LIFE MANAGEMENT INSTITUTE **LOMA**

PRINCIPLES OF LIFE AND HEALTH INSURANCE

GENE A. MORTON

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FLMI Insurance Education Program
Life Management Institute LOMA

LOMA is an international association founded in 1924. Through education, training, research, and information-sharing, LOMA is dedicated to promoting management excellence in leading life and health insurance companies and other financial institutions. LOMA conducts research on various company operations, including financial planning, human resources, and information management. Among its activities is the sponsorship of the FLMI Insurance Education Program, an educational program intended primarily for home office and branch office employees.

The FLMI Insurance Education Program is comprised of two levels—Level I, "Fundamentals of Life and Health Insurance," and Level II, " Functional Aspects of Life and Health Insurance." Level I is designed to help students achieve a working knowledge of the life and health insurance business. Level II is intended to further the student's career development by providing a more detailed understanding of life and health insurance and related business and management subjects. Upon the completion of Level I, the student is awarded a Certificate. Upon the completion of both levels, the student is designated a Fellow of the Life Management Institute (FLMI) and is awarded a diploma.

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Preface

This text is designed to give the reader a full understanding of the basic principles underlying the life and health insurance industry and to describe the insurance industry's most widely marketed products. Although the book has been written for students taking the introductory course in LOMA's FLMI Insurance Education Program, it is well suited for any learning situation in which there is a need for a base of knowledge in the fundamentals of life and health insurance. A student guide and an instructor's manual have been developed to accompany the book.

Because this book will serve as an introduction to the subject of insurance for many of its readers, jargon and technical language have been kept to a minimum. Each important term (indicated in boldface type) is defined and/or explained in nontechnical language when it is introduced; further, the text contains a comprehensive glossary of insurance terms. For the reader who does not have access to insurance forms, the appendix contains a sample life insurance policy and application blank, and examples of other insurance forms are included within the text.

Industry statistics are cited throughout the text primarily to give the reader a "feel" for the size and the economic impact of the insurance industry in the United States and Canada, as well as to indicate evolving patterns and trends within the industry. Unless otherwise noted, those statistics which are given in the text and accompanying figures have been taken from the 1983 *Life Insurance Fact Book* (a publication of the American Council of Life Insurance) and the 1983 edition of *Canadian Life Insurance Facts* (a publication of the Canadian Life and Health Insurance Association).

In developing *Principles of Life and Health Insurance*, I have drawn on the knowledge and experience of many people. I am especially indebted to the following members of the Life Management Institute's Curriculum

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Gene A. Morton

Contents

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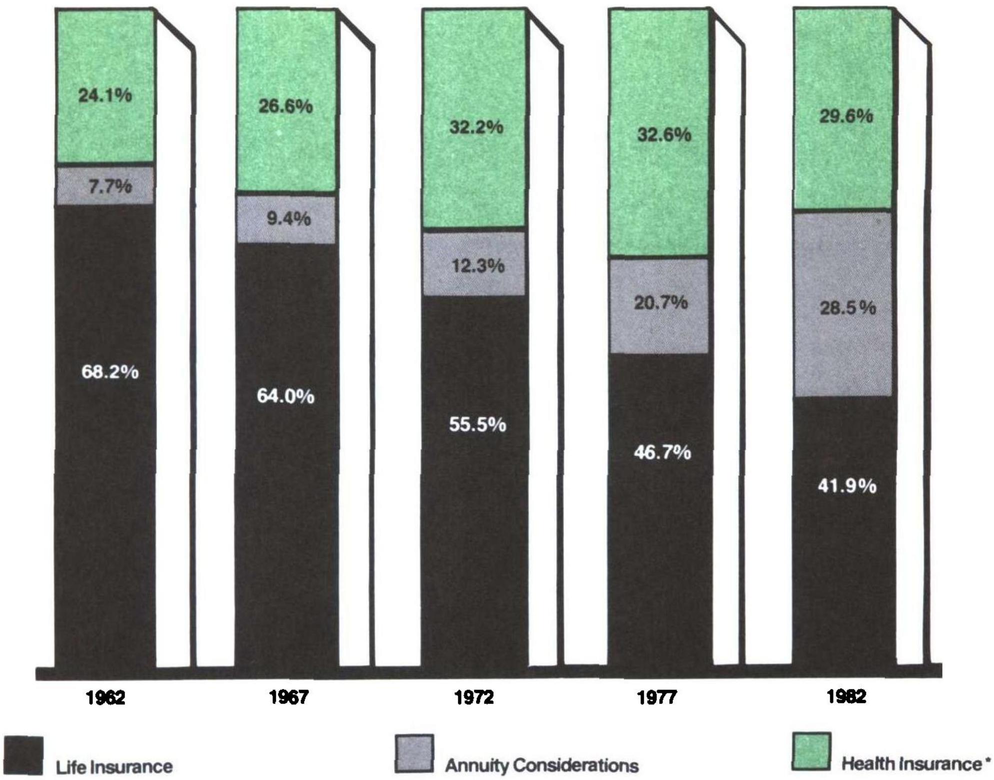
Insurance and the Insurance Industry

In terms of its age, the modern life insurance business is an infant when compared to many other industries. In terms of its size, however, the industry is among the world's largest. Life insurance products were not widely offered until the 1800s, and health insurance products were not available generally until the early part of this century. Yet, through time, the amount of life insurance in force in the United States and Canada has grown to over $5 trillion, and health insurance products cover most of the people in both countries.

The primary reason for this tremendous growth lies in the nature and purpose of insurance products. All insurance provides protection against some of the economic consequences of loss. Thus, insurance responds to the need of all persons for security. The insurance industry designs, revises, alters, and updates its insurance policies constantly to meet this need. However, despite these changes, the underlying purpose of these policies remains the same: providing economic protection against financial loss.

Essentially, an insurance policy is a contract – a legally enforceable agreement – under which the insurance company agrees to pay a certain amount of money, called the policy benefit, when specific losses occur, provided the insurer receives a specified amount of money, called the premium. In this way, the risk, or chance, of economic loss is transferred to the insurance company. This text will be concerned primarily with the kinds of insurance which provide protection from the economic losses resulting from death, disability (because of accident or sickness), and old age. These kinds of insurance are, respectively, life insurance, health insurance, and annuities, and they may be designed to cover individuals or members of groups. Figure 1-1 illustrates the percentage of life insurance companies' business attributable to each of these kinds of insurance.

FIGURE 1-1
Distribution of premium income of United States life insurance companies



*Includes some premiums for Workers' Compensation and some premiums for auto and other liability insurance.

Life insurance provides a specified sum of money if the person who is insured dies while the policy is in effect. ***Health insurance*** pays specified benefits if the person who is insured becomes sick or has an accident. Health insurance can take two forms, medical expense coverage and disability income coverage. Medical expense coverage provides for payment of hospital, surgical, and doctor bills and related medical expenses to the extent specified in the policy. Disability income coverage provides for payment of a specified income benefit while the person who is insured is unable to work because of disability. An ***annuity*** provides a series of benefit payments for either a specified period or for the lifetime of the person receiving the benefit.

Although this text will concentrate on life insurance, health insurance, and annuities, these are not the only kinds of insurance available. Property and liability insurance are two other major kinds of insurance. ***Property insurance*** provides a benefit should covered property be damaged or lost because of fire, theft, accident, or other cause described in the policy. ***Liability insurance*** provides a benefit payable on behalf of a covered party who is held legally responsible (liable) for harming others or their property. Both property and liability policies place limits on the amount of the benefit that the company will pay.

Automobile insurance policies often include both property and liability coverage. Suppose, for example, that you are driving a car which is covered by an automobile policy and you accidentally crash through your neighbor's front door. The damage to your neighbor's home will be paid by your policy's liability coverage; the money to repair your car will come from your policy's property coverage. This example, of course, does not cover all the types of property and liability insurance on the market today, but it provides instead an indication of the nature of such coverage.

LOSS AND THE BASIC PRINCIPLES OF INSURANCE

All insurance products are designed according to certain basic principles which apply to the concept of economic loss. In order for a potential loss situation to be considered insurable, it must have certain characteristics:

1. The loss must occur by *chance.*
2. The loss must be *definite.*
3. The loss must be *significant.*
4. The *rate* of loss must be *predictable.*
5. The loss must *not* be *catastrophic* to the insurer.

These five basic principles form the foundation for the business of insurance, much as the rules of physics form the foundation for airplane design. A *potential* loss which does not have these characteristics generally is not considered an *insurable* loss unless the lack of one or more characteristics can be compensated for in some way.

The Loss Must Occur by Chance

In order for any potential loss to be insurable, the element of chance must be present. The loss should be caused by either an unexpected event or by an event which is not intentionally caused by the person covered by the insurance. For example, people cannot generally control whether they will become disabled and unable to work because of accident or sickness; hence, insurance companies can offer disability income policies to provide economic protection against financial losses caused by such chance events. When this principle of loss is applied in its strictest sense to life insurance, an apparent problem arises: death is *certain* to occur. However, the *timing* of an individual's death is normally out of the control of the individual.

Therefore, although the event being insured – death – is a certain event rather than a chance event, the timing of that event usually does occur by chance.

The Loss Must Be Definite

An insurable loss must be definite in terms of *time* and *amount*. An insurer must be able to determine *when* to pay a benefit and *how much* the benefit should be. Death, disability, and old age are generally identifiable conditions. The amount of economic loss resulting from these conditions can, however, be subject to interpretation.

Insurers use two types of contracts to define the amount of the benefit that will be due – *valued contracts* and *contracts of indemnity*. A ***valued contract*** is one in which the amount of the benefit is set in advance. In life insurance, the amount of the death benefit is specified in the policy. For example, if a woman buys a $50,000 insurance policy on her life, the $50,000 death benefit is listed in the policy. The amount of this stated benefit is called the ***face amount*** or ***face value*** of the policy because this amount is generally listed on the face, or first, page of a life insurance policy.

A ***contract of indemnity*** is one in which the amount of the benefit is based on the actual amount of financial loss as determined at the time of loss. The contract states that the amount of the benefit is equal to the amount of the financial loss or the maximum amount stated in the policy, whichever is *less*. Hence, the policyowner cannot submit a ***claim*** – that is, a request for payment under the terms of the policy – for an amount which is higher than the actual amount of the financial loss.

Many hospital expense policies pay a benefit based on the actual cost of an individual's hospitalization and, as such, are contracts of indemnity. For example, if a man buys a hospital expense policy, the policy will state the maximum amount payable to cover his expenses while he is hospitalized. If his actual expenses while he is hospitalized are less than that maximum amount, the insurance company will not pay him the stated maximum; instead, the insurance company will pay him a sum based on the actual amount of his hospital bill.

The Loss Must Be Significant

People lose things with frustrating regularity. Pens, umbrellas, and sunglasses are all too often not where we know we left them. Such losses are not apt to be very significant financially. Replacing a pen does not cause financial hardship to most people. These types of losses are *not* normally insured; the administrative expense of paying benefits when such a small loss occurs would drive the cost for such insurance protection so high in relation to the amount of the potential loss that most people would find the protection uneconomical.

On the other hand, some types of losses would cause financial hardship to most people. For example, if an employed person were to be injured in an accident which resulted in that person's being unable to work for a year, the resulting income loss would be significant. Hence, this type of loss is insurable.

The Rate of Loss Must Be Predictable

To provide a benefit in case of a specific loss, an insurer must be able to predict the probable rate of loss, or loss rate. The ***loss rate*** is the number and timing of losses that will occur in a given group of insureds while the coverage is in force. An insurer must be able to predict this loss rate in order to determine the proper premium amount to charge each policyowner to ensure that adequate funds are on hand to pay claims as they become due.

However, from an individual's viewpoint, losses which may be suffered are not predictable; through the ages, people have tried crystal balls, tarot cards, and tea leaves in an attempt to predict an individual's future. Neither an individual nor an insurance company can determine in advance when a *specific person* will die, become disabled, or need hospitalization. However, it is possible to predict with a high degree of accuracy the number of people in a *given large group* who will die or become disabled or need hospitalization during a given period of time.

These predictions of future losses are based on the concept that events which *seem* to occur at random *actually* follow a pattern. When the pattern is identified through observation of the past, the likelihood that a given event will occur, called the ***probability*** of the event, can be determined.

An important concept in determining this probability is the ***law of large numbers***. According to the law of large numbers, the larger the number of observations made of a particular event, the more likely it will be that the observed results produce an estimate of the "true" probability of the event's occurring. For example, if you toss an ordinary coin, there is a 50-50 probability that it will land with the heads side up; this is a calculable probability. Two or even a dozen tosses might not give the result of an equal number of heads and tails. If you tossed the coin 1,000 times, though, you could expect a count of approximately 500 heads and 500 tails to occur. The more often you toss the coin, the closer you will come to observing an equal number of heads and tails, and the closer your findings will be to the "true" probability.

The law of large numbers is applied to insurance company predictions of probable future losses. An insurance company collects specific information about a large number of people so that the insurance company can