

FN241: Session 3-2

Legal Principles and
Analysis of Insurance Contracts

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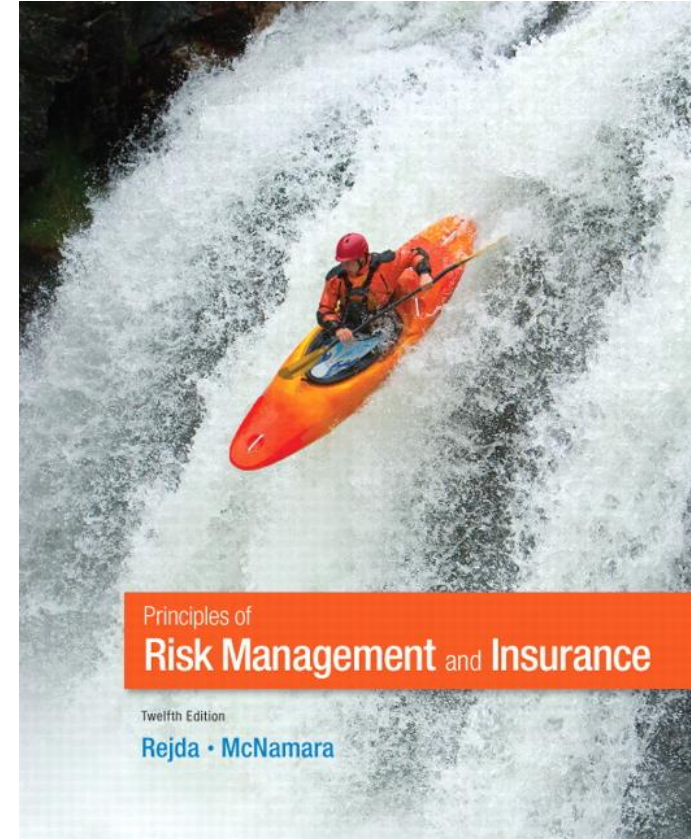
Bachelor of Economics, International Program

Thammasat University

Reading

George, E. Rejda, and Michael McNamara,
“Principal of Risk Management and Insurance”,
Pearson; 12th Edition (2013).

Chapter: 9-10



Legal Principles in Insurance

Principle of Indemnity

The insurer agrees to pay no more than the actual amount of the loss

- Purpose:
 - To prevent the insured from profiting from a loss
 - To reduce moral hazard

Principle of Insurable Interest

The insured must stand to lose financially if a loss occurs

- Purpose:
 - To prevent gambling
 - To reduce moral hazard
 - To measure the amount of loss
- When must insurable interest exist?
 - Property insurance: at the time of the loss
 - Life insurance: only at inception of the policy

Principle of Subrogation

Substitution of the insurer in place of the insured for the purpose of claiming indemnity from a third person for a loss covered by insurance.

- Purpose:
 - To prevent the insured from collecting twice for the same loss
 - To hold the negligent person responsible for the loss
 - To hold down insurance rates

Principle of Utmost Good Faith

A higher degree of honesty is imposed on both parties to an insurance contract than is imposed on parties to other contracts

- Supported by three legal doctrines:
 - Representations are statements made by the applicant for insurance
 - A concealment is intentional failure of the applicant for insurance to reveal a material fact to the insurer
 - A warranty is a statement that becomes part of the insurance contract and is guaranteed by the maker to be true in all respects

Example: Indemnity and Insurable Interest

1) Actual Cash Value Policy:

- Ashley purchased a dining room set for \$5000 and insured the furniture on an actual cash value basis. Three years later, the set was destroyed in a fire. At the time of loss, the property had depreciated in value by 50 percent. The replacement cost of a new dining room set at the time of loss was \$6000. Ignoring any deductible, how much will Ashley collect from her insurer? Explain your answer.
- Nicholas owns a laptop computer that was stolen. The laptop cost \$1000 when it was purchased five years ago. A similar laptop computer today can be purchased for \$500. Assuming that the laptop was 50 percent depreciated at the time the theft occurred, what is the actual cash value of the loss?

Example: Indemnity and Insurable Interest

2) Valued Policy:

- Megan owns an antique table that has a current market value of \$12,000. The table is specifically insured for \$12,000 under a valued policy. The table is totally destroyed when a tornado touches down and damages Megan's home. At the time of loss, the table had an estimated market value of \$10,000. How much will Megan collect for the loss? Explain your answer.

Example: Indemnity and Subrogation

- A drunk driver ran a red light and smashed into Kristen's car. The cost to repair the car is \$8000. She has collision insurance on her car with a \$500 deductible.
 - Can Kristen collect from both the negligent driver's insurer and her own insurer?
Explain your answer.
 - Explain how subrogation supports the principle of indemnity.

Analysis of Insurance Contracts

Agenda

- Basic parts of an insurance contract
- Definition of the “Insured”
- Endorsements and Riders
- Deductibles
- Coinsurance
- Other-insurance provisions

Basic Parts of an Insurance Contract

- **Declarations** are statements that provide information about the particular property or activity to be insured
- Insurance contracts typically contain a page or section of **definitions**
- The **insuring agreement** summarizes the major promises of the insurer
- Insurance contracts contain three major types of **exclusions**
 - Excluded perils, e.g., flood, intentional act
 - Excluded losses, e.g., a professional liability loss is excluded in the homeowners policy
 - Excluded property, e.g., pets are not covered as personal property in the homeowners policy

Basic Parts of an Insurance Contract

- Exclusions are necessary because:
 - Some perils are not commercially insurable
 - e.g., catastrophic losses due to war
 - Extraordinary hazards are present
 - e.g., using the automobile for a taxi
 - Coverage is provided by other contracts
 - e.g., use of auto excluded on homeowners policy
 - Moral hazard is present or it would be difficult to measure the amount of loss
 - e.g., coverage of money limited to \$200 in homeowners policy
 - Coverage not needed by typical insureds
 - e.g., homeowners policy does not cover aircraft

Definition of the “Insured”

- An insurance contract must indicate the persons or persons from whom the protection is provided
 - Some policies insure only one person, e.g., most life insurance policies
 - The named insured is the person or persons named in the declarations section of the policy
 - A policy may cover other parties even though they are not specifically named
 - e.g., the homeowners policy covers resident relatives under age 24 who are full-time students away from home

Endorsements and Riders

- In property and liability insurance, an endorsement is a written provision that adds to, deletes from, or modifies the provisions in the original contract
 - e.g., an earthquake endorsement to a homeowners policy
- In life and health insurance, a rider is a provision that amends or changes the original policy
 - e.g., a waiver-of-premium rider on a life insurance policy

Deductibles

- A deductible is a provision by which a specified amount is subtracted from the total loss payment that otherwise would be payable
- The purpose of a deductible is to:
 - Eliminate small claims that are expensive to handle and process
 - Reduce premiums paid by the insured
 - Under the large loss principle, insurance should pay for high severity losses; small losses can be budgeted out of the person's income
 - Reduce moral and morale hazard

Deductibles

- With a straight deductible, the insured must pay a certain amount before the insurer makes a loss payment - e.g., an auto insurance deductible
- An aggregate deductible means that all losses that occur during a specified time period are accumulated to satisfy the deductible amount

In health insurance

- A calendar-year deductible is a type of aggregate deductible that is found in basic medical expense and major medical insurance contracts
- A corridor deductible is a deductible that can be used to integrate a basic medical expense plan with a supplemental major medical expense plan
- An elimination (waiting) period is a stated period of time at the beginning of a loss during which no insurance benefits are paid

Deductibles: Example

A manufacturing firm incurred the following insured losses, in the order given, during the current policy year.

Loss	Amount of Loss
A	\$ 2500
B	3500
C	10,000

How much would the company's insurer pay for each loss if the policy contained the following type of deductible?

1. \$1000 straight deductible
2. \$15,000 annual aggregate deductible

Coinsurance

- The purpose of coinsurance is to achieve equity in rating
 - A property owner wishing to insure for a total loss would pay an inequitable premium if other property owners only insure for partial losses
 - If the coinsurance requirement is met, the insured receives a rate discount, and the policyowner who is underinsured is penalized through application of the coinsurance formula

Coinsurance

- A coinsurance clause in a property insurance contract encourages the insured to insure the property to a stated percentage of its insurable value
 - If the coinsurance requirement is not met at the time of the loss, the insured must share in the loss as a coinsurer

$$\frac{\text{Amount of insurance carried}}{\text{Amount of insurance required}} \times \text{Loss} = \text{Amount of recovery}$$

Example: assume that a commercial building has an actual cash value of \$1,000,000 and that the owner has insured it for only \$600,000. If an 80 percent coinsurance clause is present in the policy. If a replacement cost policy is used, the required amount of insurance would be based on replacement cost. What will the recovery be paid by the insurer?

Coinsurance

Insurance to Full Value

Assume that 2000 buildings are valued at \$200,000 each and are insured to full value for a total of \$400 million of fire insurance. The following fire losses occur:

2 total losses = \$ 400,000

30 partial losses at \$20,000 each = \$ 600,000

Total fire losses paid by insurer = \$1,000,000

Pure premium rate = $\frac{\$1,000,000}{\$400,000,000}$

= 25 cents per \$100
of insurance

Coinsurance

Insurance to
Half Value

Assume that 2000 buildings are valued at \$200,000 each and are insured to half value for a total of \$200 million of fire insurance. The following fire losses occur:

2 total losses (\$400,000)

Insurer pays only = \$200,000

30 partial losses at \$20,000 each = \$600,000

Total fire losses paid by insurer = \$800,000

Pure premium rate = $\frac{\$800,000}{\$200,000,000}$

= 40 cents per \$100
of insurance

Coinsurance in Health Insurance

- Health insurance policies frequently contain a percentage participation clause
 - The clause requires the insured to pay a certain percentage of covered medical expenses in excess of the deductible
 - The purpose is to reduce premiums and prevent overutilization of policy benefits

Other-insurance Provisions

- The purpose of other-insurance provisions is to prevent profiting from insurance and violation of the principle of indemnity
 - Under a pro rata liability provision, each insurer's share of the loss is based on the proportion that its insurance bears to the total amount of insurance on the property

$$\text{Company A} \quad \frac{\$300,000}{\$500,000} \text{ or } .60 \times \$100,000 = \$ 60,000$$

$$\text{Company B} \quad \frac{\$100,000}{\$500,000} \text{ or } .20 \times \$100,000 = \$ 20,000$$

$$\text{Company C} \quad \frac{\$100,000}{\$500,000} \text{ or } .20 \times \$100,000 = \underline{\$ 20,000}$$

$$\text{Total loss payment} \quad = \$100,000$$

Other-insurance Provisions

- Under contribution by equal shares, each insurer shares equally in the loss until the share paid by each insurer equals the lowest limit of liability under any policy, or until the full amount of the loss is paid

Example 1:

<i>Amount of Loss = \$150,000</i>			
	<i>Amount of Insurance</i>	<i>Contribution by Equal Shares</i>	<i>Total Paid</i>
Company A	\$100,000	\$50,000	\$50,000
Company B	\$200,000	\$50,000	\$50,000
Company C	\$300,000	\$50,000	\$50,000

Example 2:

<i>Amount of Loss = \$500,000</i>			
	<i>Amount of Insurance</i>	<i>Contribution by Equal Shares</i>	<i>Total Paid</i>
Company A	\$100,000	\$100,000	\$100,000
Company B	\$200,000	\$100,000 + \$100,000	\$200,000
Company C	\$300,000	\$100,000 + \$100,000	\$200,000

Question?