



Fundamentals of

RISK AND

INSURANCE

EMMETT J. VAUGHAN

THERESE VAUGHAN

FUNDAMENTALS OF RISK AND INSURANCE

NINTH EDITION

EMMETT J. VAUGHAN
THERESE M. VAUGHAN



JOHN WILEY & SONS, INC.

Acquisitions Editor	Leslie Kraham
Marketing Manager	Charity Robey
Senior Production Editor	Patricia McFadden
Design Director	Madelyn Lesure
Production Management	Hermitage Publishing Services
Cover Photo	Kurt C. Vanderhoef

This book was set in 10/12 Times Ten Roman by Hermitage Publishing Services and printed and bound by R. R. Donnelley and Sons. The cover was printed by Lehigh Press.

This book is printed on acid-free paper (∞).

Copyright © 2003 John Wiley & Sons, Inc. All rights reserved.

No part of this publication may be reproduced, stored in a retrieval system or transmitted in any form or by any means, electronic, mechanical, photocopying, recording, scanning or otherwise, except as permitted under Sections 107 or 108 of the 1976 United States Copyright Act, without either the prior written permission of the Publisher, or authorization through payment of the appropriate per-copy fee to the Copyright Clearance Center, 222 Rosewood Drive, Danvers, MA 01923, (978) 750-8400, fax (978) 750-4470. Requests to the Publisher for permission should be addressed to the Permissions Department, John Wiley & Sons, Inc., 605 Third Avenue, New York, NY 10158-0012, (212) 850-6011, fax (212) 850-6008, E-Mail: PERMREQ@WILEY.COM. To order books, please call 1(800) 225-5945.

Includes copyrighted material used with permission of the Insurance Services Office.

ISBN 0-471-21687-9

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

ABOUT THE AUTHORS

Emmett J. Vaughan holds the Partington Professorship in Insurance at the University of Iowa, where he is Partington Professor of Insurance. Professor Vaughan received his undergraduate degree in economics from Creighton University and his M.A. and Ph.D. in economics and insurance from the University of Nebraska.

Therese M. Vaughan is currently Commissioner of Insurance for the State of Iowa. Commissioner Vaughan received her undergraduate degree in economics and insurance from the University of Iowa and her Ph.D. in insurance from the Wharton School of Business.

PREFACE

This ninth edition of *Fundamentals of Risk and Insurance* marks the thirtieth anniversary of the first edition, published in 1972. At the time the first edition was published, the field of insurance was quite different from what it is today. Many of the current forms of insurance coverage did not exist; the world seemed a simpler place. Medicare was not yet ten years old, and Richard Nixon was president of the United States. Automobile no-fault was an experiment that had been adopted by a single state (Massachusetts) and only three states had compulsory automobile insurance (New York, North Carolina, and Massachusetts). The 1943 Standard Fire Policy was the standard form of coverage for most commercial entities and the Family Auto Policy was the standard for personal automobile insurance. Universal life insurance was not yet on the drawing board and endowment policies were a staple for the life insurance agent. There was no such thing as long-term care insurance, no individual retirement accounts, and ERISA was not yet a gleam in a Congressperson's eye. The Social Security tax base was \$9000 and the Medicare Part B premium was \$5.60 a month.

The world has changed dramatically since 1972, and the field of insurance has changed with it. As insurance has changed, so too has *Fundamentals of Risk and Insurance*. A new co-author has been added and, regretfully, the book has lengthened. (The two are not related, although there is a temptation to plead that two authors have twice as much to say.) Although our editors have urged, with every edition, that we attempt to avoid expanding the book, there is, quite honestly, more to say in 2002 than there was in 1972. The book has grown in length from the modest 24 chapters in the first edition to 34 in this edition.

Although the book has changed over the years, its purpose, organization, and approach remain essen-

tially the same. The original goal was to create a consumer-oriented text, and we have maintained this orientation in the present edition. The first edition of this book was written in response to a perceived need for an insurance textbook that addressed the principles of risk management without abandoning the discussion of insurance. The reception to the book over the past three decades has been gratifying. At least a part of the book's success is due to the fascinating subject matter it deals with. Experience indicated that insurance can be an exciting subject. University surveys repeatedly show that insurance courses usually score near the top in enrollment popularity, and students often rank the insurance courses they have taken as the most useful ones in college. This comes as no surprise to those of us who find this field so fascinating. It is satisfying, however, to find that our excitement can be shared by our students.

SCOPE OF THE SUBJECT

As a point of departure, it may be helpful to describe briefly exactly what the book is all about. As the title indicates, the ninth edition of *Fundamentals of Risk and Insurance* is about *risk* and about *insurance*. Its objective is to summarize the pervasive nature of pure risk on the individual and on society, and to illustrate the way in which insurance can be used to deal with the problems posed by such risk. It is a book on insurance theory as well as on how students can use insurance personally.

The intent from the beginning has been to create a text that is consumer oriented. The main emphasis is on the insurance product and the use of insurance within the risk management framework. The traditional fields of life insurance, health insurance,

property and liability insurance, and social insurance are treated in terms of their relationship to the wide range of insurable risks to which the individual and the business firm are exposed.

The text is designed for use in a college-level survey of the area of risk and insurance. As an introduction to the subject, it is intended for students who have had little or no prior education in insurance. It may serve as the basis for more advanced texts for those students who intend to specialize in the field of insurance, and at the same time it constitutes a compendium of what an informed citizen and consumer should know about the subject.

WHY STUDY INSURANCE?

The reasons for studying insurance are varied. For some, the study is undertaken in preparation for a career in the field. Others study to improve their knowledge of the subject to become more knowledgeable consumers. The average individual will spend a significant percentage of his or her disposable income on insurance over a lifetime, and one of the logical reasons for studying insurance is to learn how it can be used in personal financial planning. Still others study insurance as a part of the discipline of risk management, the managerial function that aims at preserving the operating effectiveness of the organization.

Although each of these reasons is adequate justification for the study of insurance, whether that study should be considered *essential* for business students depends on the approach and the specifics of what is studied. Some have argued that the study of insurance per se is a narrow specialty, yet the broader discipline of risk management—of which insurance buying is only a part—is clearly a function that all future managers should understand. A proper understanding of the methods of dealing with exposures to loss is essential to organizational leaders. Although insurance is only one of the techniques that can be used to deal with pure risks, risk management decisions presuppose a thorough understanding of the nature and functions of insurance.

We believe that insurance and risk management is a subject that needs to be taught in colleges and universities. Far from being the narrow specialty it is sometimes characterized as, the study of insurance has a breadth that few disciplines equal. As you progress through the book, you will encounter applications from economics, statistics, finance, accounting, law, decision theory, and ethics.

Because the study of risk management and insurance draws on these different disciplines, it is sometimes considered a subset of one of them. Thus, in many colleges and universities, insurance and risk management are a part of the finance curriculum, reflecting the financial nature of the risk management function. In other schools, it is considered a part of economics, while in still others it is located in another department. This organizational ambiguity reflects the confusion concerning what the study of risk management and insurance entails.

In fact, risk management and insurance is a separate and distinct discipline, which draws on and integrates the knowledge from a variety of other business fields. In a micro sense, it is a discipline in which a variety of methodologies are brought to bear on a significant problem.

Viewed from a macro perspective, the study of insurance addresses a variety of important issues facing society today: the high cost of medical care, crime, the tort system, pollution and the environment, and the broad subject of ethics. Indeed, it is not an exaggeration to say that the debates in the insurance arena address questions of what kind of society we will have and who will pay for what. Debates over the cost of insurance and the way in which insurance prices should be determined have intensified over the past two decades. Increasingly, the debate over insurance availability and affordability have come to center stage as the debate over the cost of automobile insurance, access to health care, responsibility for pollution, product liability, and medical malpractice have become crises. As consumers, we are all dramatically affected by the way in which insurance operates.

Finally, the study of risk management and insurance is a fertile field for considering the subject of ethics in business and in society. Indeed, the ubiquitous presence of ethical problems in the field of insurance transactions raises an important question: is ethics something to be studied and learned, or is it something innate in the individual?

ORGANIZATION OF THE BOOK

This book is divided into three major sections. In the first section, we examine the concept of risk, the nature of the insurance device, and the principles of risk management. This section also provides an overview of the insurance industry and the manner in which it operates.

The second section examines the traditional fields of life and health insurance as solutions to the risks

connected with the loss of income. The Social Security system, workers' compensation, and other social insurance coverages are discussed in this section to permit students to integrate the coverage under these programs in planning income protection.

The final section deals with the risks associated with the ownership of property and legal liability. The coverages applicable to the individual or family are treated in chapters that are separate from those designed for the business firm, permitting those instructors who prefer to concentrate on insurance for the individual to give only slight treatment to commercial coverages.

The book is designed to fit a one-semester or two-quarter course, but it may be adapted to longer and shorter sequences. We have composed what we consider to be a logical sequence of subject matter, but the book can be used flexibly. Sections Two and Three in particular may be taken in different order.

CHANGES IN THE NINTH EDITION

The thirty years that have passed since the publication of the first edition of *Fundamentals of Risk and Insurance* have been marked by significant change in the field of insurance. The second through the eighth editions are a chronology of that change. As the field of insurance and the environment in which it operates continue to change, our purpose has been to capture the flavor of that change in each revision. Changes in the legal environment, revisions in policy forms and the introduction of new types of insurance, and a myriad of new problems continue to make insurance an exciting field of study, but a challenge to the authors of textbooks.

One recent development that helps to mitigate the problems posed by the constantly changing nature of the insurance field is the increase in the resources available on the Internet. In the eighth edition we added Web site listings at the end of each chapter. In this edition, we have continued and expanded references to insurance-oriented Web sites. Most students will not need to be told about the significant impact that the Internet and World Wide Web have had on education. There are numerous insurance-related Web sites and the number continues to grow. These Web sites can be a valuable source of information on the changes that continue to occur in both government-sponsored programs and in the insurance industry. Although the authors have visited each of the sites listed, Web sites tend to come and go and the URLs

may change over time. Despite these impediments, the Web sites listed at the end of each chapter are a useful point of departure for exploring this valuable resource.

In the first through the sixth editions, we included sample policy forms as appendixes, bound with the text. As policy forms have grown in length (with larger type and simplified language), the number of pages devoted to sample policy forms increased, compounding the length problem. In the seventh and eighth editions, the policy forms that were printed in the bound volume in the first six editions were printed in a separate booklet. A number of users had suggested the separate booklet for policy forms, but the response from most users persuaded us that this was an unsatisfactory arrangement. In this edition, we are providing the sample policy forms on a CD, in an Acrobat format. We hope that this will prove to be a convenient arrangement for the students and for those instructors who prefer that students have policy forms in hand during the discussion.

CHANGES IN ORGANIZATION

The major changes in organization and presentation of the material are in Section I. We have divided the chapter on risk management from the first eight editions into two chapters. This allowed for a modest increase in the material on risk management, and also resolved a thirty-year dilemma about the order of the chapters that introduce risk management and insurance. In the first through eighth editions, we chose to introduce the concept of insurance first, and then risk management, on the premise that understanding something about the way that insurance works made it somewhat easier to understand the significance of risk management. With the separation of the material on risk management into two chapters, we can introduce the basic concept of risk management, then explain the concept of insurance, and then return to the discussion of risk management to discuss specific applications of the principles. To accommodate the expanded discussion of risk management, we have condensed (slightly) our earlier discussion of the fields of insurance and combined this material with the chapter that introduces the concept of insurance.

CHANGES IN MATERIAL

In addition to the organization changes, other changes update the material to reflect the changes in

the field of insurance since 1999, when the eighth edition was published. Those changes have been both numerous and significant. In 1999, Congress enacted the Financial Services Modernization Act, removing the Depression-era restrictions on the combination of banking and insurance and prompting what will very likely be change in the structure of the insurance industry. The presidential election of 2000 witnessed a more than lively debate over the future of Social Security, with frequent references to a lockbox and what was referred to as the risky scheme of privatization. A new homeowners policy was introduced in the year 2000, along with new commercial property forms, a new commercial crime program, and significant changes in other forms of coverage. In 2001, Congress passed and the president signed the Economic Growth and Tax Relief Reconciliation Act of 2001, with significant changes in the federal estate tax and qualified retirement plans.

ACKNOWLEDGMENTS

We have been supported and encouraged in this revision by many people. First and foremost are the members of our families, all of whom sacrificed much to assist us. We thank them all for their help, but, more important, for their understanding.

As a book progresses through successive editions, the number of persons to whom an author is indebted increases geometrically, since the efforts of so many people become a part of the work. First, we owe much to our teachers, whose influence left an indelible mark on us and on this book. In addition, we owe a debt of gratitude to the many reviewers and users who have helped to shape the book. Although much has been altered as the book moved through successive editions, our debt continues to colleagues and students who provided criticism and suggestions on the earlier editions. As a result, there are many people to whom special thanks are due. They include our colleague, Professor Michael Murray, who has shared his insights with us over the years and whose influence has been significant. The reviewers of the first eight editions, whose contributions to those editions helped to shape this one as well, were Tom Auippa, Richard C. Allgood, Garth H. Allen, Albert L. Auxier, W. Oscar Cooper, Robert W. Cooper, Richard Corbett, Bill Feldhaus, Roger A. Formisano, John W. Haney, Kenneth J. Krepas, E. J. Leverett, Joseph R. Morrin,

Robert J. Myers, John J. O'Connell, Mike Thorne, S. Travis Pritchett, Dede Pahl, Gary K. Stone, and Robert Witt.

In addition, we owe a debt of gratitude to the reviewers of this edition, who offered valuable suggestions that helped to shape the final work. They were Darlene Dicco of Hofstra University, Aaron Lieberman of the University of Central Florida, and Jim Milanese of the Bryan School of Business and Economics.

We owe special thanks to Mandell S. Winter, Jr. and Michael Snowden of the College for Financial Planning, for their assistance in reviewing the seventh, eighth, and ninth editions. Their suggestions and insights helped us to clarify many concepts and to avoid errors that would otherwise have marred the book. Mr. Winter's contributions to the seventh and eighth editions and Mr. Snowden's assistance in this edition went far beyond that of a reviewer and we are grateful for their assistance.

We also offer thanks to all of our former students. Their many comments and intelligent questions contributed to the design of the book and to the examples and illustrations used. Each of the past graduate teaching assistants at the University of Iowa who have shared with the senior author the pleasant task of teaching the basic insurance course at the University of Iowa contributed significantly to the earlier editions and to this one. They are Lois Anderson, Phillip Brooks, Robb Fick, Tim Hamann, Terry Leap, Lacy McNeill, Joseph Panici, Mark Power, Lori Rider, Roger Stech, Ellen Steele, Mike Steele, Patrick Steele, Art Cox, Robert Carney, and Changsu Ouh.

We also thank the users of the first eight editions who took time to write to us with their suggestions and comments.

From the teachers who will use this book as a text, we will be grateful to receive advice concerning any errors that should be corrected and any material that should be added or omitted when it is again revised. To the students who will be compelled to read it, we extend the hope that the material presented will seem as exciting and interesting as it has seemed to us.

*Emmett J. Vaughan
Iowa City, Iowa*

*Therese M. Vaughan
Des Moines, Iowa*

January 2002

CONTENTS

SECTION ONE RISK, INSURANCE, AND RISK MANAGEMENT

Chapter 1 The Problem of Risk I

The Concept of Risk	2
Current Definitions of Risk	2
Our Definition of Risk	2
Uncertainty and Its Relationship to Risk	3
The Degree of Risk	4
Risk Distinguished from Peril and Hazard	5
Classifications of Risk	6
The Burden of Risk	8
The Growing Number and Variety of Pure Risks	8
Increasing Severity of Losses	9
Managing Risk	10

Chapter 2 Introduction to Risk Management 12

The History of Modern Risk Management	13
Risk Management Defined	15
Risk Management Tools	16
Risk Control	16
Risk Financing	17
Risk Management as a Business Function	18
Distinguishing Characteristics of Risk Management	19
Risk Management's Contribution to the Organization	20
The Risk Manager's Job	21
Risk Management and Speculative Risks	21
Misconceptions about Risk Management	22
Universal Applicability	22
Anti-Insurance Bias?	23
Risk Management and the Individual	23
The Risk Management Process	23
Determination of Objectives	23
Identifying Risk Exposures	25
Evaluating Risks	27
Consideration of Alternatives and Selection of the Risk Treatment Device	29

Implementation of the Decision	29
Evaluation and Review	29

Chapter 3 The Insurance Device 33

The Nature and Functions of Insurance	33
Risk Sharing and Risk Transfer	33
Insurance Defined from the Viewpoint of the Individual	34
Risk Reduction through Pooling	34
Insurance Defined from the Viewpoint of Society	39
Insurance: Transfer or Pooling?	40
Insurance and Gambling	40
The Economic Contribution of Insurance	40
Elements of an Insurable Risk	41
Randomness	41
Economic Feasibility	42
Self-Insurance	42
The Fields of Insurance	43
Private (Voluntary) Insurance	43
Social Insurance	46
Public Guarantee Insurance Programs	49
Similarities in the Various Fields of Insurance	51

Chapter 4 Risk Management Applications 53

Risk Management Decisions	54
Utility Theory and Risk Management Decisions	54
Decision Theory and Risk Management Decisions	54
The Rules of Risk Management	56
Risk Characteristics as Determinants of the Tool	58
The Special Case of Risk Reduction	58
Buying Insurance	59
Common Errors in Buying Insurance	59
Need for a Plan	59
Other Considerations in the Choice between Insurance and Retention	60
Selecting the Agent and the Company	61
Alternatives to Commercial Insurance	63
Self-Insurance	63
Captive Insurance Companies	66
Risk Retention Act of 1986	67

Chapter 5 The Private Insurance Industry 71

A Brief History of Private Insurance	72
Insurance in Antiquity	72
Origins of the Modern Insurance Business	72
Insurance in the United States	73
Classification of Private Insurers	74
Classification by Type of Product	74
Classification by Place of Incorporation and Licensing	74
Insurers Classification by Legal Form of Ownership	75
Marketing Systems	80
The Agent	80
Life Insurance Distribution Systems	81
Property and Liability Distribution Systems	82
Insurance Marketing and the World Wide Web	83
Corporate Combinations	83
Banks and Insurance	84
Cooperation in the Insurance Industry	85
Rating Organizations	86
Distressed and Residual-Risk Pools	86
Educational Organizations	87
Insurance Trade Associations	88
Reinsurance Organizations	88
Competition in the Insurance Industry	88
Price Competition	88
Quality Competition	90
Is the Insurance Industry Really Competitive?	90

Chapter 6 Regulation of the Insurance Industry 95

The Why of Government Regulation of Insurance	95
The Why of Regulation Generally	95
Approaches to Government Control of Business	96
Rationale for Regulation of the Insurance Industry	97
Goals of Insurance Regulation	99
A Brief History of Insurance Regulation	99
Regulation Today	101
The Current Regulatory Structure	101
National Association of Insurance Commissioners	102
Areas Regulated	102
Solvency Regulation	102
Market Regulation	105
Regulation of Rates	107
Risk-Retention Groups	110
State versus Federal Regulation	111
Pressure for Repeal of the McCarran-Ferguson Act	111
Arguments Favoring Federal Regulation	111
Arguments Favoring State Regulation	112
Consequences of the Repeal of the McCarran-Ferguson Act	112
Repeal of the McCarran-Ferguson Act as a States-Rights Issue	113
State versus Federal Regulation and Public Choice	113
Appendix: The Availability/Affordability Debate	114
The Essence of the Debate	114
Existing Subsidies in the Insurance Market	114

Income Redistribution Effects of Subsidies in Insurance	118
Causes of Availability Problems	118
Causes of Affordability Problems	119
Availability and Affordability and Public Choice	120

Chapter 7 Functions of Insurers 124

Functions of Insurers	124
Rate making	124
Some Basic Concepts	125
Types of Rates	126
Production	129
Underwriting	129
The Agent's Role in Underwriting	130
Underwriting Policy	130
Process of Underwriting	130
Postselection Underwriting	131
Credit Scoring	132
Loss Adjustment	132
Adjusters	133
Courses of Action in Claim Settlement	133
Adjustment Process	133
Difficulties in Loss Settlement	134
The Investment Function	134
Miscellaneous Functions	135
Legal	135
Accounting	135
Engineering	135
Appendix: Retrospective Rating Plans	136
The Retrospective Formula	136

Chapter 8 Financial Aspects of Insurer Operations 139

Statutory Accounting Requirements	139
Differences between Statutory Accounting and GAAP	140
Terminology	141
The NAIC Codification Project	141
Property and Liability Insurers	142
Concept of Earned Premiums	142
Incurred Losses	143
Expenses Incurred	143
Summary of Operations	143
Life Insurance Companies	145
Life Insurer Assets	145
Life Insurer Liabilities	146
Life Insurers' Policyholders' Surplus	146
Life Insurer Summary of Operations	147
Surplus Drain in Life Insurance	147
Reinsurance	148
Nature of Reinsurance	148
Types of Reinsurance Treaties	148
Reinsurance in Property and Liability Insurance	148
Reinsurance in Life Insurance	149
Functions of Reinsurance	149

The Catastrophe Risk Exchange (CATEX)	150
Risk Financing Alternatives to Reinsurance	150
Taxation of Insurance Companies	152
State Premium Tax	153
Federal Income Taxes	153

Chapter 9 The Legal Framework 157

Insurance and the Law of Contracts	158
General Requirements of an Enforceable Contract	158
Void and Voidable	160
Special Legal Characteristics of Insurance Contracts	160
Insurance Is a Contract of Indemnity	161
Insurance Is a Personal Contract	166
Insurance Is a Unilateral Contract	166
Insurance Is a Conditional Contract	166
Insurance Is a Contract of Adhesion	167
Insurance Is an Aleatory Contract	167
Insurance Is a Contract of Utmost Good Faith	167
The Insurance Contract as a Contract	171
Policy Construction	172

SECTION TWO LIFE AND HEALTH INSURANCE

Chapter 10 Managing Personal Risks 175

Objectives in Managing Personal Risks	176
Other Steps in Managing Personal Risks	177
Managing Risks Associated with Premature Death	177
Identifying Risks Associated with Premature Death	177
Measuring Risks Associated with Premature Death	177
The Estate Liquidity Need	187
Estate Planning	187
Trusts	191
The Risks Associated with Superannuation	192
The Risk of Outliving the Retirement Accumulation	192
Estimating the Accumulation Need	193
The Risks Associated with Disability	193
Needs Analysis for the Disability Risk	194
Resources Available to Meet the Disability Risk	194
Addressing Unmet Disability Income Needs	195
Evaluating the Medical Expense Exposure	195
Managing the Risk of Unemployment	195
State Unemployment Insurance Programs	195
Retention and Risk Reduction	196

Chapter 11 Social Insurance Programs 199

Old-Age, Survivors', Disability, and Health Insurance	200
Eligibility and Qualification Requirements	200
Financing	201
Amount of Benefits	201
Classes of Benefits	202

Summary of Qualification Requirements	204
Loss of Benefits—The OASDHI Program	204
Soundness of the Program	208
Workers Compensation	213
Historical Background	213
Rationale of Workers Compensation Laws	214
Principles of Workers Compensation	214
An Overview of State Workers Compensation Laws	215

Chapter 12 Introduction to Life Insurance 220

Some Unique Characteristics of Life Insurance	221
Life Insurance Is Not a Contract of Indemnity	221
Types of Life Insurance Contracts	221
Reasons for Difference in Term and Cash Value Insurance	222
The Level Premium Concept	222
Tax Treatment of Life Insurance	224
Code Definition of Life Insurance	225
Impact of the 1984 Rules	225
Current Life Insurance Products	226
Term Insurance	226
Whole-Life Insurance	227
Universal Life Insurance	228
Variable Life Insurance	228
Adjustable Life Insurance	229
Endowment Life Insurance	229
Participating and Nonparticipating Life Insurance	230
General Classifications of Life Insurance	230
Ordinary Life Insurance	230
Industrial Life Insurance	230
Group Life Insurance	231
Credit Life Insurance	233
Total Life Insurance in Force in the United States	233
Other Types of Life Insurance	233

Chapter 13 The Actuarial Basis of Life Insurance 237

Life Insurance Premium Computation	238
Mortality	238
Interest	238
The Net Single Premium	241
The Net Level Premium	243
Reserves on Life Insurance Policies	245
Benefit-Certain and Benefit-Uncertain Contracts	247

Chapter 14 The Life Insurance Contract—General Provisions 251

Inception of the Life Insurance Contract	252
General Provisions of Life Insurance Contracts	252
Entire Contract Clause	252
Ownership Clause	253
Beneficiary Clause	253

Incontestable Clause	254
Misstatement of Age Clause	254
Grace Period	255
Reinstatement	255
Suicide Clause	256
Aviation Exclusions	256
War Clause	256
Settlement Options	257
Interest Option	257
Installments for a Fixed Period	257
Installments of a Fixed Amount	257
Life Income Options	257
Taxation of Policy Proceeds under Various Settlement Options	260

Chapter 15 The Life Insurance Contract—Other Provisions 263

Nonforfeiture Values	263
Cash Option	264
Paid-Up Reduced Amount	265
Extended Term Insurance	265
Policy Loan Provisions	266
Automatic Premium Loan	266
Dividend Provisions	267
Important Optional Provisions	268
Disability Waiver of Premium Provision	268
Accidental Death Benefit	270
Guaranteed Insurability Option	271
Common Disaster Clause	272
Spendthrift Clause	272
Rights of Creditors to Life Insurance Proceeds	272
Cost-of-Living Riders	273
Universal Life Policy Provisions	273
Premium and Cost of Insurance Provision	273
Changes in the Amount of Insurance	273
Death Benefit Provision	274

Chapter 16 Special Life Insurance Forms 277

Specialized Life Contracts	277
Mortgage Redemption Policy	278
Joint Mortgage Protection Policy	278
Survivorship Whole Life	278
Family Income Policy	279
Family Income Rider	279
Family Maintenance Policy	280
Family Protection Policy	280
Return-of-Premium and Return-of-Cash-Value Policy	281
Modified Whole Life	282
Graded-Premium Whole Life	282
Indexed Whole Life	282
Single-Premium Life	282
Juvenile Insurance	283
Indeterminate Premium Policies	284
Low-Load and No-Load Life Insurance	285
Advantages and Disadvantages of Special Forms	285

Chapter 17 Buying Life Insurance 288

Decisions in Buying Life Insurance	289
Buy Term and Invest the Difference?	289
Life Insurance as an Investment	291
Choosing the Company	292
Comparing Differences in Cost	294
The NAIC Life Insurance Illustrations Model Regulation	297
NAIC Model Replacement Regulation	298
Industry Reform Initiatives	298
Shopping for Universal and Variable Life	299
Some Additional Tax Considerations	301
Section 1035 Exchanges (“Rollovers”)	301
Life Insurance and Divorce Agreements	302

Chapter 18 Annuities and Pension Benefits 306

Annuities	307
Classification of Annuities	308
Income Tax Treatment of Annuities	309
Annuities and the Federal Estate Tax	310
Specialized Annuities	311
Annuities as Investments for Retirement	314
Qualified Retirement Plans	314
A General Overview of Qualified Plans	315
Types of Qualified Plans	315
Factors Influencing Benefit Levels	
Significance of the Nature of the Employer’s Promise	320
Other Benefits	322
Required Joint and Survivor Option	322
Period Certain Payments	322
Distribution Requirements	323
Taxation of Distributions	324
Individual Retirement Accounts	325
Traditional IRAs	325
The Roth IRA	327
A Concluding Note	327

Chapter 19 Managing the Retirement Risk 330

An Overview of the Retirement Risk	330
Causes of the Retirement Risk	331
Two Risks Associated with Retirement	331
Retirement Risk Alternatives	331
An Overview of the Retirement Planning Process	331
Countering the Urgency Deficit	334
Constructing a Retirement Plan	334
Estimating Retirement Needs	334
Planning the Accumulation	338
Managing the Distribution	338

Chapter 20 Health Insurance: Disability Income Insurance 344

General Nature of Disability Income Insurance	345
Types of Insurers	345
Methods of Marketing	345

Need for Disability Income Insurance	345
Short-Term versus Long-Term Disability Coverage	346
Disability Income Underwriting and Pricing	347
Disability Income Contracts	348
Perils Covered	348
Occupational- Non-occupational Disability	
Waiting Periods	348
Limitations on Amount of Coverage	349
Definitions of Disability Income Policies	349
Exclusions in Disability Income Contracts	350
Payments for Other Than Total Disability	351
Optional Benefit Provisions	352
Individual Health Insurance Policy Provisions	354
Individual Health Insurance Continuance	
Provisions	354
Uniform Provisions	355
Optional Uniform Provisions	356
Programming and Buying Disability Income Insurance	357
Determining Disability Income Coverage Needs	357
Evaluating Existing Sources of Protection	358
Taxation of Disability Income	358
Cost of Disability Income Insurance	359

Chapter 21 Health Insurance: Coverage for Medical Expenses 362

Background on the Current Health Insurance	
Market	363
Historical Development of Health Insurance in the United States	363
Current Deficiencies in the System	366
Previous Attacks on the Access Problem	369
Efforts to Reduce Costs	370
The Health Insurance Market	371
The Public Sector	371
The Private Sector	372
Distribution of Insurance Buyers	373
The Insurance Product	373
Traditional Forms of Medical Expense Insurance	373
HMO Contracts	375
Exclusions under Health Insurance Policies	376
Coordination of Benefit	376
Other Medical Expense Coverages	377
Limited Health Insurance Policies	377
Dental Expense Insurance	377
Limited Policies—Prescription Drugs	378
Medical Savings Accounts	378
Medicaid	379
Buying Health Insurance	381
First-Dollar Coverages	381
Taxes and Health Care Costs	381
The Future of Health Insurance	381
The Failure of Past Efforts	381
The Attack on Managed Care	382
Proposals for National Health Insurance	383
The Future	384

Chapter 22 Health Insurance for the Elderly 387

Medicare	388
The Traditional Medicare Program	388
Traditional Program Medicare Supplement	
Policies	393
Medicare+ Choice	395
Medical Savings Accounts	398
Medicare+ Choice Medicare Supplement	
Insurance	398
The Future of Medicare	399
Long-Term Care Insurance	400
Nature of the Long-Term Care Exposure	400
Inadequacy of Medicare for Long-Term Care Needs	400
Development of LTC Insurance	401
Coverage of LTC Policies	402
Cost of LTC Insurance	405
The Life Insurance Accelerated Benefits Alternative to LTC	405
Viatication	405
Medicaid Planning	406
Statutory Restrictions	406
Spousal Impoverishment Provisions	407
Estate Recovery	407
Medicaid Partnerships	407

Chapter 23 Employee Benefits and Other Business Uses of Life and Health Insurance 411

Employee Benefits Generally	412
Group Life and Health Insurance as Employee Benefits	413
Group Term Life Insurance	413
Group Ordinary Life Insurance	413
Group Paid-Up Life Insurance	413
Group Universal Life	414
Survivor Income Benefit Insurance	414
Retired Lives Reserve	414
Funding Issues	414
Funding through a 501(c)(9) Trust	415
Accounting for Retiree Health Care Costs	416
Pensions	416
Legislation Affecting Pension Plans	416
Qualification Requirements	417
Top-Heavy Plans	
Funding Pensions	418
ERISA Pension Plan Termination Insurance	421
Cafeteria Employee Benefit Plans	422
Some Specialized Uses of Life Insurance in Business	422
Business Continuation Insurance	422
Key-Person Insurance	423
Split-Dollar Plan	423
Deferred Compensation	424
Summary	424

SECTION THREE PROPERTY AND LIABILITY INSURANCE

Chapter 24 The Homeowners Policy – General Provisions 427

The Homeowners Policy Program	427
Historical Development	428
General Nature of the Homeowners Program	428
Homeowners Section I Coverage	428
Section I Coverages: An Overview	429
Perils Insured	429
Dwelling and Other Structures Coverage	431
Personal Property Coverage	432
Loss of Use Coverage	436
Additional Coverages	436
Homeowners Deductibles	438
Other Provisions	438
Section I Conditions	438
General Conditions Applicable to Sections I and II	440

Chapter 25 The Homeowners Policy Forms 444

Differences among Homeowners Forms	444
Homeowners 2 Broad Form	445
Homeowners 3 Special Form	445
Homeowners 4 Contents Broad Form	450
Homeowners 5 Comprehensive Form	450
Homeowners 6 Condominium Unit-Owners Form	451
Homeowners 8 Modified Coverage Form	453
Homeowners Section I Optional Coverages	454
Optional Perils	454
Other Endorsements	454

Chapter 26 Other Personal Forms of Property Insurance 458

Monoline Fire Dwelling Program	459
Current Dwelling Program	459
Eligibility	459
Coverages under the Dwelling Program	460
Endorsements to the Dwelling Program Forms	460
Mobilehome Program	461
ISO Mobilehome Program	461
Eligibility	462
Coverage on the Mobilehome	462
Flood Insurance	462
General Nature of the Program	463
The Residential Flood Insurance Policy	464
Inland Marine Coverage for the Individual	466
Personal Inland Marine Floaters	467
Scheduled Personal Property Endorsement	467
The Personal Property Floater	469
Wedding Present Floater	470
Insurance on Watercraft	470
Buying Property Insurance for the Individual	471
Pricing and Cost Considerations	471

Choosing the Form	472
Tailoring the Coverage under the Homeowners Policy	472
Flood Insurance	473
Title Insurance	473
Torrens System	474

Chapter 27 Negligence and Legal Liability 477

Criminal and Tortious Behavior	478
Negligence and Legal Liability	478
There Must Be Negligence	478
There Must Be Actual Damage or Loss	481
Negligence Must Be the Proximate Cause of the Damage	482
Defenses to Negligence	484
Possible Changes in the Tort System	487
Summary	488

Chapter 28 General Liability Insurance for the Individual 490

Liability Insurance in General	490
Types of Liability Insurance	491
Comprehensive Personal Liability Coverage	491
General Nature of the Coverage	492
Personal Liability Coverage	492
Medical Payments to Others	498
Additional Coverages	499
Section II Conditions	501
Cost of Personal Liability Insurance	502
Optional Personal Liability Endorsements	502
Professional Liability Insurance	503
Malpractice Insurance	503
Errors and Omissions Insurance	504
Umbrella Liability Policy	504
Exclusions under the Umbrella Liability Policy	505
Cost of the Umbrella	505

Chapter 29 The Automobile and its Legal Environment 508

A Brief Overview of Automobile Coverages	509
Automobile Liability Insurance	509
Medical Payments Coverage	509
Physical Damage Coverage	509
Uninsured Motorists Coverage	509
Legal Liability and the Automobile	509
Vicarious Liability and the Automobile	509
Guest Hazard Statutes	510
Automobile Liability Insurance and the Law	511
Insurance for High-Risk Drivers	512
The Automobile Insurance Problem and Changes in the Tort System	514
Criticisms of the Traditional System	514
The No-Fault Concept	515

Cost of Automobile Insurance	519
Insurance Services Office Automobile Rating Systems	519
The Rating System and Equity	521
The Shifting View of Auto Insurance	522

Chapter 30 The Personal Auto Policy 525

General Nature of the Personal Auto Policy	525
Eligibility	526
Policy Format	526
Liability Coverage	527
Liability Insuring Agreement	527
Liability Exclusions	529
Other Liability Coverage Provisions	531
Medical Payments Coverage	532
Medical Payments Insuring Agreement	532
Medical Payments Exclusions	532
Limitations Applicable to Medical Payment Recoveries	533
Uninsured Motorist Coverage	533
Uninsured Motorist Insuring Agreement	533
Underinsured Motorist Coverage	534
Physical Damage Coverage	535
Physical Damage Insuring Agreement	535
Physical Damage Exclusions	537
Other Physical Damage Provisions	538
Policy Conditions	539
Part E—Duties after an Accident or Loss	539
Part F—General Provisions	539
Endorsements to the PAP	541
Extended Liability Coverage	541
Named Non-Owner Policy	541
Miscellaneous Type Vehicle Endorsement	541
Antique and Classic Automobiles	544
Buying Automobile Insurance	544
Liability Coverage	544
Medical Payments Coverage	545
Physical Damage Coverage	545
Uninsured Motorist Coverage	546
Cost Differences among Companies	546
Summary	546

Chapter 31 Commercial Property Insurance 549

Commercial Property Coverage	550
Commercial Property Direct Loss Coverages	551
Commercial Property Coverage Policies	551
Building and Personal Property Coverage Form	551
Blanket Insurance	557
Reporting Form Coverage	557
Builder's Risk Coverage Form	558
Condominium Association Coverage Form	558
Condominium Commercial Unit Owner's Coverage Form	558
Standard Property Policy	558
Plate Glass Insurance	558

Commercial Property Coverage for Indirect Loss	559
Business Interruption Insurance	559
Extra Expense Insurance	560
Contingent Business Interruption and Extra Expenses	560
Leasehold Interest Insurance	561
Rain Insurance	561
Boiler and Machinery Insurance	561
The ISO Breakdown Protection Coverage Form	562
Direct Damage Equipment Coverages	562
Indirect Loss Boiler and Machinery Coverages	563
Deductibles	564
Suspension	564
Transportation Coverages	564
Ocean Marine Insurance	564
Inland Marine Insurance	565
The National Flood Insurance Program	569
The General Property Form Flood Insurance Policy	569
Nonresidential Condominiums	570
Insurance against Dishonesty	570
Dishonesty Insurance Coverage Triggers	570
The ISO Crime Insurance Program	571
Employee Crime Coverages	572
Nonemployee Crime Coverages	573
Package Policies for Business Firms	575
Commercial Package Policy	575
Businessowners Policy	575
Summary	576

Chapter 32 Commercial Liability Insurance 580

Employers Liability and Workers Compensation	581
Workers Compensation Policy	581
General Liability Insurance	583
General Liability Exposures	583
Commercial General Liability Coverage	585
Other Portfolio Liability Coverages	592
Miscellaneous General Liability Coverages	592
Commercial Automobile Insurance	594
Business Auto Coverage Form	594
Garage Coverage Form	596
Truckers Coverage Form	597
The Motor Carrier Coverage Form	598
Aviation Insurance	599
Aircraft Liability Insurance	599
Hull Coverage	600
Liability Insurance for Common Carriers	600
The Liability of a Common Carrier	600
Insurance Requirements	600
Motor Truck Cargo Policy—Trucker's Form	601
Insurance for Bailees	601
Bailee Liability	601
Bailee Liability Coverages	602
Excess Liability and Umbrella Liability Coverage	602
Excess Liability Distinguished from Umbrella Liability Contracts	603
Umbrella Liability Policies	603

Chapter 33 Surety Bonds and Credit Insurance 607

Surety Bonds	608
Suretyship Distinguished from Insurance	608
Contract Bonds	609
Court Bonds	609
License and Permit Bonds	611
Public Official Bonds	611
Miscellaneous Bonds	611
Credit Insurance	612
Types of Policies	612
Coinsurance and the Normal Loss	613
Collection Service	613
Credit Enhancement Insurance	614
Municipal Bond Guarantee Insurance	614
Municipal Lease Insurance	614
Commercial Paper Insurance	614
Industrial Development Bond Insurance	614
Money Market Fund Insurance	614

Chapter 34 Insurance in the Future 617

Social Insurance Programs	617
The Social Security System	618
Medicare	618
Health Insurance	618
Changes in the Legal Environment	618
Changes in the Tort System	618
Workers Compensation Laws	621

Protection for Catastrophe Exposure	621
Federal Tax Laws	622
Possible Changes in the Pattern of Regulation	622
Changes in the Insurance Industry	625
Changes in Industry Structure	625
Changes in Distribution Patterns	625
Changes in Forms of Coverage	626
Globalization of Insurance	626
Multinational Corporations	627
Financial Services Trade Barriers	627
Foreign Insurers in the United States	627
U.S. Insurers Abroad	628
A New Problem—The Terrorism Exposure	628
Some Persistent Problems	629
The AIDS Problem	629
Genetic Testing	630
Crime and Its Associated Costs	631
Availability and Affordability of Insurance	631
Lack of Consumer Sophistication	632
Unwarranted Criticism of the Insurance Industry	632
Career Opportunities in Insurance	633
Opportunities in the Insurance Sales Field	633
Nonsales Opportunities in the Insurance Industry	634
Opportunities in the Risk Management Field	634
Concluding Observation	634
Glossary	637
Author Index	661
Subject Index	663

CHAPTER I

THE PROBLEM OF RISK

*“When I use a word,” Humpty Dumpty said, in a rather scornful tone,
“it means just what I choose it to mean—neither more nor less.”*

*“The question is,” said Alice, “whether you can make
words mean so many different things.”*

*“The question is,” said Humpty Dumpty, “which is
to be master, that’s all.”*

— LEWIS CARROLL
Through the Looking Glass

CHAPTER OBJECTIVES

When you have finished this chapter, you should be able to

- Define and explain the meaning of the term *risk*
- Distinguish among the terms *risk*, *peril*, and *hazard*
- Identify and explain the classes of hazards
- Differentiate between pure risk and speculative risk
- Differentiate between fundamental and particular risk
- Describe the categories into which pure risk may be subdivided
- Identify and explain the principal methods of handling risk

You see the mangled metal of two cars that have collided on an interstate highway. A fire engine with its siren screaming roars down the street. A building in your neighborhood burns or you see an ambulance racing to the hospital. All these tragic events arouse your interest and emotions. After the noise and excitement have died down, you are grateful that the

loss did not happen to you and you may even feel sorry for whoever suffered the loss. But you’re glad that it wasn’t you. Losses like these happen to some people, while others go along happily, free from misfortune. The fact that these losses or similar events could happen to you, and the fact that you can’t tell for sure whether or not they will, is a condition we