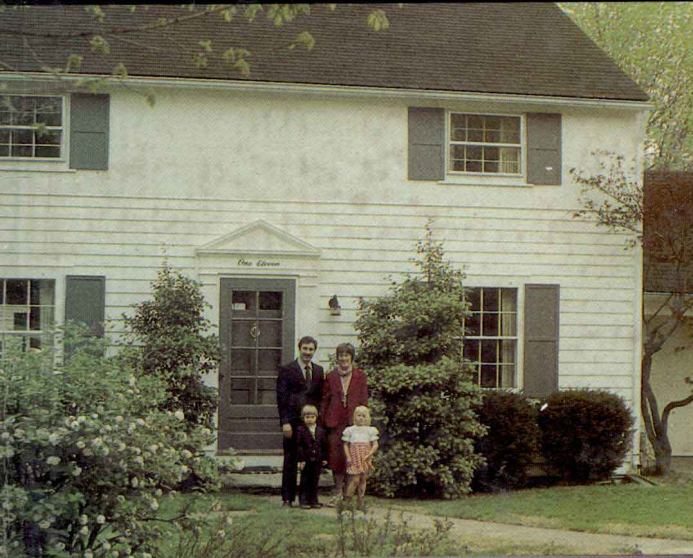


second edition

Introduction to INSURANCE



MARK S. DOREMAN

second edition

INTRODUCTION TO INSURANCE

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Preface

THE COVER

The author of an introductory insurance text faces several initial problems in beginning a book. How does one define one's subject without using jargon and definitions unfamiliar to the reader? How can one create a picture representing the "essence of insurance" when insurance is an intangible, nearly invisible, product and service. My solution to these problems appears on the cover. Each of the four pictures represents a different aspect of our modern, industrial society. While there are no pictures of insurance policies or insurance companies, all the pictures represent activities made possible to some extent because numerous different insurance transactions have been made.

For example, the family in front of the house owns three different life insurance policies. One of the policies will be used to repay the mortgage in the event of the premature death of the father. A second policy will provide income to maintain the family in the event of the father's death. A third policy will provide the family with income in the event of the mother's premature death. In addition to these life insurance policies, the father's employer provides a group life insurance policy on the father's life and group health insurance policy covering all the family members. Moreover, the employer will provide a pension for the

family when the father retires. The pension benefit is really an insurance policy called an “annuity.” The mother, who worked several years before the son and daughter were born, will be entitled to receive social security retirement benefits. Social security is a form of insurance called “social insurance” since it is provided by the government. The house in the picture is mortgaged, and both the savings and loan association’s and the family’s interest are insured by a homeowners’ insurance policy. This family owns several other insurance policies, including automobile insurance, but the importance of insurance in providing for the family’s well-being and financial security should already be clear.

The next time you go to a shopping mall, remember that if it were not for insurance, the shopping mall would not be there. Before the mall was built, it was a construction site. Before beginning work, the contractors and subcontractors probably had to post a surety bond, a form of insurance transaction. In addition the contractor needed general liability insurance in case somebody was injured by an employee’s negligence. Workers’ compensation insurance was needed in case any of the contractor’s employees were injured while at work. Property insurance was needed to protect all the property, equipment, and construction materials at the construction site. Life insurance might have been used to allow the partners in the construction firm to continue the business if one of the partners died. And the architect that designed the project probably was insured against lawsuits claiming damages to others due to his errors and omissions in the mall’s design.

Today, with the mall completed, occupied by merchants, and used daily by thousands of shoppers, insurance is vital. The owners of the mall will be insured against loss of the mall from such perils as fire, vandalism, and smoke damage. The merchants will have their inventory insured while it is in the store and, perhaps, while it is in transit to their store and, perhaps again, while it is being delivered to their customers. The merchants also may insure their profits in the event that their business is interrupted by fire or some other peril. Liability insurance to provide protection in the event a customer is injured due to a merchant’s negligence is a practical necessity. Numerous other examples of insurance allowing the mall to be developed and to operate could be set forth. By now I hope you can see that insurance is the nearly invisible transaction that is essential to a shopping mall’s construction and operation.

The picture of Mt. St. Helens is included as a symbolic reminder, not that human beings are at the “mercy of the elements” but, rather, that insurance allows people to cope intelligently with the destructive forces found on this planet. As a matter of fact, volcanic damage, as is true of earthquake and flood damage, is not generally covered by privately operated insurance plans. The reasons for this lack of coverage in the private marketplace are set forth in Chapter Two. On the other hand, not many of the natural disruptive forces are of the scope of Mt. St. Helens. Thus, the damage done by tornados, lightning, and snow and ice storms, which regularly destroy property, take lives, and cause injuries, are regularly prevented from causing the economic destruction of the victims who own insurance. This remarkable transaction—insurance—allows our society and its members to maintain economic order despite the Earth’s disorder.

The fourth picture on the cover is a steel mill. I’m most grateful to Armco, Inc., for providing this picture and allowing me to use it on the cover. It represents the idea that, for a business to make steel (or any other manufactured or processed good), to deliver a service, or to provide jobs, insurance is necessary. The focus of this text is on personal insurance

purchased by individual consumers; it is not on business, or “commercial,” insurance. Nevertheless, the subject of business uses of insurance, as we related in our discussion of the shopping mall, is not unrelated to our individual lives. Moreover, many of the readers of this text may well pursue careers related to the field of business insurance.

WHY STUDY INSURANCE?

On occasion I have asked my students why they have elected to study the subject of insurance. Typical answers have been “I know that I’m going to have to buy insurance some day, so I thought I’d learn about it.” “My friend told me to take the course because she liked it.” “I’m planning on going into the insurance business, so I thought I’d learn about it in school.” “I’m a business major, and I think that all businesspeople should know about insurance.” These are all good reasons for studying insurance. After taking an introductory insurance course, a student should have an understanding of how insurance helps us to solve some of our personal financial problems. One purpose of this book is to introduce some basic insurance concepts from the consumer’s viewpoint and thus promote intelligent, informed purchases of insurance.

Not only does the purchase of insurance enable an individual to solve some personal financial problems, but the operation of insurance systems enables society to solve some of its financial problems as well. A second purpose of this book is to examine some very important national questions that relate to insurance. The following list of current topics, all questions of national concern, relate to the subject of insurance:

1. Is the social security system bankrupt?
2. Is arson increasing beyond tolerable levels?
3. Can professional liability insurance, particularly medical malpractice insurance, be privately insured, or should the government provide this coverage?
4. Should we have a national system of no-fault automobile insurance?
5. What should consumers be told about the cost of their life insurance?

It is not the purpose of this book to provide answers to these important and complex issues. Rather, its purpose is to provide students with some background information so that they can see the questions more clearly and thus form their own conclusions as to what the best answers are. Many speeches have been given and many articles have been written on each of the topics listed. Proponents and opponents of various positions on each of the issues have made charges and countercharges. Perhaps if speakers and writers knew that their audiences understood the questions clearly, self-serving arguments camouflaged by strained logic and sophistry would give place to more direct and honest discussion. Because insurance questions tend to be complex, speakers in some instances have subjected the public to the mushroom treatment—to keep them in the dark. It is the author’s hope that study of this text will let in some light.

This book presents the terminology and basic principles of insurance clearly, correctly, and simply. Examples and figures are used frequently to illustrate points. Readers will learn the meanings of many new words such as “risk,” “suretyship,” “coinsurance,” and

“subrogation.” They will also learn about three forms of insurance protection widely purchased in America: homeowners’ insurance, automobile insurance, and life insurance.

Students who have completed my insurance course have generally described it as useful, interesting, and important; it is my hope that readers will make the same general statement about this book.

ACKNOWLEDGMENTS

I treasure my friends as among my greatest joys. As I have completed the revision of this text, I have had the assistance and friendship of many people. I am truly grateful to them and wish to acknowledge their help and support.

As was the case with the first edition, my dear wife, Marcia, proofread every page of the manuscript and made numerous valuable suggestions. Her support, enthusiasm, and calm disposition have been invaluable.

My friend Ron Kettler, professor of English at Miami University, again lent his considerable talent and skill in improving my prose. My friend Joseph Waggener, professor of Educational Media at Miami, assisted with the cover photography.

Four reviewers read the majority of the manuscript and provided valuable comments, suggestions, and criticisms. My close friend and colleague, Saul W. Adelman, not only reviewed the manuscript but provided several useful ideas for illustrations and examples. Other reviewers, whose comments and suggestions can be found throughout the text include (in alphabetical order) James Chastain (Howard University), William Feldhaus (Georgia State University), and James Muck (Milwaukee Institute of Technology).

Several reviewers focused their attention and expertise on specific areas. Robert J. Myers, former chief actuary of the Social Security System and author of a comprehensive textbook on the subject, provided a carefully detailed review of the chapter on social security. Fikry Gahin (University of Utah) carefully reviewed the presentation of some of the basic terminology in Chapter One. My colleague Wayne Staton reviewed much of the material relating to the legal aspects of insurance. Two reviewers from the Insurance Services Office provided useful notes and clarifications on the chapters relating to homeowners’ insurance and automobile insurance. I would also like to acknowledge the cooperation of the Insurance Services Office.

My students at Miami University provided a fertile harvest of ideas, directly by their comments and criticism and indirectly by their challenging questions. Two graduate research assistants, Donald F. Sarb and Mark A. Jackson, provided careful help with some bibliographic chores. Tracy Sollenberger and Mary Bibyk toiled diligently in helping me type the manuscript, as did the energetic Joan McLaughlin. In addition I wish to acknowledge the help of Vickie Nichol.

Numerous contributions made to the first edition of this work by friends, colleagues, and critics remain in this edition, and I again acknowledge these efforts, with much gratitude.

I've written this book for students, and I've been delighted at the favorable feedback the first edition of this text produced. As I complete this Preface, and launch the second edition on its educational mission, I look forward to receiving additional comments.

Mark S. Dorfman

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INSURANCE AND THE MANAGEMENT OF RISK

The first three chapters of this text are designed to introduce the reader to one of the most interesting and important financial transactions made in our society: the insurance transaction. The insurance transaction is one that most people make frequently, yet it is one that most consumers do not understand well. What explains this general lack of understanding of such an important aspect of our financial lives? Frequently, it is because people do not understand the language of insurance. Chapter One defines and illustrates such words as "peril" and "loss," words usually found in insurance policies. Although they are commonly used, such words have precise meanings that are known to insurance professionals but are often misunderstood by consumers.

Chapter Two presents the general principles underlying the operation of all private insurance systems. These principles explain how insurance systems operate in general.

"Risk management" is a broader term than "insurance." Risk management implies an organized approach to solving the financial problems posed by potential losses. Insurance is only one of several ways of dealing with such problems. Chapter Three presents a description of the risk management method of problem solving.

The principles and terminology set forth in Part One comprise the foundation of the study of insurance. Much of the material that follows builds on the ideas contained here. Thus it is important to read carefully and understand thoroughly these first chapters to establish a solid basis for the rest of the book.