vehicles 204

Case Application 206

Insight 10.1: Rented a Car Lately? Then You've Been Trapped in the Liability and Collision Maze 195

Insight 10.2: Carjacking—A New Violent Risk for Motorists 197

Insight 10.3: When the Insurer Totals Your Car 200

Insight 10.4: Can I Be Canceled? 203

CHAPTER 11

Automobile Insurance and Society 208

Approaches for Compensating Automobile Accident Victims 209
 Automobile Insurance for High-Risk Drivers 217
 Cost of Automobile Insurance 219
 Shopping for Automobile Insurance 221

Case Application 228

Insight 11.1: Protecting Yourself from the Other Guy 213

Insight 11.2: Why Did My Rates Go Up after an Accident? 222

Insight 11.3: No Quick Fix for the Auto-Insurance Mess 223

Insight 11.4: Insurance Shopper's Worksheet 225

PART FOUR

Commercial Property and Liability Risks 230

CHAPTER 12

Commercial Property Insurance 232

Overview of Commercial Package Policy 233
 Building and Personal Property Coverage Form 235