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CPCU 500

Assignment 1: Introduction to Risk Management

- Understanding and Quantifying Risk

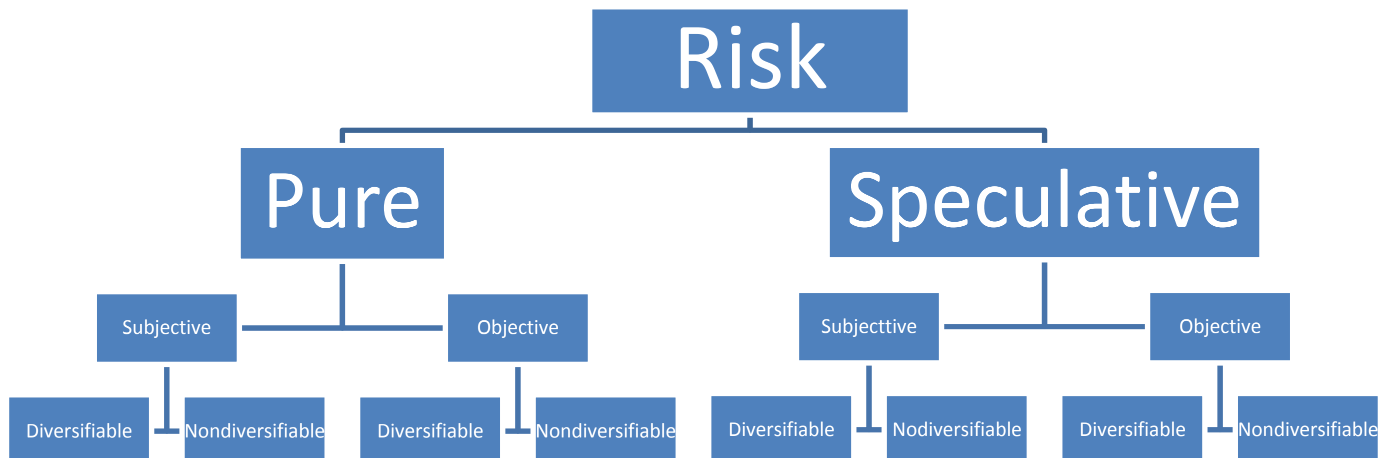
Risk – The uncertainty about outcomes, some of which can be negative

Uncertainty – Risk involves uncertainty about the type of outcome, the timing of the outcome, or both

Possibility – An outcome or event may or may not occur

Probability – The likelihood that an outcome or event will occur.

- Classifications of Risk



Pure	**Speculative**
• Chance of loss or no loss; no chance of gain • Insurable	• Chance of loss, no loss, or gain • Not generally insurable • Investments: inflation risk, market risk, financial risk, interest rate risk, liquidity risk • Business: price risk, credit risk

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Objective	**Subjective**

• Measurable variation in uncertain outcomes based on facts and data
• Insurable
	• Perceived amount of risk based on an individual's or organization's opinion
	• Not generally insurable
	• Differs from objective risk because of the following:
	    • Familiarity and control
	    • Severity over frequency

Diversifiable	**Nondiversifiable**
• Affects only some individuals, businesses, or small groups • Nonsystematic risk or specific risk • Insurable • Can be managed by spread of risk	• Affects a large segment of society at the same time • Systematic risk or fundamental risk • Not generally insurable privately although some insurers cover earthquake, hurricane • Government covers both nondiversifiable risk (e.g. flood) and diversifiable risk (e.g. workers' compensation)

- Financial Consequences of Risk
  1. Expected cost of losses or gains
  2. Expenditures on risk management
  3. Cost of residual uncertainty

- Basic Purpose and Scope of Risk Management

  Risk Management – A system for planning, organizing, leading, and controlling the resources and activities that an organization needs to protect itself from the adverse effects of accidental losses.

- Loss Exposures

  Loss exposure – Any condition the present a possibility of loss, whether or not an actual loss occurs

  - Elements of Loss Exposures
    1. An asset exposed to loss

Property loss exposure – A condition that present the possibility that a person or an organization will sustain a loss resulting from damage (including destruction, taking, or loss of use) to property in which that person or organization has a financial interest.
Tangible property – Property that has a physical form
Intangible property – Property that has no physical form
Real property – Tangible property consisting of land, all structures permanently attached to the loss, and whatever is growing on the land.
Personal property – All tangible property other than real property
Liability loss exposure – A condition that presents the possibility that a person or organization will sustain a loss resulting from a claim alleging that the person or organization is legally responsible for injury and/or damage
Personnel loss exposure – A condition that present the possibility of loss caused by a key person's death, disability, retirement, or resignation that deprives an organization of that person's special skill or knowledge that the organization cannot readily replace.
Personal loss exposure – A condition that presents the possibility of an individual's or family's loss caused by a family member's illness, death, disability, or unemployment
Net income loss exposure – A condition that present the possibility of loss caused by a reduction in net income

2. Cause of loss (also called peril)
   Hazard – A condition that increases the frequency and/or severity of loss
   Moral Hazard – A condition that increases the frequency and/or severity of loss resulting from a person acting dishonestly
   Morale Hazard – A condition that increases the frequency and/or severity of loss resulting from careless or indifferent behavior
   Physical Hazard – A condition of property, persons, or operations that increases the frequency and/or severity of loss.
   Legal Hazard – A condition of the legal environment that increases the frequency and/or severity of loss.
3. Financial consequences of that loss.

- Risk Management Benefits

	Component	
	Lower Expected Losses	**Less Residual Uncertainty**
Individuals	Preserves financial resources	Reduces anxiety
Organizations	Preserves financial resources Makes an organization more attractive as an investment opportunity	Reduces Deterrence effect

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Society	Preserves financial resources	Improves allocation or productive resources

- ## Risk Management Program Goals

Pre loss goals – Risk management program goals that should be in place even if no significant losses occur.

1. Economy of operations – A risk management program should operate economically and efficiently; that is, the organization generally should not incur substantial costs in exchange for slight benefits.
2. Tolerable uncertainty – Involves keeping managers' uncertainty about losses at tolerable levels. Managers should be able to make and implement decisions effectively without being unduly affected by uncertainty.
3. Legality – The risk management program should help to ensure that the organization's legal obligations are satisfied. These legal obligations will typically be based on the following:
   - Standard of care that is owed to others
   - Contracts entered into by the organization
   - Federal, state, and local laws and regulations
4. Social responsibility – Both a pre-loss and post-loss goal for many organizations, includes acting ethically and fulfilling obligations to the community and society as a whole.

Post loss goals – Risk management program goals that should be in place in the vent of a significant loss.

1. Survival – For individuals, survival means staying alive. For organizations, survival means resuming operations to some extent after an adverse event
2. Continuity of operations – No loss can be allowed to interrupt the organization's operations for any appreciable time.
3. Profitability – In a for-profit organization, the goal is to generate net income. In a not-for-profit organization, the goal is to operate with the budget.
4. Earnings stability – Rather than strive for the highest possible level of profit (or surplus) in a given period, some organizations emphasize earnings stability over time.
5. Social responsibility – Same as above.
6. Growth – The goal of risk management in a growing organization might be to protect its expanding resources so that its path of expansion is not blocked or reversed by a substantial loss.

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It is common for post-loss goals to conflict with pre-loss goals, or for pre-loss goals to compete with each other.

Pre-Loss Goals	**Explanation**	**Application**
Economy of operations	• RM program should not incur substantial costs for small benefit	• Measure economy by benchmarking
Tolerable uncertainty	• Uncertainty should not unduly affect management decisions	• Provide assurances that risk control and risk financing are managing loss exposures
Legality	• Legal obligations are based on: • Standards of care • Contracts • Laws and regulations	• Ensure the organization: • Meets the standard of care owed to others • Meets contractual obligations • Complies with laws and regulations
Social responsibility	• Acting ethically, fulfilling obligations to the community and to society	• Potential for enhancing the organization's reputation

- ## The Risk Management Process

Step	**Objective**	**Tasks**
1	Identify loss exposures	• Document analysis (e.g. questionnaires, financial statements, contracts, insurance policies, flowcharts, loss history) • Compliance reviews • Inspections • Expertise within and beyond the organization
2	Analyze loss exposures	• Analyze the following: • Loss frequency • Loss severity • Total dollar loss • Timing
3	Examine feasibility of risk management techniques	• Risk control techniques • Avoidance • Loss prevention

		• Loss reduction
		• Separation
		• Duplication
		• Diversification
		
		• Risk financing techniques
		  • Transfer (e.g. insurance, hold-harmless agreements, hedging)
		  • Retention

4	Select appropriate risk management techniques	• Based on:
		  • Quantitative financial considerations (i.e. forecast expected losses, effect of risk management techniques, and after-tax costs)
		  • Qualitative nonfinancial considerations (e.g. ethical considerations, maintaining operations, peace of mind)

5	Implement selected risk management techniques	• Purchasing loss reduction devices or contracting loss prevention services • Funding retention programs • Implementing and reinforcing loss control programs • Selecting insurance providers • Obtaining insurance and paying premiums
6	Monitor results and revise the risk management plan	• Establish standards of acceptable performance • Compare actual results to standards • Correct substandard performance or revise standards • Evaluating standards that have been substantially exceeded
Next	Return to Step 1	• Identify new or changing loss exposures

Assignment 2: Risk Assessment

- Identifying Loss Exposures

Method	Components	Description	Advantages/Disadvantages
Document analysis	Risk assessment questionnaires and checklists	• Published by insurers, AMA, IRMI, RIMS and others • Checklists identify loss exposures • Questionnaires capture descriptive info • Insurer questionnaires relate to commercially insurable loss exposures • Risk management questionnaires address insurable and noninsurable loss exposures	• Questionnaires require considerable expense, time and effort • Standardized surveys are relevant for most; can be used by those with little risk management expertise • Standardized surveys cannot uncover all loss exposures; may not reveal key info
	Financial statements and accounting records	• Balance sheets report assets, liabilities, and owners' equity as of a specific date • Income statements report profit or loss for a specific periods (i.e. revenues minus expenses) • Statements of cash flows summarize effects of operating, investing, and financing activities during a specific period	• Help identify major categories of loss exposures • Do not identify or quantify individual loss exposures • Depict past activities; are of limited help in identifying projected values or future events
	Contracts	• Contracts can increase or decrease property and liability loss exposures • Hold-harmless agreements obligate one party to assume another party's legal liability in the event of a specified loss • Indemnification is the process of restoring an individual or organization to a pre-loss financial condition	• Helps identify both property and liability loss exposures and determine who has assumed liability for which exposures • Can ensure that the organization is not assuming liability disproportionate to its stake in the contract
	Insurance policies	• Analyzing insurance policies reveals many insurable loss	• May not show all the loss exposures the organization

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		exposures an organization faces	faces • Overlooks uninsurable loss exposures

Method	**Components**	**Description**	**Advantages/Disadvantages**
Document analysis, continued	Organizational policies and records	• Corporate by-laws, board minutes, employee manuals, procedure manuals, mission statements, and risk management policies	• Identifies both loss exposures and pending changes in loss exposures • One drawback is the volume of documents organizations generate
	Flowcharts and organizational charts	• Flowcharts show nature and use of resources as well as sequence and relationships of operations • Organizational charts depict hierarchy and help identify key personnel	• Flowcharts identify critical loss exposures and potential bottlenecks • Organizational charts track information flow and identify personnel loss exposures • Organizational charts do not reflect the importance of the individual to continued operations
	Loss histories	• The organization's own loss history or that of comparable organizations	• Can indicate current or future loss exposures • Cannot identify exposures that have not resulted in past losses
Compliance review		• Determines an organization's compliance with local, state, and federal regulations and statues • Remaining in compliance requires ongoing monitoring	• Helps organizations minimize or avoid liability loss exposures • Expensive and time consuming
Personal inspection		• Information-gathering visits to sites within and outside an organization • Include discussions with front-line personnel	• Reveal loss exposures that would not appear in written descriptions • Require individuals with specialized background and experience
Expertise	Within the organization	• Interviews with a range of employees from every level of the organization	• Can elicit info about what happened in the past • Can indicate what might be planned for the future

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	Beyond the organization	• Practitioners in law, finance, statistics, accounting, auditing and the technology of the organization's industry	• The special knowledge of experts in identifying particular loss exposures is invaluable • Hazard analysis often identifies previously overlooked loss exposures

Balance sheet – The financial statement that reports the assets, liabilities,, and owner's equity of an organization as of a specific date.

Income statement - The financial statement that reports an organization's profit or loss for a specific period by comparing the revenues generated with the expenses incurred to produce those revenues.

Statement of cash flows – The financial statement that summarize the cash effects of an organization's operating, investing, and financing activities during a specific period.

Hold-harmless agreement – A contractual provision obligating one party to assume another party's legal liability in the event of a specified loss.

Indemnification – The process of restoring an individual or organization to a pre-loss financial position.

- Data Requirements for Exposure Analysis
  - Data of Past Losses – The most common basis of an analysis of current or future loss exposures is information about past losses arising from similar loss exposures. This is not always an ideal way to determine futures loss exposures because there may not be sufficient data on which to make a meaningful forecast and the data may not be reliable. To accurately analyze loss exposure using data on past losses, the data should meet the following four criteria:
    1. Relevant Data – The past loss data for the loss exposure in question must be relevant to the current or future loss exposures.
    2. Complete Data – Obtaining complete data about past losses for particular loss exposures often requires relying on others, both inside and outside of the organization. What constitutes complete data depends largely on the nature of the loss exposure being considered.
    3. Consistent Data – To reflect past patterns, loss data must also be consistent in at least two respects. First, the loss data must be collected on a consistent basis for all recorded

losses. Second, data must be expressed in constant dollars, to adjust for differences in price levels.

4. Organized Data **–** If data are not appropriately organized they will be difficult for the insurance or risk management professional to use to identify patterns and trends that will help to reveal and quantify potential future loss exposures.

- ## Nature of Probability

Theoretical probability – Probability that is based on theoretical principles rather than on actual experience.

Empirical probability – Probability that is based on actual experience.

Probability analysis – A technique for forecasting events on the assumption that they are governed by an unchanging probability distribution. Particularly effective for projecting losses in organization that have (1) a substantial volume of data on past losses and (2) fairly stable operations so that (except for price level changes) patters of past losses presumably will continue in the future.

Law of large numbers – A mathematical principal stating that the actual (empirical) relative frequency of each of the possible outcomes more nearly approaches the true (theoretical) probability of that outcome as the number of independent events increases. It can be used when the events being forecast meet the following criteria

1. The events have occurred in the past under substantially identical condition and have resulted from unchanging, basic causal forces.
2. The events can be expected to occur in the future under the same, unchanging conditions.
3. The events have been, and will continue to be, both independent of one another and sufficiently numerous.

- ## Using Probability Distributions

Probability Distribution – A presentation (table, chart,, or graph) of probability estimates of a particular set of circumstances and of the probability of each possible outcome.

Discrete Probability Distribution - Have a finite number of possible outcomes.

Continuous Probability Distribution – Have an infinite number of possible outcomes.

Measure	Definition	Notes
Central tendency	The single outcome that is the most representative of all possible	• In analyzing a probability distribution, central tendency represents the best guess as to what

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	outcomes included within a probability distribution	the outcome will be • The three most widely accepted measures of central tendency are the mean, median, and mode.
Expected value	The weighted average of all the possible outcomes of a theoretical probability distribution	• The weights are the probabilities of the outcomes • Formula applies to theoretical discrete probability distributions
Mean	The sum of the values in a data set divided by the number of values (numeric average)	• Used with empirical distribution constructed from historical data • Only a good estimate of the expected value if underlying conditions remain constant over time
Median	The value at the midpoint of a sequential data set with an odd number of values, or the mean of the two middle values of a sequential data set with an even number of values	• The median has a cumulative probability of 50% • Can be helpful in selecting retention levels and upper limits of insurance coverage
Mode	The most frequently occurring value in a distribution	• Knowing the mode allows insurance and risk management professionals to focus on the outcomes that are the most common • The relationship between the mean, median, and mode is illustrated by the distribution's shape (i.e. symmetrical vs. skewed)
Dispersion	The variation among values in a distribution	• Measures the extent to which the distribution is spread out rather than concentrated around the expected value • Less dispersion means less uncertainty about expected outcomes
Standard deviation	The average of the differences (deviations) between the values in a distribution and the expected value (or mean) of that distribution	• Indicates how widely dispersed the values in a distribution are • Standard deviation provides a measure of how sure an insurance or risk management professional can be about estimates of future losses
Coefficient of variation	The distribution's standard deviation divided by its mean or expected value	• Compares two distributions with different shapes, means, or standard deviations • Higher coefficient of variation means greater relative variability • Can be used to determine whether a particular loss control measure has made losses more or less predictable

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Normal Distribution – A probability distribution that, when graphed, generates a bell-shaped curve.

- ## Analyzing Loss Exposures

Loss Frequency – The number of losses that occur within a specific period.

Loss Severity – The dollar amount of loss for specific occurrence.

Probable Maximum Loss (PML) – An estimate of the largest loss that is likely to occur.

Maximum Possible Loss (MPL) – The total value exposed to loss at any one location or from any one event.

The Prouty Approach – A method for considering frequency and severity together.

The four categories of loss frequency are:

1. Almost nil – extremely unlikely to happen; virtually no possible
2. Slight – could happen but has not happened
3. Moderate – happens occasionally
4. Definite – happens regularly

The three categories of loss severity are:

1. Slight – organization can readily retain each loss exposure
2. Significant – organization cannot retain the loss exposure, some part of which must be financed
3. Severe – organization must finance virtually all of the loss exposure or endanger its survival

		Loss Frequency			
		Almost Nil	**Slight**	**Moderate**	**Definite**
Loss Severity	**Severe**	Reduce or prevent / Transfer	Reduce or prevent / Transfer	Reduce or prevent / Retain	Avoid
	Significant	Reduce or prevent / Transfer	Reduce or prevent / Transfer	Reduce or prevent / Retain	Avoid
	Slight	Reduce or prevent / Retain	Reduce / Retain	Reduce or prevent / Retain	Prevent / Retain

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Total dollar losses – The total dollar amount of losses for all occurrences during a specific period.

Timing – When losses occur and when loss payments are made.

Data Credibility – The level of confidence that available data can accurately indicate future losses.

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Assignment 3: Risk Control

- Risk Control Techniques

Risk Control – A conscious act or decision not to act that reduces the frequency and/or severity of losses or makes losses more predictable.

Technique	Definition	Notes
Avoidance	Ceasing or never undertaking an activity so that the possibility of a future loss occurring from that activity is eliminated	• Proactive avoidance eliminates all potential exposures • Reactive avoidance eliminates potential future exposures • Avoiding one loss exposure can create another • Complete avoidance is typically neither feasible or desirable
Loss prevention	A technique that reduces the frequency of a particular loss	• May also affect loss severity • Implemented before a loss to break sequence of events that leads to loss • May reduce frequency of one loss but increase frequency of another
Loss reduction	A technique that reduces the severity of a particular loss	• May also prevent losses • Pre-loss measures reduce property damage and the number of people injured • Post-loss measures include emergency procedures, salvage, rehab, PR, legal defenses • A disaster recovery plan ensures resources are available to facilitate continuity of operations
Separation	A technique that disperses a particular asset of activity over several locations and regularly relies on that asset or activity as part of the organization's working resources	• Appropriate if an organization can operate with only a portion of resources intact • Usually a byproduct of another management decision • Reduces severity, but can increase loss frequency
Duplication	A technique that uses backups, spares, or copies of critical property, information, or capabilities and keeps them in reserve	• Appropriate if an asset or activity is so important that consequences of loss justify the expense and time of duplication • Reduces loss severity; not as likely to increase frequency as separation is • Duplication can incorporate nonowned assets
Diversification	A technique that spreads loss exposures over numerous projects, products, markets, or	• Resembles duplication and separation, but is used to manage business risks rather than hazard risks

	regions	• Can increase loss frequency

- ## Risk Control Goals
  - Implement Effective and Efficient Risk Control – A risk control measure is effective if it enables an organization to achieve desired risk management goals, such as the pre-loss goals off economy of operations, tolerable uncertainty, legality, and social responsibility or the post loss goals of survival, continuity of operations, profitability, earnings stability, growth, and social responsibility. A risk control measure is efficient if it is the least expensive of all possible effective measures.
  - Comply With Legal Requirement - An organization may be required to implement certain risk control measures if a state or federal statute mandates specific safety measures, such as protecting employees from disability or safeguarding the environment against pollution.
  - Promote Life Safety – Life safety is the portion of fire safety that focuses on the minimum building design, construction, operation, and maintenance requirements necessary to assure occupants of a safe exit from the burning portion of the building. Promoting life safety can be expanded beyond fire safety to incorporate any cause of loss that threatens the life of employees or customers. Therefore, organizations must be concerned about other causes of loss, such as product safety, building collapse, industrial accidents, environmental pollution, or exposure to hazardous activities that may create the possibility of injury of death.
  - Ensure Business Continuity – Business continuity is designed to meet both the primary risk management program post-loss goals of survival and continuity of operations.
- ## Application of Risk Techniques
  - Property Loss Exposures – Insurance producers and underwriters commonly examine commercial property loss exposures based on construction, occupancy, protection, and environment (known by their acronym – COPE)

COPE Factor	**Description**	**Risk Control Technique**
Construction	Construction materials and techniques range from simple frame construction (lease resistive to fire) to fire-resistive (most fire resistive) construction with a wide variety of choices in between.	Loss prevention and loss reduction through construction techniques designed to minimize frequency and severity of losses.
Occupancy	There are nine different classifications of occupancy, ranging from residential to	Loss reduction through safety training and emergency evacuation procedures.

	industrial, with each classification presenting its own unique risk to real property.	
Protection	There are two categories of protection, internal or external. Internal protection refers to what the organization does to protect its own real property. External protection refers to what fire departments and other public facilities do to safeguard the general public, including the organization, from fire and other causes of loss.	Two loss reduction measures used for internal fire protection are fire detection and suppression. External protection could involve security systems and security guard services.
External Environment	A building exposed to many hazards from outside sources, such as neighboring buildings. COPE factors are used to evaluate neighboring buildings fire risk and the risk of transfer to the organization's real property.	The loss prevention and reduction measures may include relocation away from external hazards and fire protection to the exterior of the property to prevent or reduce the likelihood of fire from another building to the organization's property.

- Liability Loss Exposures – three risk control techniques can be used to control liability losses.
  - Avoid the activity that creates the liability loss exposure
  - Decrease the likelihood of the losses occurring (loss prevention)
  - If a loss does occur, minimize its effect on the organization (loss reduction)

- Personal Loss Exposures – Unavoidable because all organizations have key employees. These loss exposures can arise from events both inside and outside the workplace. Organizations generally incorporate three different risk control techniques when addressing personnel loss exposure: loss prevention, loss reduction, and separation. Organizations find that the most cost-effective measures are those that can be implemented in the workplace, such as preventing and reducing workplace injury and illness. An organization may attempt to prevent personnel causes of loss that occur outside of the workplace by controlling key employees' activities through employment contracts,; for example, placing restrictions on hazardous activities such as sky diving, flying personal aircraft, riding motorcycles, and so on.
- Net Income Loss Exposures – Can be associated with property, liability, or personnel loss exposures. Therefore, any of the risk control measures that control these three categories of loss exposures also indirectly net income loss exposures. Two risk control measures that

are directly aimed at reducing the severity of net income losses are separation and duplication

- ## Business Continuity Management

Definition: A process that identifies potential threats to an organization and provides a methodology for ensuring an organization's continued business operations.

Steps in the Business Continuity Process

1. Identify the organization's critical functions
2. Identify the risks (threats) to the organization's critical functions
3. Evaluate the effect of the risks on those critical functions
4. Develop a business continuity strategy
5. Develop a business continuity plan
6. Monitor and revise the business continuity process

Most business continuity plans contain the following:

- Strategy the organization is going to follow to manage the crisis
- Information about the roles and duties of various individuals in the organization
- Steps that can be taken to prevent any further loss or damage
- Emergency response plan to deal with life and safety issues
- Crisis management plan to deal with communication and any reputation issues (reputation management) that may arise
- Business recovery and restoration plan to deal with losses to property, processes, or products
- Access to stress management and counseling for affected parties

Ethical Considerations – Risk control goals dictate that individuals and organizations implement risk control measure that are effective and efficient. One method of determining investment in risk control is performing a cost/benefit analysis. The cost/benefit decision criterion leads to some ethical issues. Any risk control measure applied to risks involving the possibility of human fatality needs to determine the value of a human life.

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Assignment 4: Risk Financing

- Risk Financing Goals

Goal	Notes
Pay for losses	• Ensure funds are available to pay losses when they occur • Particularly important in situations that disrupt normal activities • Also important for other reasons (e.g. public relations) • Includes paying for actual losses/retained losses + transfer costs (e.g. buying options to hedge against exchange rate risk, insurance premiums)
Manage the cost of risk	• Administrative expenses • Include internal admin and purchasing services • Unavoidable; savings by modifying/eliminating procedures • Risk control expenses • Reduce frequency/severity or increase predictability • Devote resources only if benefit of risk control measure > its cost • Risk financing expenses • Incurred to manage risk financing measures • Transaction costs, broker commissions, fees • Vary based on measure chosen and market conditions
Manage cash flow variability	• Acceptable variability depends on the following: • The organization's size • Financial strength • Management's risk tolerance • Degree to which other stakeholders are willing to accept risk • Determine maximum tolerable variability and arrange risk management programs within those parameters
Maintain appropriate liquidity	• Liquidity is required to pay retained losses • As retention increases so does the need for liquidity • Consider both internal and external sources of capital • Internally - sell assets or retain cash flow • Externally - borrow, issue debt, issue stock
Comply with legal requirements	• Some laws and regulations require specific risk financing measures • Alternatively, legal requirements will affect how risk financing measures are implemented • Contractual obligations may create obligations (e.g. lease requiring insurance)

- Retention & Transfer

Risk Financing – A conscious act or decision not to act that generates the funds to pay for losses and risk control measures or to offset variability in cash flows.

Retention – A risk financing technique by which losses and variability in cash flows are financed by generating funds within the organization

Transfer – In the context of risk management, a risk financing technique by which the financial responsibility for losses and variability in cash flows is shifted to another party.

Insurance – A risk financing measure that transfers the potential financial consequences of certain specified loss exposures from the insured to insurer.

Alternative risk transfer (ART) – Those risk financing measures that do not fall into the category of guaranteed cost insurance

Retention Funding Measures:

1. Current expensing of losses
2. Using an unfunded reserve
3. Using a funded reserve
4. Borrowing funds

Advantages of Retention:

- Cost savings
- Control of claims process
- Timing of cash flows
- Incentives for risk control

Limitations on Risk Management Measures

- Risk transfer measures (including insurance) are not typically pure transfers, but are some combination of retention and transfer. Most, if not all, risk transfer measures involve some type of limitation on the potential loss amounts that are being transferred. These limitations can be deductibles, limits, or other restrictions so that the individual or organization (transferor) pays at least some portion of the loss.
- The ultimate responsibility for paying for the loss remains with the individual or organization. Risk financing does not eliminate the transferor's legal responsibility for the loss if the transferee fails to pay.

Advantages of Transfer

- Reducing exposure to large losses
- Reducing cash flow variability
- Providing ancillary services
- Avoiding adverse employee and public relations

Measure	**Description**	**Advantages**

Retention funding	• Current expensing of losses relies on current cash flow to cover losses
	• Least formal, but least assurance that funds will be available
		• Cost savings by avoiding the following:
		  • Administrative costs
		  • Premium taxes
		  • Moral hazard costs
		  • Social loading costs
		  • Adverse selection costs
		• Control of claims handling process and greater flexibility in investigation and settlement negotiation
		• Avoids up-front payment (e.g. premium) allowing use of those funds, and can shorten delay between loss and payment
		• Provides incentive for risk control

	• An unfunded reserve uses accounting entries to denote potential liabilities • Organization does not support that potential loss with any specific assets	
	• A funded reserve supports potential loss payment with cash, securities, or other liquid assets • Can be fairly informal or highly complex	
	• Borrowing funds is retention because the organization will, in time, use it own earnings to repay the loan	

Risk transfer	• Limitations on risk transfer include the following:
	  • Deductibles
	  • Coverage limits
	  • Other restrictions so transferor pays some portion of the loss
	• Ultimate responsibility for paying loss remains with organization
		• Reducing exposures to large losses
		• Reducing cash flow variability by reducing the effect of retaining large losses
		• Providing ancillary services such as risk assessment and control, claims admin, and litigation services
		• Avoiding adverse employee and public relations by transferring the claims admin process

- ## Selecting Appropriate Risk Financing Measures

Ability of Retention and Transfer to Meet Risk Financing Goals		
Risk Financing Goal	**Retention**	**Transfer**
Pay for Losses	Depends on magnitude of losses and structure and management retention	Primary benefit of transfer measures

	measure, as well as the relative strength of cash flows	
Manage the Cost of Risk	Primary benefit of retention	Rarely the most cost effective option
Manage Cash Flow Variability	Typically exposes the individual or organization to more variability in cash flows	Important benefit of transfer measures
Maintain an Appropriate Level of Liquidity	Depends on magnitude of losses and structure and management of retention measure, as well as the relative strength of cash flows	Generally reduces the level of liquidity needed
Comply With Legal Requirements	Depends on structure and management of retention measure	Secondary benefit of transfer measures.

The Effect of Frequency and Retention or Transfer Decision		
	Low Frequency	**High Frequency**
Low Severity	Retain	Retain
High Severity	Transfer	Avoid (if possible) Retain (last resort)

The following individual – or organization – specific characteristics can affect the selection of appropriate risk financing measures:

- Risk tolerance
- Financial condition
- Core operations
- Ability to diversify
- Ability to control losses
- Ability to administer the retention plan

- ## Risk Financing Measures

Guaranteed Cost Insurance

Primary layer – The first level of insurance coverage above any deductible

Excess layer – A level of insurance coverage above the primary layer

Excess coverage – Insurance that covers losses above an attachment point, below which there is usually another insurance policy or self-insured retention

Umbrella policy – A policy that provides coverage above underlying policies and may also offer coverage not available in the underlying policies, subject to a self-insured retention

Buffer layer – A level of excess insurance coverage between a primary layer and an umbrella policy.

<table>
<tr><th colspan="3">Multilayered Liability Insurance Program including a Buffer Layer</th></tr>
<tr><td colspan="3">Excess layer 3</td></tr>
<tr><td colspan="3">Excess layer 2</td></tr>
<tr><td colspan="3">Excess layer 1</td></tr>
<tr><td colspan="3">Umbrella policy</td></tr>
<tr><td rowspan="2">General liability
(primary layer)</td><td>Buffer layer</td><td rowspan="2">Employer’s liability
(primary layer)</td></tr>
<tr><td>Auto liability
(primary layer)</td></tr>
</table>

Self-insurance – A form of retention under which an organization records its losses and maintains a formal system to pay for them. Good for high frequency exposures because it is more efficient than filing many claims with an insurer. Requires claim administration services similar to those provided by an insurer including:

- Recordkeeping
- Claim adjustment
- Loss reserving
- Litigation management
- Regulatory requirements
- Excess coverage insurance

Large deductible plan – An insurance policy with a per occurrence or per accident deductible of $100,000 or more. Under a large deductible plan the insurer adjusts and pays all claims, even those below the deductible level. The insurer then seeks reimbursement from the insured for those claism that ball below the deductible.

Captive insurer, or captive – A subsidiary formed to insure loss exposures of its parent company and the parent’s affiliates.

Special Types of Group Captives

Risk Retention Group (RRG) – A group captive formed under the requirements of the Liability Risk Retention Act of 1986 to insured parent organizations.

Rent-a-captive – An arrangement under which an organization rents capital from a captive to which it pays premiums and receives reimbursement for its losses. Each insured keeps its own premium

and loss account, so no risk transfer occurs among the members. However, there is no statutory separation of capital and assets in a rent-a-captive.

Protected cell company (PCC) – A corporate entity separated into cells so that each participating company owns and entire cell but only a portion of the overall company. Similar to a rent-a-captive except that each member is assured that other members and third parties cannot access its assets in the event that any of those other members become insolvent.

Finite risk insurance plan – A risk financing plan that transfers a limited amount of risk to an insurer.

Pool – A group or organizations that insure each other's loss exposures

Retrospective rating plans – a risk financing plan under which an organization busy insurance subject to a rating plan that adjusts the premium rate after the end of the policy period based on a portions of the insured's actual losses during the policy period.

Loss limit – The level at which a loss occurrence is limited for the purpose of calculating a retrospectively rates premium.

Hold-Harmless Agreements – Noninsurance risk transfer measure; that is, a risk financing measure that transfers all or part of the financial consequences of loss to another party, other than an insurer. A hold harmless-agreement can be a stand-alone contract or a clause within a contract.

Capital Market Solutions

Capital market – A financial market in which long-term securities are traded.

Securitization – The process of creating a marketable investment security based on a financial transaction's expected cash flows.

Insurance securitization – The process of creating a marketable insurance-linked security based on the cash flows that arise from the transfer of insurable risks. An example is catastrophe bonds.

Hedging – The purchase or sale of one asset to offset the risks associated with another asset.

Derivative – A financial contract that derives its value from the value of another asset.

Contingent Capital Arrangement – An agreement, entered into before any losses occur, that enables an organization to raise cash by selling stock or issuing debt at prearranged terms after a loss occurs that exceeds a certain threshold.

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Assignment 5: Enterprise-Wide Risk Management

- Traditional Risk Management Versus ERM
  - Traditional risk management is concerned primarily with pure risk
  - ERM emphasizes the interrelationships between pure and speculative risk.
  - The two important benefits provided by the ERM approach verses traditional risk management are:
    - Improved risk communication
    - Enhanced decision making
  - A strong ERM program encourages the by-in of an organization's stakeholders by establishing management strategies that protect the organization's reputation and assets
  - **Business Model –** The core aspects of an organization, including its vision, mission, strategies, infrastructure, policies, offerings, and processes[
  - **Chief Risk Officer –** a generic term for the senior risk professional engaged in ERM in an enterprise; distinct from "Chief Risk Officer," a title given to some risk professionals who report to senior management
  - **Pure Risk –** A chance of loss or no loss, but no chance of gain.
  - **Speculative Risk –** A chance of loss, no loss, or gain.
  - ERM will generally result in management by consensus.

Category	**RM**	**ERM**
Operational risk	Yes	Yes
Financial risk	No	Yes
Strategic risk	Limited to operational strategies	Yes
Strategic integration	Operational only or none – technical risk management	Enterprise-wide
Performance metrics	Activities and results	Metrics appropriate to the eventuality and risk
Organizational penetration	Limited integration: risk handled in silos; operational responsibilities delegated to departments or retained by risk manager	Systemic integration: risk owners at every level; job descriptions; all risks belong to all, not segregated in any one silo
Outcomes	Minimize; mitigate; eliminate risk	Optimize risk

- Improving Strategic Decision Making With ERM
  - Enterprise-wide risk management (ERM) considers the global array of risk that affect an organization, which ban be represented by a three-dimensional depiction of attributes. These attributes are:
    - Resources
    - Events
    - Impacts
  - The enterprise risk manager, who is often called a chief risk officer, typically reports to the organization's chief executive officer (CEO)
  - The chief risk officer helps the enterprise create a risk culture in which individual department heads and project managers are identified as risk owners.
  - The improved decision making that results in an organization that adopts an ERM approach provides increased management accountability.

- ERM in Approaching Business Uncertainties

Sample ERM Goals

- Identify opportunities for and threats to achieving organizational goals
- Incorporate planning to take advantage of opportunities and mitigate threats to the organization
- Anticipate and reduce deviations from expected outcomes
- Anticipate and recognize emerging risks
- Improve business resiliency and sustainability
- Drive consistency in risk taking
- Optimize risk taking, considering appetite and tolerance
- Reduce earnings volatility
- Improve risk management competencies throughout the organization
- Encourage proactive management behavior in treating risks
- Achieve greater stakeholder consensus for risk management
- Increase management accountability and risk-based performance management
- Establish a consistent basis for risk-based decision making and planning
- Enhance the health and safety of employees, customers, and their communities
- Design and enhance appropriate management controls to more effectively and efficiently reduce defects and minimize loss
- Boost internal and external stakeholder confidence and trust
- Enable better-informed governance
- Improve external transparency and risk disclosure
- Comply with relevant legal and regulatory requirements and international norms
- Establish cross-functional and organizational awareness of risks posed in specific geographies

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- Major Risk Management Frameworks and Standards

Standard	Organization	Summary
ISO 31000:2009	International Organization for Standardization	Provides an international standard for risk management as well as a generic approach to risk management applicable within any industry sector. Overall, the standard emphasizes that risk management is integral to an organization's structures, strategies, and goals.
BS 31100	British Standards Institution	Is intended to be a scalable standard that can be used by individuals responsible for risk management activity in organizations of all sectors and sizes as a basis for understanding, developing, implementing, and maintaining proportionate risk management.
COSO II	Committee of Sponsoring Organizations of the Treadway Commission	Provides a mechanism for initiating a dialogue with an organization's board and senior executives about establishing ERM goals as part of the strategic management process. Focuses on threats to the organization and application of controls.
AS/NZS 4360	Standards Australia/Standards New Zealand Joint Technical Committee on Risk Management	Is designed for directors, elected officials, chief executive officers, senior executives, line managers and staff across a wide range of organizations. Builds consultation and communication into the ERM process and includes the entire organization in a collaborative environment.
FERMA	Federation of European Risk Management Association	Elements include: The establishment of consistent terminology, a process by which risk management can be executed, an organized risk management structure, risk management goals. The standard is intended for public and private organizations and recognizes that risk has both an upside and a downside.
Basel II	Basel Committee on Banking Supervision	Establishes an international standard that banking regulators can use when creating regulations regarding the amount of capital banks need to keep in reserve to guard against the financial and operational risks. A purpose of Basel II is to ensure that capital allocation is more risk sensitive.
Solvency II	European Commission	Consists of regulatory requirements for insurance

		firms operating in the European Union. Facilitates the development of a single market in insurance services in Europe.

- Sub-frameworks exist that are not considered to be enterprise wide risk management frameworks, but that provide specific industries and sector with guidance. Space Systems Risk Management is an example of one of these sub-frameworks.

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Assignment 6: Insurance as a Risk Management Technique

- How Insurance Reduces Risk
- Benefits of Insurance

Benefit	**Explanation**	**Example**
Pay for losses	The primary role of insurance is to indemnify individuals and organizations for covered losses.	A factory that burns is rebuilt, restoring employment to the workers and a revenue stream to the investors.
Manage cash flow uncertainty	Insurance provides financial compensation when covered losses occur. Therefore, insurance greatly reduces the uncertainty created by many loss exposures.	A family is able to purchase a home with the assurance that their homeowners policy will compensate them for their investment if a loss occurs.
Comply with legal requirements	Insurance can be used both to meet the statutory and contractual requirements of insurance coverage and to provide evidence of financial resources.	A car owner purchases automobile insurance to meet state financial responsibility requirements.
Promote risk control activity	Insurance policies may provide insureds with incentives to undertake loss control activities as a result of policy requirements or premium savings incentives.	Insurance premiums on an office building are reduced when a sprinkler system is installed.
Efficient use of insured’s resources	Insurance makes it unnecessary to set aside large amounts of money to pay for the financial consequences of risk exposures that can be insured. This allows that money to be used more efficiently.	A business owner is able to use capital to make investments in equipment rather than holding money in reserve for losses that might occur.
Support for insured’s credit.	Insurance facilitates loans to individuals and organizations by guaranteeing that the lender will be paid if the collateral for the loan is destroyed or damaged by an insured event, thereby reducing the lenders uncertainty.	An investment group obtains a loan for the construction of an apartment building. The insurance policy names the mortgage company, which will be compensated to the extent of loan value in the event of a loss.

Source of investment funds	The timing of insurer's cash flows, premiums collected upfront, and claims paid at a later date enable insurers to invest funds.	An insurance company invests in municipal bonds for the construction of schools and public buildings, which supports job growth and community involvement.
Reduces social burden	Insurance helps reduce the burden of uncompensated accident victims to society.	A family breadwinner is injured in an auto accident but is paid by insurer rather than rely on social welfare programs.

- ## Characteristics of an Ideally Insurable Loss Exposure

Characteristic	**Why it is Important**
Pure risk	• Insurance not designed to finance speculative risks • The purpose of insurance is to indemnify the insured for loss • Insureds should not profit from a loss
Fortuitous losses (accidental and unexpected)	• If the insured controls whether a loss occurs, it creates moral hazard • An insurer cannot calculate appropriate premium if the chance of loss increases when a policy is issued
Definite and measurable	• The insurer needs to be able to determine the cause of loss and whether the insured event occurred during the policy period • Insurers cannot determine appropriate premium if they cannot measure the frequency and severity of potential losses

Large number of similar exposure units	• The law of large numbers has the following three criteria:
	  • The events have occurred in the past under substantially identical conditions and have resulted from unchanging, basic causal forces.
	  • The events can be expected to occur in the future under the same unchanging conditions.
	  • The events have been, and will continue to be, independent and sufficiently numerous.

Independent and not catastrophic	• For insurers to use pooling effectively, exposure units must be independent • Pooling works less well if exposure units are correlated • In addition, an insurer should not insure a single loss exposure tat would pose serious financial hardship if a loss occurred
Affordable	• Insurer should be able to charge a premium the insured can pay • If premiums are too high, there will be no demand • Exposures involving low severity, high frequency are generally considered uninsurable due to loss adjustment expenses

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- Insurability of Commercial Loss Exposures

Ideally Insurable Characteristics: Commercial Property loss Exposures			
	Fire Cause of Loss	**Windstorm Cause of Loss**	**Flood Cause of Loss**
Pure Risk	Yes (except arson-for-profit)	Yes	Yes
Fortuitous	Yes (except arson-for-profit)	Yes	Yes
Definite and measurable	Yes	Yes	Yes
Large number of similar exposure units	Depends on property location, property type, and use	Depends on property location, property type, and use	Depends on property location, property type, and use
Independent and not catastrophic	Yes	Can be catastrophic	Can be catastrophic
Premiums are economically feasible	Yes	Depends on location	Depends on location

Ideally Insurable Characteristics: Commercial Liability Loss Exposures		
	Premises and Operations Liability	**Products Liability**
Pure Risk	Yes	Yes
Fortuitous	Yes	Yes
Definite and measurable	Yes	Depends on product
Large number of similar exposure units	Yes	Depends on product
Independent and not catastrophic	Yes	Can be catastrophic
Premiums are economically feasible	Yes	Depends on product

Ideally Insurable Characteristics: Commercial Personal Loss Exposures		
	Death	**Retirement**
Pure Risk	Yes	Yes
Fortuitous	Yes	Depends on circumstances and personnel involved

Definite and measurable	Depends on personnel involved	Depends on personnel involved
Large number of similar exposure units	Depends on personnel involved	Depends on personnel involved
Independent and not catastrophic	Yes	Yes
Premiums are economically feasible	Yes	N/A

Ideally Insurable Characteristics: Commercial Net Income Loss Exposures		
	Net income loss associated with property losses	**Net income loss associated with liability losses**
Pure Risk	Yes	Yes
Fortuitous	Yes	Yes
Definite and measurable	Yes	May no be definite
Large number of similar exposure units	Yes	Yes
Independent and not catastrophic	May be catastrophic	Yes
Premiums are economically feasible	Yes	N/A

- Insurability of Personal Loss Exposures

Ideally Insurable Characteristics: Personal Property loss Exposures			
	Fire Cause of Loss	**Windstorm Cause of Loss**	**Flood Cause of Loss**
Pure Risk	Yes (except arson-for-profit)	Yes	Yes
Fortuitous	Yes (except arson-for-profit)	Yes	Yes
Definite and measurable	Yes	Yes	Yes
Large number of similar exposure units	Yes	Yes	Yes
Independent and not catastrophic	Yes	Can be catastrophic	Can be catastrophic
Premiums are economically feasible	Yes	Depends on location	Depends on location

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Ideally Insurable Characteristics: Personal Liability Loss Exposures		
	Premises Liability	**Automotive Liability**
Pure Risk	Yes	Yes
Fortuitous	Yes	Yes
Definite and measurable	Yes	Yes
Large number of similar exposure units	Yes	Yes
Independent and not catastrophic	Yes	Yes
Premiums are economically feasible	Yes	Yes

Ideally Insurable Characteristics: Personal Net Income Loss Exposures	
	Unemployment cause of loss
Pure Risk	Yes
Fortuitous	Depends on person involved
Definite and measurable	Yes
Large number of similar exposure units	Yes
Independent and not catastrophic	Yes
Premiums are economically feasible	Yes

Ideally Insurable Characteristics: Personal Life, Health and Retirement Loss Exposures			
	Life	**Health**	**Retirement**
Pure Risk	Yes	Yes	Yes
Fortuitous	Yes (except for suicide)	Depends on cause of loss	No usually, but may be forced retirement
Definite and measurable	Yes	Depends on cause of loss	Yes
Large number of similar exposure units	Yes	Yes	Yes
Independent and not catastrophic	Yes	Yes	Yes
Premiums are economically feasible	Usually	Usually	N/A

- Government Insurance Programs
  - Rationale for Government Involvement
    - To fill insurance needs unmet by private insurers

- To compel people to buy a particular type of insurance
- To obtain greater efficiency and/or provide convenience to insurance buyers To achieve collateral social purposes

- Levels of Government Involvement
  - Exclusive insurer
  - Partner with private insurers
  - Competitor to private insurers
- Federal Compared with State Programs

Examples of Property-Liability Insurance Offered by the Federal Government		
Plan	**Characteristics of Government Plan**	**Relationship to Private Insurance**
National Flood Insurance Program	• Meets previously unmet needs to flood insurance • Serves the social purposes of amending and enforcing building codes and reducing new construction in flood zones	• Federal government can act as primary insurer • Federal government can partner with private insurers. Private insurers sell the insurance and pay claims; government reimburses insurers for losses not covered by premiums and investment income.
Terrorism Risk Insurance Program	• Designed to temporarily meet the unmet needs for a backstop to insured terrorism losses. • Serves the social purpose of preventing economic disruptions that market failure in terrorism coverage could have caused	• Private insurers act as the primary insurer for terrorism coverages • Federal government temporarily acts as reinsurer for terrorism coverage
Federal Crop Insurance	• Provides crop insurance at affordable rates to reduce losses that result from unavoidable crop failures • Covers most crops for perils such as drought, disease, insects, excess	• Federal government subsidizes and reinsures private insurers; private insurers sell and service federal crop insurance. • Private insurers also independently offer crop insurance for certain

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	rain, and hail.	perils

Examples of Property-Liability Insurance Offered by State Governments		
Plan	**Characteristics of Government Plan**	**Relationship to Private Insurance**
Fair Access to Insurance Requirements (FAIR) Plans	• Make basic property insurance available to property owners who are otherwise unable to obtain insurance because of their property's location or any other reason	• Organization varies by state. Typically it is an insurance pool. Through which private insurers collectively address an unmet need for property insurance on urban properties. • Does not replace normal channel of insurance, is only consumers who could not obtain coverage in the private market.
Workers Compensation Insurance	• Helps employers meet their obligations under state statues to injured workers.	• Private insurers provide most workers' compensation insurance. • State government can operate as an exclusive insurer, as a competitor to private insurers, or as a residual market
Beach and Windstorm Plans	• Mark property insurance against the windstorm cause of loss available to property owners who are otherwise unable to obtain insurance because of their property's location.	• Organization varies by state: some states are insurance pools of private insurers; other states are ultimately guaranteed with taxpayer funds. • Does not replace normal channels of insurance; is only for consumers who could not obtain coverage in the private market
Residual Auto Plans	• Make compulsory	• Organization varies by

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	automobile liability coverage available to high-risk drivers who have difficulty purchasing coverage at reasonable rate in the private market	state. Typically it is an insurance pool through which private insurers collectively address an unmet need for compulsory auto liability coverage. • Does not replace normal channels of insurance; is only for consumers who could not obtain coverage in the private market.

Assignment 7: Insurance Policy Analysis

- ## Distinguishing Characteristics of Insurance Policies

  The distinguishing characteristics of insurance policies are indemnity, utmost good faith, fortuitous losses, contract of adhesion, exchange of unequal amounts, conditional, non-transferable.

  - Indemnity

    Principle of indemnity – The principle that insurance policies should compensate the insured only for the value of the loss.

    Contract of indemnity – A contract in which the insurer agrees, in the event of a covered loss, to pay an amount directly related to the amount of the loss

    Despite the fact that some policies do not adhere to the principal of indemnity (i.e. valued policies); in order to reduce or avoid moral hazards, insurance policies should *not* do either of the following:

    - Overindemnify the insured
    - Indemnity insured more than once per loss

      Collateral source rule – A legal doctrine that provides that the damages owed to a victim should not be reduced because the victim is entitled to recovery money from other sources, such as an insurance policy.

  - **Utmost Good Faith** – An obligation to act with complete honesty and to disclose all relevant facts.
  - **Fortuitous Losses –** Losses that happen accidentally or unexpectedly. For a loss to be fortuitous, reasonable uncertainty must exit about its probability or timing.
  - **Contract of adhesion** – A contract to which one party must adhere as written by the other party.
    - Courts have ruled that any ambiguities or uncertainties in contracts are to be construed against the party who drafted the agreement because that party had the opportunity to express its intent clearly and unequivocally in the agreement.
    - In cases concerning insurance policies, the level of sophistication of the insured has had the following effects on court decisions:
      - *Unsophisticated insured.* Usually, the insurer has drafted a ready-made policy and the insured has little or no control over the policy's wording. This is true of most homeowners and personal auto insurance policies. Ambiguities in these cases are typically interpreted against the insurer. This is the case for most personal insurance consumers.
      - *Sophisticated insured*. In a minority of cases, the insured (or its representatives) draft all or part of the insurance policy. Alternatively, the insurer and a sophisticated insured negotiate the policy working. In these cases, the contract of adhesion doctrine may not apply. Courts do no necessarily interpret any ambiguity in the insured's favor if the insured had some understanding and ability to alter the policy working before entering

the agreement. Sophisticated insured include many medium to large organization with dedicated risk management functions.

- **Reasonable expectations doctrine –** A legal doctrine that provides for an ambiguous insurance policy clause to be interpreted in the way that an insured would reasonably expect.

- Exchange of Unequal Amounts – For insurance policies, the consideration offered by the insured is the premium; the consideration offered by the insurer is the promise to indemnify the insured in the event of a covered loss. There is no requirement that the amounts exchanged be equal in value. In most insurance policies, the tangible amounts exchanged, the premium from the insured, and any payments made by the insurer, will be unequal.
- Conditional
  - **Conditional contract** – A contract that one or more parties must perform only under certain conditions.
- Nontransferable – Insurance policies are sometimes referred to as "personal contracts" to indicate their nontransferable or nonassignable nature. An insurance policy is a contract between two parties; the insured cannot assign (transfer) the policy to a third party without the insurer's written consent.

Characteristic	Notes

Indemnity	• Policies should compensate only for the value of the loss
	• Policyholder should not profit from insurance
	• Insurance policies are contracts of indemnity; however:
	  • They include limits, deductibles, and other limitations
	  • They do not indemnify for nonfinancial expenses (e.g. lost time)
	  • How the loss is valued determines the level of indemnity
	• Some policies violate principle of indemnity (e.g. valued policy)
	• Should not overindemnify, or indemnify more than once per loss
	• Sometimes duplicate coverage is available and justifiable (i.e. collateral source rule)

Utmost good faith	• Obligation to act with complete honesty and to disclose all relevant facts • If an insured conceals/misrepresents a material fact, or commits fraud, the insurance policy can be voided • An insurer must fulfill promises outlined in the policy (i.e. investigate and pay claims promptly); failure exposes insurers to legal liability • Most common violations of utmost good faith: fraud, buildup of claims filed by insureds
Fortuitous losses	• Losses that happen accidentally or unexpectedly • For insurance, loss must be fortuitous from insured's standpoint • Not all fortuitous losses are covered (e.g. wear and tear) • Some nonfortuitous losses are covered (e.g. losses outside policy period but

	after retroactive date on "claims made" liability policy)

Contract of adhesion	• A contract to which one party must adhere as written by the other party
	• Insurance typically involve little or no negotiation
	• Insurer chooses the wording and insured can "take it or leave it"
	• Courts construe ambiguities against the party who drafted the wording
	  • Ambiguities involving unsophisticated insureds are construed against the insurer
	  • With sophisticated insureds, contract adhesion doctrine may not apply
	• Reasonable expectations doctrine provides for ambiguous policy clauses to be interpreted in the way that an insured would reasonably expect

Exchange of unequal amounts	• Consideration offered by insured is the premium; consideration offered by the insurer is promise to indemnify; amounts not of equal value • In insurance, tangible amounts exchanged will be unequal • However, when both tangible and intangible amounts are considered, values exchanged are closer • Equitable distribution of risk costs - insured's premium should be commensurate with risk presented to insurer • Finite risk policies involve exchange of amounts closer in value
Conditional	• A contract that one or more parties must perform only under certain conditions • Insurer is obliged to pay covered losses only if insured has fulfilled all policy conditions • Exception: when insurer is willing to waive some of the conditions
Nontransferable	• Insurance policies are "personal contracts" • Not transferable or assignable by insured (i.e. exceptions xxx death • Are transferable by insurer (e.g. sale to another insurer)

- ## Structure of Insurance Policies

Monoline policy – An insurance policy that covers a single type of insurance.

Package policy – An insurance policy that covers more than one type of insurance.

Coverage part – One or more forms that together provide coverage for a line of insurance.

- Self-Contained and Modular Policies
  Self-contained policy – A single document that contains all the agreements between the insured and the insurer and that forms a complete insurance policy.
  Modular policy – An insurance policy that consists of several different documents, none of which by itself forms a complete policy.

- Preprinted Forms – Most insurance policies are assembled from one or more preprinted forms and endorsements. Preprinted forms are developed for use with many different insureds. Therefore, they refer to the insured in general terms (such as “the insured” or “You”) so that the forms can be used in multiple insurance policies without customization. The declarations page then adds the specific information about the insured that customizes the insurance policy.
  - Standard Forms – An insurer may use the standard forms that are also used by other insurers. Insurance service and advisory organizations, such as ISO and the American Association of insurance Services (AAIS), have developed standard insurance form for use by individual insurers.
  - Many insurers have developed their own company-specific preprinted forms, especially for high-volume lines of insurance (such as auto or homeowners) or for coverage in which the insurer specializes (such as recreational vehicle insurance). Nonstandard forms include provisions that vary from standard-form provisions and often contain coverage enhancements not found in standard forms.
- **Manuscript Forms** – An insurance policy form that is drafted according to terms negotiated between a specific insured (or group of insureds) and an insurer.
- Related Documents – Several other documents can become part of an insurance policy, either by being physically attached or by being referenced within the policy. Examples include the completed insurance application, endorsements, the insure’s bylaws, and the terms of relevant statutes.
  - Because endorsements are usually intended to modify a basic policy form, the endorsement provisions often differ from basic policy provisions. This difference can lead to questions of policy interpretation. The following two general rules of policy interpretation apply to endorsements:
    1. An endorsement takes precedence over any conflicting terms in the policy to which it is attached.
    2. A handwritten endorsement supersedes a computer-printed or typewritten one. Handwritten alterations tend to reflect true intent more accurately than to preprinted policy terms.

- Policy Provisions

Categories of Property-Casualty Insurance Policy Conditions		
Category	**Description**	**Effect on Coverage**
Declarations	Unique information on the insured; list of forms included in policy	Outline who or what is covered, and where and when coverage applies.
Definitions	Words with special meanings in policy	May limit or expand coverage based on definitions of terms.
Insuring Agreements	Promise to make payment	Outline circumstances under which the insurer agrees to pay

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Conditions	Qualifications on promise to make payment	Outline steps insured needs to take to enforce policy
Exclusions	Limitations on promise to make payment	Limit insurer's payments based on excluded persons, places, things, or actions
Miscellaneous Provisions	Wide variety of provisions that may alter policy	Deal with the relationship between the insured and the insurer or establish procedures for implementing the policy.

- Declarations
  - Policy or policy number
  - Policy inception and expiration dates (policy period)
  - Name of the insurer
  - Name of the insurance agent
  - Name of the insured(s)
  - Names of persons or organization whose additional interest are covered (for example, a mortgagee, a loss payee, or an additional insured)
  - Mailing address of the insured
  - Physical address and description of the covered property or operations.
  - Numbers and edition dates of all attached forms and endorsements
  - Dollar amounts of applicable policy limits
  - Dollar amounts of applicable deductibles
  - Premium
- Definitions – Usually at the beginning for personal lines policies and at the end for commercial lines policies. Boldface type or quotation marks are typically used to distinguish words and phrases that are defined elsewhere in the policy.
- **Insuring agreement** – A statement in an insurance policy that the insurer will, under certain circumstances, make a payment or provide a service. The term "insuring agreement" is usually applied to statements that introduce a policy's coverage section. However, "insuring agreement" can also be used to describe statement introducing coverage extension, additional coverages, supplementary payments, and so on.
  - Scope of Insuring Agreements – Insuring agreements can be divided into the following two broad categories:
    1. *Comprehensive, all-purpose insuring agreements.* This category provides extremely broad, unrestricted coverage that applies to virtually all causes of loss or to virtually all situations. This broad coverage is both clarified and narrowed by exclusions, definitions, and other policy provisions.
    2. *Limited or single*-purpose insuring agreements. Insuring agreements in this category restrict coverage to certain causes of loss or to certain situations. Exclusions,

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definitions, and other policy provisions service to clarify and narrow coverage, but may also broaden the coverage.

- Insuring Agreements for Secondary or Supplemental Coverages – Many insurance policies include secondary or supplemental coverages in addition to the main coverage in the insuring agreement. The coverages are described by terms such as “coverage extensions,” “additional coverages,” or “Supplementary payments.” Generally, a “coverage extension” extends a portion of the basic policy coverage to apply to a type of property or loss that would not otherwise be covered. An “additional coverage” adds a type of coverage not otherwise provided. “Supplementary payments” clarify the extent of coverage for certain expenses in liability insurance. All of these coverages are considered insuring agreements. However, the labels for such coverage vary by policy.
- Other Provisions Functioning as Insuring Agreements – Other policy provisions may also serve as insuring agreements by granting or restoring coverage otherwise excluded. These ther policy provides could be anywhere in the policy. Examples include the exception of “mobile equipment” in the auto exclusion of the CGL policy and an exception to liquor liability exclusion for business that are not involved in the DRAM shop business.

- Conditions

  <u>Policy Condition</u> – Any provision in an insurance policy that qualifies an otherwise enforceable promise of the insurer. Some policy conditions are found in a section of the policy title “Conditions,” whereas others are found in the forms, endorsements, or other documents that constitute the policy.

- Exclusions

  Six Purposes of Exclusions

  1. Eliminate coverage for uninsurable loss exposures – Some loss exposures (such as war) possess few if any of the ideal characteristics of an insurable loss exposure. Exclusion allow insurers to preclude coverage for these loss exposures.
  2. Assist in managing moral and morale hazards – Some insureds’ behavior is altered when they purchase insurance. Exclusions enable insurers to limit the moral and morale hazard incentive by limiting coverages for causes of loss over which the insured had some control.
  3. Reduce likelihood of coverage duplications – In some cases, two insurance policies provide coverage for the same loss. Exclusions ensure that two policies work together to provide complementary, not duplicate, coverage and that insureds are not paying duplicate premiums.
  4. Eliminate coverage not needed by the typical insured – Exclusions allow insurers to exclude coverage for loss exposures not faced by the typical insured. This means that all insured would not have to share the costs of covering the loss exposures that relatively few insured have.

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5. Eliminate coverages requiring special treatment – Exclusions eliminate the coverage that require rating, underwriting, loss control, or reinsurance treatment substantially different from what is normally required by the insurance policy.
6. Assist in keeping premiums reasonable – Exclusions allow insurer to preclude risks that would otherwise increase costs. By keeping costs down, insurers can offer premium that a sufficiently large number of insurance buyers consider reasonable.

- Miscellaneous Provisions – Often are unique to particular types of insurers, as in the following examples:
  - A policy issued by a mutual insurer is likely to describe each insured's right to vote in the election of the board of directors.
  - A policy issued by a reciprocal insurer is likely to specify the attorney-in-fact's authority to implement its power on the insured's behalf.

- Policy Analysis
  - Pre-Loss Policy Analysis – Insureds should conduct pre-loss policy analysis to ensure that the insurance policy being purchased is appropriate for their loss exposures. Determining whether and how much coverage applies before a loss has occurred can be extremely difficult. Pre-loss policy analysis require a wide range of skills, including the following:
    - Understanding the alternative ways in which insurance policies customarily describe coverage in addressing loss exposures.
    - Identifying and evaluating insurance policy provisions that depart from the customary approach
    - Understanding the loss exposure or loss exposure to which the policy applies
  - Post-Loss Policy Analysis – After a loss occurs, an individual can analyze a policy to determine if the loss is covered by answering the following six questions.
    1. Does an enforceable insurance policy exist?
    2. Did the loss occur to an insured party who has an insurable interest
    3. Has the insured met all policy conditions?
    4. Has an insured even occurred?
    5. What dollar amount, if any, is payable?
    6. Do any external factors affect the claim?

    If the answer to any of questions 1 through 4 is no, then the insurance policy does not provide coverage. Questions 5 and 6 determine how much is payable under an insurance policy that does provide coverage.
    - DICE Review – The DICE acronym represent four of the six categories of property-casualty policy provisions

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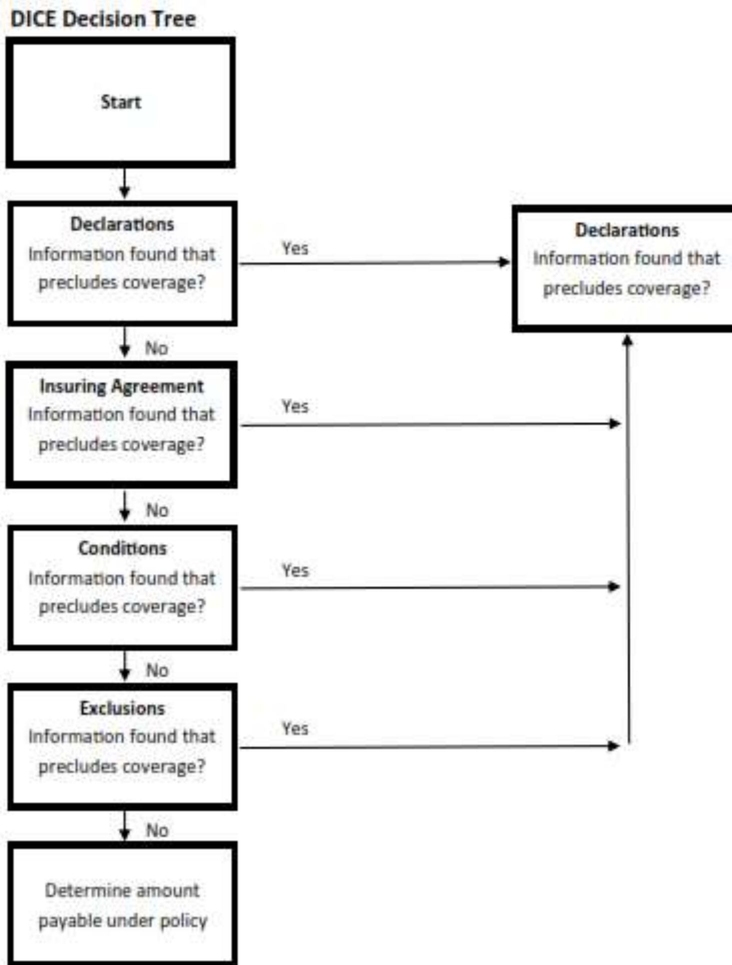

- Determining Amounts Payable – After using the DICE method to determine whether the claim is covered, the next step is to determine how much is payable under that insurance policy. The amount payable under a given insurance policy can be affected no only by the value of the loss but also by policy limits and deductibles, self-insured retentions, valuation provisions, co-insurance provisions, negotiated settlement for liability losses, and other conditions.

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Assignment 8: Common Policy Concepts

- Insurable Interest

Insurable Interest – An interest in the subject of an insurance policy that is not unduly remote and that would cause the interested party to suffer financial loss if an insured event occurred. The policy provision of insurable interest is designed to ensure that the insured is actually exposed to potential loss. The following is the insurable interest policy provision from the ISO HO-3 policy:

SECTION 1 – CONDITIONS

A. Insurable Interest And Limit of Liability

Even if more than one person has an insurable interest in the property covered, we will not be liable in any one loss:

1. To an "insured" for more than the amount of such "insured's" interest at the time of loss; or
2. For more than the applicable limit of liability.

- Reasons for Insurable Interest Requirement
  1. It supports the principal of indemnity
  2. It prevents the use of insurance as a wagering mechanism
  3. It reduces the moral hazard incentive that insurance may create for the insured.
- Basics of Insurable Interest
  - Ownership interest in property
  - Contractual obligation
    1. *Contractual rights regarding persons.* A contract may give a party the right to bring a claim against a second party without entitle the first party to make a claim against any specific property belonging to the second party. For example, if Anthony does not pay his credit card debt, the credit card company can bring a claim against Anthony for the outstanding amount but does not have the right to repossess any of Anthony's property as payment for the debt. In this situation, the credit card company is an unsecured creditor. Unsecured creditors do not have insurable interest in debtor's property
    2. *Contractual rights regarding property.* Some contracts allow one party to bring a claim against specific property held by the second party. For instance, if Anthony purchases an auto subject to a secured loan, the lender may repossess the car if Anthony fails to make payments. This type of contract generally creates an insurable interest in the secured property equal to the debt's remaining balance.
  - Exposure to legal liability

Sometimes property is not owned by a party but that party still has legal responsibility for, or financial interest in, the property. Examples include:

- A hotelkeeper has an insurable interest in guests' property.
- A tenant has an insurable interest in the portion of the premises the tenant occupies.
- A contractor typically has an insurable interest in the building under construction.

- **Factual expectancy** – A situation in which a party experiences an economic advantage if an insured event does not occur or, conversely, economic harm if the vent does occur.
- Representation of another party
  - *Agents.* An agent may insured property in the agent's name for the principal's benefit. Although the insurance proceeds are ultimately payable to the principal, the agent has an insurable interest.
  - *Trustees.* A trustee may insure property in the trustee's name for the trust's benefit. The trustee has an insurable interest but must give the insurance proceeds to the trust.
  - *Bailees.* A bailee may insure property in the bailee's name for the bailor's benefit. The bailee has an insurable interest and then pays the insurance proceeds to the bailor

- .Multiple Parties With Insurable Interest

  Both a mortgagee and homeowner have an insurable interest. Property may also be jointly owned under one of the following interest:
  - **Joint tenancy** – A concurrently owned an undivided interest in an estate that transfers to a surviving joint tenant upon the death of the other.
  - **Tenancy by the entirety** – A joint tenancy between husband and wife
  - **Tenancy in common** – A concurrent ownership of property, in equal or unequal shares, by two or more joint tenants who lack survivorship rights.
  - **Tenancy in partnership** – A concurrent ownership by a partnership and its individual partners of personal property used by the partnership.

- ## Insurance to Value

Insurance to Value – The choice of a limit in property insurance that approximates the maximum potential loss.

Industry Language – Insurance to Value, Coinsurance, and Insurance-to-Value

The property policy limit chose should be close to the value of the insured property. Many insurance professionals call this fully insuring the property, but it is also called insurance to value. The term insurance to value is often confused with provisions in homeowners and businessowners insurance policies called insurance-to-value provisions. The distinction is important. Insurance to value (without hyphens) refers to

the provisions in specific property insurance policies that determine the amounts payable by the policy based on the relationship between the policy limit and the insured property's value. Insurance-to value provisions are similar to coinsurance provisions in commercial property insurance policies. They both are based on the relationship between policy limits and the insured property's value. However, they determine the amounts payable using different formulas.

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- Coinsurance Formula

$$\text{Amount Payable} = \frac{\text{Limit of insurance}}{\text{Value of Covered Property (at time of loss)} \times \text{Coinsurance percentage}} \times \text{Total amount of Covered Loss}$$

Insurance students often remember this formula as "did over should times loss," which can be written as follows

$$\text{Amount Payable} = \frac{\text{Did}}{\text{Should}} \times \text{Loss}$$

Where

"did" = The amount of insurance carried (the policy limit, and

"should = The minimum amount that should have been carried to meet the coinsurance requirement based on the insurable value at the time of loss.

The following three points are crucial in apply the coinsurance formula:

1. Applying the coinsurance formula is necessary only when the coinsurance requirement is not met, because the policy limits are less than the insurable value multiplied by the coinsurance percentage. In other words, the coinsurance penalty applies only when the "did" is less than the "should." If the coinsurance requirement is met ("did" is greater than or equal to "should"), the amount payable is the full loss amount, subject to the deductible, applicable policy limits, and other relevant policy provisions.
2. The insurer never pays more than the loss amount. If the amount of insurance carried is greater than the minimum policy limit required ("did" is great than or equal to "should"), the coinsurance formula itself would indicate that the insurer should pay more than the loss amount.
3. The insurer never pays more than the applicable policy limits. If the loss amount is greater than the minimum policy limits required by the coinsurance clause ("loss" is great than "should"), the formula might indicate that the insurer would pay more than the policy limits. However, the insurer's obligation would not exceed the applicable policy limits.

- Insurance-to-Value Provisions in Homeowners and Business owners Policies
  Despite similarities, the insurance-to-value provisions in homeowners and businessowners policies are different from coinsurance. With insurance-to value provisions, the amount payable by the insurer will not be less than the ACV (subject to policy limits). The advantage of the insurance-to-value requirement compared with the coinsurance requirement is that the penalty for underinsurance is limited.

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- Property Valuation Methods

Method	**Description**	**Notes**
Actual cash value (ACV)	Replacement cost at the time of the loss minus depreciation (i.e. reduction in value due to wear and tear, or obsolesce)	• Replacement cost minus depreciation • Market value (i.e. price at which property could be sold on the open market by an unrelated buyer and seller) • Broad evidence rule (i.e. based on court decisions that require all relevant factors to be considered) • Insurance to value = ACV
Replacement cost	The current cost or repairing or replacing damaged property or of buying or building new property of like kind and quality even if this exceeds the original purchase price	• Does not apply to certain types of property (e.g. antiques, art are valued at ACV using current market value) • Some policies require the insured to rebuild with identical construction, at the same location, and for the same purpose or depreciation is deducted • Some policies allow insured to settle for ACV and refile for replacement cost within 180 days • Insurance to value = replacement cost
Agreed value	The insurer and the insured agree on the value of the insured object and state it in a policy schedule	• Typically used for antiques, paintings or other items for which a value can be difficult to determine • If a total loss occurs, insurer pays agreed value • Partial losses are paid on ACV, repair cost, replacement cost, or whatever other valuation method the policy specifies
Functional valuation	Determines the value of the property by comparing it to the cost of property that can perform the same function even if it is not identical	• Used when replacing buildings or personal property with property of like kind and quality is not practical and when ACV method does not meet insurance needs

- Reasons for Property Insurance Deductibles
  - Reduces moral and morale hazard incentives and encourage risk control by the insured
  - Eliminate the need for the insurer to process small losses, thereby reducing the insurer's loss costs and loss adjustment expenses

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Dollar trading – An insurance premium and loss exchange in which the insured pays the insurer premiums for low value losses, and the insurer pays the same dollars back to the insured, after subtracting expenses.

- Liability Deductibles and Self-Insured Retentions

Per event deductible – A deductible that applies to each item, each location, each claim, or each occurrence.
Aggregate deductible – A deductible that applies collectively to all losses occurring during a specific period, typically a policy year.
Straight deductible – A dollar amount the insurance must pay toward a covered loss.
Split deductible – A deductible provision that applies one deductible for most causes of loss but a different, higher deductible for other specified causes of loss.
Percentage deductible – A deductible expresses as a percentage of some other amount, such as the amount of insurance, the covered property's value, or the amount of the loss.
Time deductible – A deductible expressed in terms of the time delay between when a loss occurs and when coverage begins.

- Other Sources of Recovery

Source	Notes

Noninsurance agreements	• Examples:
	  ◦ Lease contract or bailment agreement
	  ◦ Credit card protection plan
	  ◦ Extended warranty

Negligent third parties	• A first-party right of recovery does not eliminate the responsible third party's obligation to pay • A first-party insurer cannot deny a claim because of the liable third party's obligation to pay • Most first-party policies have provisions that address duplicate recovery; "subrogation" • If the third party or that party's insurer pays, the insured is required to reimburse his or her insurer

Other insurance in the same policy	• Property and/or liability policies may provide two or more coverages under the same policy
	• Examples:
	  ◦ Scheduled personal property also covered under unscheduled personal property
	  ◦ A crime form and building form that both cover building damage by burglars
	  ◦ Property (e.g. fire extinguishing equipment) that qualifies for coverage a both part of the building and personal property

	◦ Injured passenger with first-party medical coverage and coverage under the responsible driver's liability insurance • If the multiple coverage available have different valuation provisions, amounts recoverable differ • Policy provisions can limit or specify which coverage applies
Other insurance in a similar policy	• Coverage overlaps can occur because the same party is protected by two or more policies usually issued by different insurers • These situations are often resolved with each insurer sharing some portion of the loss
Other insurance in dissimilar policies	• A loss is often covered by more than one type of insurance, often from two or more insurers • Examples: ◦ A utility trailer that might be covered under both the homeowner's liability and the personal auto liability policies of its owner ◦ Valet parking that might be covered under both the company's general liability and commercial auto liability • Dissimilar insurance policies do not necessarily include provisions that clearly coordinate coverage with other types of policies • Relationships between the policies can be governed by "other insurance" provisions