INTRODUCTION TO INSURANCE

January 3, 2011

www.ExigenServices.com

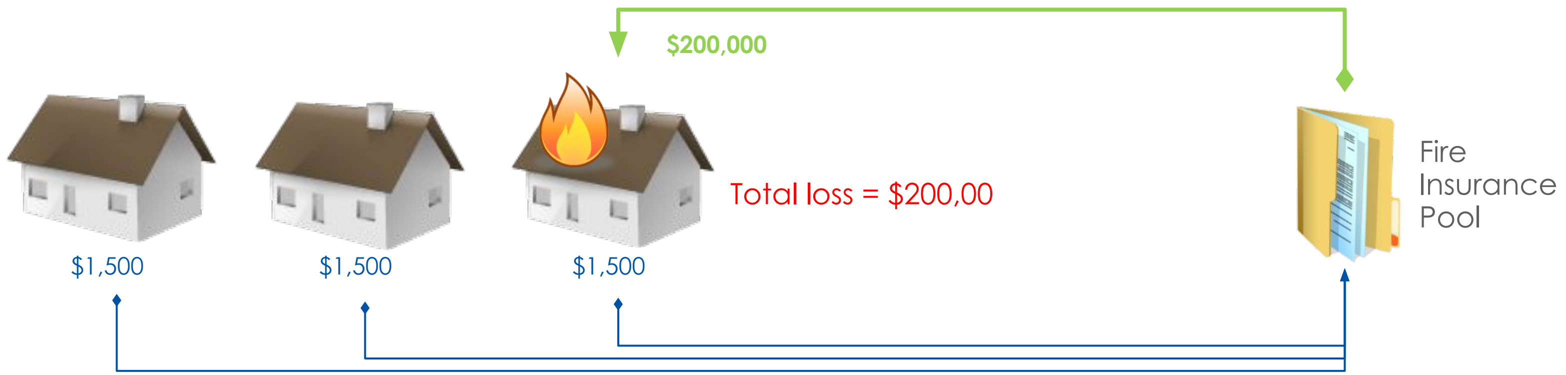
INTRODUCTION TO INSURANCE FUNDAMENTALS AND TERMINOLOGY

INSURANCE DEFINITION

Financial definition

Insurance is a financial agreement that redistributes the cost of unexpected losses.

Insurance involves the transfer of loss exposure to an insurance pool and the redistribution of losses among the members of the pool.



INSURANCE DEFINITION

Legal definition

Insurance is a contractual arrangement whereby one party agrees to compensate another party for losses.

The party that agrees to pay for losses is the **insurer**.

The party whose loss causes the insurer to make a claim payment is the **insured**.

The payment the insurer receives is called a **premium**.

Policy – is the insurance contract.

Insured's possibility of loss is called insured's **exposure to loss**.

Insurance is a branch of contract law. An insurance contract creates rights and corresponding obligations for the insurer and insured. E.g. The insurance contract creates the insured's right to collect payment from the insurer if a covered loss occurs. The insurer has a corresponding duty to pay for such loss.

FUNDAMENTAL TERMS

Loss

A typical **insurable loss** is an undesired, unplanned reduction of economic value.

Direct loss is the immediate, or first, result of insured peril.

Indirect loss, also called **consequential loss**, or **loss of use**, are a secondary result of an insured peril.

FUNDAMENTAL TERMS

Chance of Loss

The **chance of loss** is the probability of loss.

A Priori chance of loss = $\dfrac{expected\ number\ of\ loss}{number\ of\ exposure\ units}$

Ex Post chance of loss = $\dfrac{actual\ number\ of\ loss}{total\ number\ of\ exposures}$

FUNDAMENTAL TERMS

Peril and Hazard. Proximate cause

A **peril** is defined as the cause of the loss.

Hazards are conditions that increase the frequency or the severity of losses.

If an individual causes or exaggerates a loss to collect insurance proceeds, this is **insurance fraud**, and the loss result from the **moral hazard**, which is an individual's mental attitude.

Morale hazard refers to an attitude of carelessness or indifference to loss created by the purchase of an insurance contract.

Insurance contracts do not cover losses cased by an insured's fraud.

RISK

Definitions of Risk

Risk is a variation in possible outcomes of an event based on chances.

The **degree of risk** is a measure of the accuracy with which the outcome of an event based on a chance can be predicted.

Pure risk exists when there is uncertainty as to whether loss will occur (e.g. damage to property by flood or fire).

Speculative risk refers to those exposures to price change that may result in gain or loss (e.g. stock market investments).

Static risk, which can be either pure or speculative, stem from an unchanging society that is in stable equilibrium (examples of pure static risk include windstorms, death; business undertakings in a stable economy illustrates example of speculative static risk).

Dynamic risk (either pure or speculative) is produced because of changes in society (e.g. urban unrest).

Subjective risk refers to the mental state of an individual who experiences doubt or worry as to the outcome of a given event.

Objective risk is more precisely observable and measurable. In general, it’s the probable variation of actual from expected experience.

RISK

Sources of Risk

Common sources of pure risk include **property risks**; **liability risks**, and **life**, **health** and **loss of income risks** (which also are of a speculative nature).

Property Risks

All businesses and individuals that own, rent, or use property are exposed to the risk that the property may be damaged, destroyed, or stolen.

Liability Risks

Negligent acts or omissions that result in actual or imagined bodily injury and/or property damage to a third party, who brings suit against an individual or a business firm and its representatives.

Life, Health, and Loss of Income Risks

Potential losses associated with the health and well-being of individuals.

THE MATHEMATICAL BASIS FOR INSRANCE

Law of Large Numbers

The law states the greater the number of observations of an event based on chance, the more likely the actual result will approximate the expected result.

EXIGEN services

INSURANCE PREMIUM

Four Main components

Insurance Premium

=

Cost of Paying for Losses + Cost of Operating and Maintaining Insurance Pool + Reserves for Unexpected Losses − Investment Earnings