Section One

Introduction to Life and Health Insurance

Section 1 of this text is intended to introduce some basic principles insurance companies follow when they issue life and health insurance policies. Chapter 1 begins by introducing the basic principles of risk and insurance. We describe the types of risks that are insurable and some other important factors insurance companies must consider before issuing insurance policies. Chapter 2 focuses on the business of life and health insurance—how insurance companies fit within the larger context of the economy and how they operate as businesses. Chapter 3 describes how insurance is used to fulfill various personal and business needs. In Chapter 4, we describe how the insurance industry is regulated in the United States and Canada. And in Chapter 5, we describe several aspects of the insurance policy. In short, these first five chapters present an overview of life and health insurance.

CHAPTER ONE

INTRODUCTION TO RISK AND INSURANCE

CHAPTER OUTLINE

LEARNING OBJECTIVES

After reading and studying this chapter, you should be able to:

- Distinguish between speculative risk and pure risk.
- List several ways to manage financial risk.
- Identify the five characteristics of insurable risk.
- Define insurable interest and determine in a given situation whether the insurable interest requirement was met.
- Define antiselection.

All insurance provides protection against some of the economic consequences of loss. Thus, insurance meets part of individuals' and businesses' need for economic security. The insurance industry constantly designs, alters, and updates insurance products to meet various aspects of this need for economic security. Despite these product changes, however, the underlying purpose of insurance products remains the same: to provide protection against the risk of financial loss.

In order to understand insurance and how it works, you need to understand the concept of risk. In fact, risk is at the heart of every insurance policy—whether it is a life, a health, an automobile, or a homeowner's policy. It is risk that creates the need for a person or business to purchase insurance.

The Concept of Risk

Risk exists when there is uncertainty about the future. Both individuals and businesses experience two kinds of risk—speculative risk and pure risk. **Speculative risk** involves three possible outcomes: loss, gain, or no change. For example, when you purchase shares of stock, you are speculating that your initial investment will grow and that you will earn a profit on your investment. At the same time, you know there is a possibility that the price of the stock will fall and that you could lose some or all of the money you invested. Finally, you know that the price of the stock may remain the same—you will not lose money, but you will not make a profit.

speculative risk A risk that involves three possible outcomes: loss, gain, or no change.

Pure risk involves no possibility of gain; there is either a loss or no loss. An example of pure risk is the possibility that you may become disabled. If you are unable to work, you will experience an economic loss. If, on the other hand, you never become disabled, then you will incur no loss from that risk. This possibility of economic loss without the possibility of gain—pure risk—is the only kind of risk that can be insured. The purpose of insurance is to compensate for financial loss, not to provide an opportunity for financial gain.

pure risk A risk that involves no possibility of gain.

EXAMPLE Marie and Joseph Patterson have three children and are employed full time. They have used $10,000 of their savings to purchase stock in a growing software company. They believe that the software company is strong and that their investment will soon be worth a lot more than $10,000.

ANALYSIS The Pattersons' investment in a software company is an example of *speculative risk*. As a result of their investment, the Pattersons may gain financially or they may lose part or all of their investment. The Pattersons are also faced with the *pure risk* that one or both of them could die and their family would lose the income that they earn.

Risk Management

We are surrounded by risks. We take risks when we travel, when we engage in recreational activities, even when we breathe. Some risks are significant; others are not. When we decide to leave an umbrella at home, we take the risk that we might get caught in a rain shower. Such a risk is insignificant. But what about the risks in the following situations?

- Ryan McGill is a 23-year-old single man who is working his way through college with part-time jobs. What if he becomes ill and requires a long hospital stay and expensive medical treatment?
- Danielle and John Peret are working parents of two school-aged children. What if either Danielle or John becomes disabled and cannot work to support the family?
- Jack and Jean Grayson own and manage a convenience store. What if a fire damages their building?
- The Widget Software Development Company's product development process depends on the genius of two employees who are computer "whizzes." What happens to the company if one or both of them dies?
- Catherine Walker is an artist who supports herself by selling her artwork. What happens when she retires and her income is no longer sufficient to meet her economic needs?

risk management The practice of identifying risk, assessing risk, and dealing with risk.

In each situation, the individual, family, or business can use risk management to deal with the financial risk it faces. The practice of **risk management** involves identifying risk, assessing risk, and dealing with risk.[1] In order to eliminate or reduce our exposure to financial risk, we can do at least four things: (1) avoid risk, (2) control risk, (3) accept risk, and (4) transfer risk.

Avoiding Risk

The first, and perhaps most obvious, method of managing risk is simply to avoid risk altogether. We can avoid the risk of personal injury that may result from an airplane crash by not riding in an airplane, and we can avoid the risk of financial loss in the stock market by not investing in it. Sometimes, however, avoiding risk is not effective or practical.

Controlling Risk

We can try to control risk by taking steps to prevent or reduce losses. For instance, Jack and Jean Grayson in one of our earlier examples could reduce the likelihood of a fire in their convenience store by banning smoking in their building and not storing boxes or papers near the building. In addition, the Graysons could install smoke detectors and a sprinkling system in their building to lessen the extent of damage likely to result if there is a fire. In these ways, the Graysons are attempting to control risk by reducing the likelihood of a loss and lessening the severity of a potential loss.

Accepting Risk

A third method of managing risk is to accept, or retain, risk. Simply stated, to accept a risk is to assume all financial responsibility for that risk. Sometimes, as in the case of an insignificant risk—losing an umbrella—the financial loss is not great enough to warrant much concern. We assume the cost of replacing the umbrella ourselves. Some people consciously choose to accept more significant risks. For instance, a couple like Danielle and John Peret from one of the previous examples may decide not to purchase disability income insurance because they believe they can just reduce their standard of living if one of them becomes disabled.

Individuals and businesses sometimes decide to accept total responsibility for a given risk rather than purchasing insurance to cover the risk. In this situation, the person or business is said to self-insure against the risk. **Self-insurance** is a risk-management technique by which a person or business accepts financial responsibility for losses associated with specific risks. For example, many employers provide medical expense benefits to their employees. An employer can self-insure the benefit plan by setting aside money to pay employees' medical expenses or can pay those expenses out of its current income. Individuals and businesses can also decide to accept only part of a risk. For instance, an employer can partially self-insure a medical expense benefit plan by paying its employees' medical expenses up to a stated amount and buying insurance to cover all expenses in excess of that stated amount. Many employers now use self-insurance to fund their employees' health insurance plans. We describe self-insurance more fully in Section 3.

self-insurance A risk-management technique by which a person or business accepts financial responsibility for losses associated with specific risks.

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Transferring Risk

Transferring risk is a fourth method of risk management. When you transfer risk to another party, you are shifting the financial responsibility for that risk to the other party, generally in exchange for a fee. The most common way for individuals, families, and businesses to transfer risk is to purchase insurance coverage.

policy A written document that contains the terms of the contractual agreement between an insurance company and the owner of the policy.

When an insurance company agrees to provide a person or a business with insurance coverage, the insurer issues an insurance policy. The **policy** is a written document that contains the terms of the agreement between the insurance company and the owner of the policy. The agreement is a legally enforceable contract under which the insurance company agrees to pay a certain amount of money—known as the **policy benefit**, or the *policy proceeds*—when a specific loss occurs, provided that the insurer has received a specified amount of money, called the **premium**.

policy benefit A specified amount of money that an insurance company agrees to pay when a specific loss occurs.

premium A specified amount of money that the insurer receives in exchange for its promise to provide a policy benefit when a specific loss occurs.

In general, individuals and businesses can purchase insurance policies to cover three types of risk: property damage risk, liability risk, and personal risk.

- *Property damage risk.* The types of economic losses that fall under property damage risk typically include damage to your automobile, home, or personal belongings due to accident, theft, fire, or natural disaster.
- *Liability risk.* Liability risk includes economic losses that arise from your being held responsible for harming others or their property. For example, you can be held liable for damage you cause to another person's vehicle in an automobile accident. A business can be held liable for injury to an individual who slips and falls while walking through the business establishment.
- *Personal risk.* Personal risk includes the risk of economic loss associated with death, poor health, and outliving one's savings.

Insurers that sell insurance policies to provide financial security from property damage risk and liability risk are known as *property-casualty*, or *property-liability, insurance companies. Property insurance* provides a benefit if insured items are damaged or lost because of various specified perils, such as fire, theft, or accident. *Liability insurance* provides a benefit payable on behalf of a covered party who is legally responsible for unintentionally harming others or their property. Property insurance and liability insurance (also referred to as property and casualty insurance) are commonly marketed together in one policy. Suppose, for example, you are driving a car that is covered by an automobile property-liability policy and you accidentally crash through your neighbor's front door. The damage to your neighbor's home will be paid by your policy's liability coverage; the money to repair your car will come from your policy's property coverage.

Insurers that sell insurance policies to provide financial security from personal risk are known as life and health insurance companies. It is the transfer of **personal risk** to life and health insurers that we will address in this book. Both individuals and businesses purchase life and health insurance policies to provide themselves with the financial security provided by these products.

personal risk The risk of economic loss associated with death, poor health, and outliving one's savings.

CHECK POINT 1A ✔

1. What is the difference between speculative risk and pure risk?
2. Describe four ways in which an individual or business can eliminate or reduce its exposure to risk.
3. What kinds of risks do life and health insurance companies insure?

You will find the answers to the Check Point questions in the Prep Pak for this course.

Managing Personal Risks Through Insurance

You may wonder how an insurance company can afford to be financially responsible for assuming these personal risks. Insurance companies use a concept known as *risk pooling*. With risk pooling, individuals who face the uncertainty of a particular economic loss—for example, the loss of income because of a disability—transfer this risk to an insurance company. Of course, not everyone who is issued a policy to cover the risk of economic loss caused by disability will suffer a disability. In reality, only a small percentage of the individuals who purchase this type of insurance will actually become disabled at some time during the period of insurance coverage. By collecting premiums from all individuals and businesses that wish to transfer the financial risk of disability, insurers spread the cost of the few

losses that are expected to occur among all the insured persons. Insurance, then, provides protection against the risk of economic loss by applying a very simple principle.

> If the economic losses that actually result from a given peril, such as disability, can be shared by large numbers of people who are all subject to such losses *and* the probability of loss is relatively small for each person, then the cost to each person will be relatively small.

Characteristics of Insurable Risks

Insurance products are designed in accordance with some basic principles that define which risks are insurable. In order for a risk—a potential loss—to be considered insurable, it must have certain characteristics.

1. The loss must occur by *chance.*
2. The loss must be *definite.*
3. The loss must be *significant.*
4. The loss rate must be *predictable.*
5. The loss must *not* be *catastrophic* to the insurer.

These five basic characteristics used to define an insurable risk form the foundation of the business of insurance. A potential loss that does not have these characteristics generally is not considered to be an insurable risk.

The loss must occur by chance

In order for a potential loss to be insurable, the element of chance must be present. The loss should be caused either by an unexpected event or by an event that is not intentionally caused by the person covered by the insurance. For example, people cannot generally control whether they will become seriously ill; as a result, insurance companies can offer health insurance policies to provide economic protection against financial losses caused by the chance event that the person who is insured will become ill and incur medical expenses.

When this principle of loss is applied in its strictest sense to life insurance, an apparent problem arises: death is *certain* to occur. The *timing* of an individual's death, however, is usually out of the individual's control. Therefore, although the event being insured against—death—is a certain event rather than a chance event, the timing of that event usually occurs by chance.

The loss must be definite

For most types of insurance, an insurable loss must be definite in terms of *time* and *amount.* In other words, the insurer must be able to determine

when to pay policy benefits and *how much* those benefits should be. Death, illness, disability, and old age are generally identifiable conditions. The amount of economic loss resulting from these conditions can, however, be subject to interpretation.

One of the important terms of the contractual agreement between the insurance company and the owner of an insurance policy is the amount of policy benefit that will be payable if a covered loss occurs. Depending on the way in which a policy states the amount of the policy benefit, every insurance policy can be classified as either a contract of indemnity or a valued contract. A **contract of indemnity** is an insurance policy under which the amount of the policy benefit payable for a covered loss is based on the actual amount of financial loss that results from the loss, as determined at the time of loss. The policy states that the amount of the benefit is equal to the amount of the financial loss or the maximum amount stated in the contract, whichever is *less*. When the owner of such a contract submits a **claim**—a request for payment under the terms of the policy—the benefit paid by the insurance company will not be greater than the actual amount of the financial loss.

contract of indemnity An insurance policy under which the amount of the policy benefit payable for a covered loss is based on the actual amount of the resulting financial loss, as determined at the time of loss.

claim A request for payment under the terms of an insurance policy.

Many types of health insurance policies pay a benefit based on the actual cost of a person's medical expenses and, as such, are contracts of indemnity. For example, assume that Bailey Smythe is insured by a health insurance policy that will pay any covered hospital expenses Bailey incurs. The policy states the maximum amount payable to cover Bailey's expenses while he is hospitalized. If he is hospitalized and his actual hospital expenses are less than that maximum amount, the insurance company will *not* pay the stated maximum; instead, the insurance company will pay a sum that is based on the actual amount of Bailey's hospital bill. Property and liability insurance policies are also contracts of indemnity.

A **valued contract** specifies the amount of the benefit that will be payable when a covered loss occurs, regardless of the actual amount of the loss that was incurred. Most life insurance policies state the amount of the policy benefit that will be payable if the insured person dies while the policy is in force. For example, if a woman buys a $50,000 insurance policy on her life, the $50,000 death benefit is listed in the policy. The amount of the death benefit is called the policy's **face amount** or *face value* because this amount is generally listed on the face, or first, page of the policy. Some life insurance policies provide that the amount of the death benefit may change over the life of the policy. These policies are still considered valued contracts because changes in the amount of the death benefit are based on factors that are not directly related to the amount of the actual loss that will result from the insured's death.

valued contract An insurance policy that specifies the amount of the benefit that will be payable when a covered loss occurs, regardless of the actual amount of the loss that was incurred.

face amount The amount payable under a life insurance policy if the insured person dies while the policy is in force.

The loss must be significant

As described earlier, insignificant losses, like the loss of an umbrella, are not normally insured. The administrative expense of paying benefits when a very small loss occurs would drive the cost for such insurance protection so high in relation to the amount of the potential loss that most people would find the protection unaffordable.

On the other hand, some losses would cause financial hardship to most people and are considered to be insurable. For example, if a person were to be injured in an accident that resulted in a long period of disability, she* would lose a significant amount of income. Insurance coverage is available to protect against such a potential loss.

The loss rate must be predictable

In order to provide a specific type of insurance coverage, an insurer must be able to predict the probable rate of loss that the people insured by the coverage will experience. To predict the **loss rate** for a given group of insureds, the insurer must predict the number and timing of covered losses that will occur in that group of insureds. An insurer predicts the loss rate for a group of insureds so that it can determine the proper premium amount to charge each policyowner.

loss rate The rate at which covered losses are expected to occur in a specified group of insureds.

No one can predict the losses that a *specific person* will experience. We do not know when a *specific person* will die, become disabled, or need hospitalization. It is possible, however, to predict with a fairly high degree of accuracy the number of people in a *given large group* who will die or become disabled or need hospitalization during a given period of time.

These predictions of future losses are based on the concept that, even though individual events—such as the death of a particular person—occur randomly, we can use observations of past events to determine the likelihood that a given event will occur in the future. This likelihood is called the **probability** of the event. An important concept that is used to determine the probability of an event occurring is the law of large numbers.

probability The likelihood that a given event will occur in the future.

> The **law of large numbers** states that, typically, the more times we observe a particular event, the more likely it is that our observed results will approximate the "true" probability that the event will occur.

For example, if you toss an ordinary coin, there is a 50-50 probability that it will land with the heads side up; this is a calculable probability. Four, or even a dozen, tosses might not give the result of an equal or approximately equal number of heads and tails. If you tossed the coin 1,000 times,

* Rather than using both the male and female pronouns (he/she), we will alternate using the male pronoun and the female pronoun throughout this textbook.

though, you could expect a result of approximately 50 percent heads and 50 percent tails to occur. The more often you toss the coin, the more likely it is that you will observe an approximately equal proportion of heads and tails, and thus, the more likely it is that your findings will approximate the "true" probability.

Insurance companies rely on the law of large numbers when they make predictions about the covered losses that a given group of insureds is likely to experience during a given time period. Insurance companies collect specific information about large numbers of people so that they can identify the pattern of past losses that those people experienced. For many years, for example, U.S. and Canadian life insurance companies have recorded how many of their insureds have died and how old they were when they died. Insurance companies then compared this information with the general population records of the United States and Canada, noting the ages at which people in the general population had died.

Using these statistical records, insurance companies have been able to develop charts—called mortality tables—that indicate with great accuracy the number of people in a large group (of 100,000 or more) who are likely to die at each age. **Mortality tables** display the *rates of mortality*, or incidence of death, by age, among a given group of people. Insurance companies have developed similar charts, called **morbidity tables**, which display the *rates of morbidity*, or incidence of sickness and accidents, by age, occurring among given groups of people. By using accurate mortality and morbidity tables, insurance companies can predict the probable loss rates for given groups of insureds; they can use those predicted loss rates to establish premium rates that will be adequate to pay claims. You'll see an example of a mortality table in Chapter 6, where we describe how insurance companies price life insurance.

mortality tables Charts that display the incidence of death, by age, among a given group of people.

morbidity tables Charts that display the incidence of sickness and accidents, by age, among a given group of people.

The loss must not be catastrophic to the insurer

A potential loss is not considered insurable if a single occurrence is likely to cause or contribute to catastrophic financial damage to the insurer. Such a loss is not insurable because the insurer could not responsibly promise to pay benefits for the loss. To prevent the possibility of catastrophic loss and ensure that losses occur independently of each other, insurers *spread* the risks they choose to insure. For example, a property insurer would be unwise to issue policies covering all homes within a 50-mile radius of an active volcano because one eruption of the volcano could result in more claims at one time than the insurer could pay. Instead, the insurer would also issue policies covering homes in areas not threatened by the volcano.

Alternatively, an insurer can reduce the possibility that it will suffer catastrophic losses by *transferring risks* to another insurer. An insurer transfers risks to another insurer by reinsuring those risks. **Reinsurance** is

reinsurance A type of insurance that one insurance company purchases from another insurance company in order to transfer risks on insurance policies that the ceding company issued.

insurance that one insurance company—known as the *ceding company*—purchases from another insurance company—known as the *reinsurer*—in order to transfer risks on insurance policies that the ceding company issued. To **cede** insurance business is to obtain reinsurance on that business by transferring all or part of the risk to a reinsurer. An insurance company typically sets a maximum amount of insurance—known as its **retention limit**—that the insurer is willing to carry at its own risk on any one life.

cede To obtain reinsurance on insurance policies by transferring all or part of the risk to a reinsurer.

retention limit The maximum amount of insurance that an insurer is willing to carry at its own risk on any one life.

By reinsuring some risks, those risks are redistributed among several insurance companies. Some insurance companies act only as reinsurers. Other companies issue insurance policies to individuals and businesses and act as reinsurers. Reinsurers also sometimes cede risks to another reinsurer in a transaction known as a **retrocession.** The insurance company that reinsures risks in a retrocession is known as a *retrocessionaire.*

retrocession A transaction in which a reinsurer cedes a portion of its risks to another reinsurer.

An example will help illustrate a reinsurance transaction. Note, however, that there are many different types of reinsurance transactions, and this is only one example.

EXAMPLE The Alpha Insurance Company established a retention limit of $750,000. Alpha has entered into a reinsurance agreement with the Celtic Reinsurance Company. Under the terms of the reinsurance agreement, when Alpha issues a policy with a face amount that exceeds its retention limit, the amount in excess of the retention limit is automatically ceded to Celtic. Alpha recently issued a $1,250,000 policy on the life of Norma Olson.

ANALYSIS As a result of the reinsurance agreement, $500,000 of the coverage Alpha issued Norma will be ceded to Celtic. Alpha will retain liability to provide Norma with life insurance coverage of $1,250,000, but Celtic will reimburse Alpha for $500,000 of the death benefit payable if Norma dies while the policy is in force.

By setting a retention limit and entering into a reinsurance agreement, an insurance company can issue policies that have relatively large face amounts without exposing itself to an excessive amount of risk. The owners of policies that have been reinsured generally are not aware of the reinsurance agreement between the insurer and the reinsurer. The insurance company that issued the policy collects the premiums and pays the policy benefits to the proper recipient when due. (See Figure 1-1, which illustrates a reinsurance relationship.)

CHECK POINT 1B

1. What are the characteristics of an insurable risk?
2. What is the difference between a contract of indemnity and a valued contract?
3. Distinguish between a mortality table and a morbidity table.
4. How can one insurance company transfer risk to another insurance company?

Insurability of Specific Risks

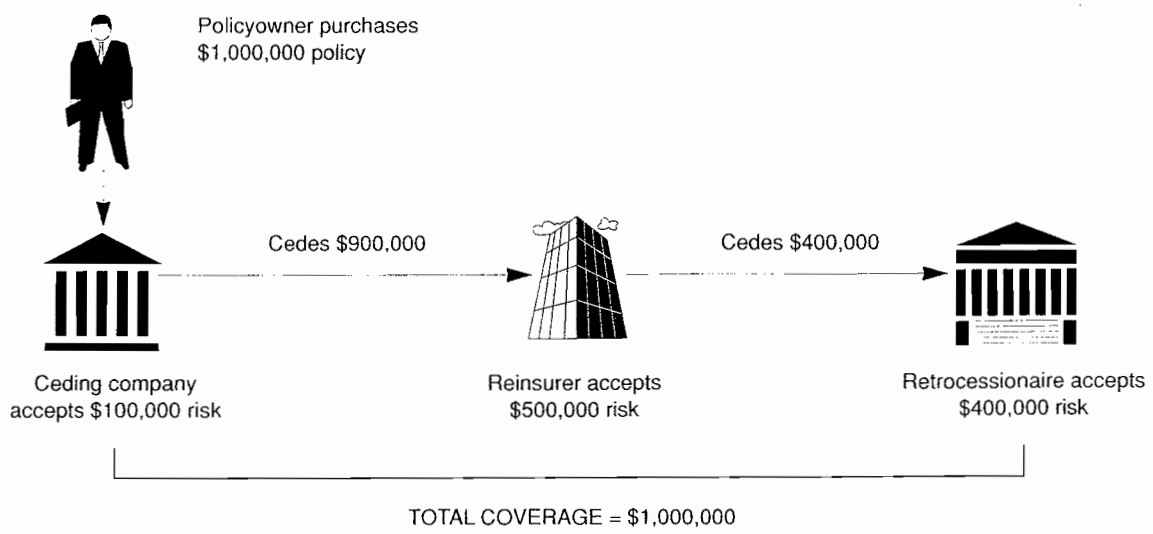
The five characteristics we just described are useful in identifying the general kinds of losses that are insurable and provide a helpful framework for the study of insurance principles and products. But, as you will learn, insurance is sold on a case-by-case basis, and insurance companies consider a number of factors in order to determine whether a proposed risk is an insurable risk. Before we describe some of these factors, you need to understand some of the terminology we'll use throughout the text to describe the people who are involved in the creation and operation of an insurance policy.

The **applicant** is the person or business that applies for an insurance policy. When a policy is issued, the person or business that owns the insurance policy is known as the **policyowner.** In most cases, the applicant is also the policyowner.

applicant The person or business that applies for an insurance policy.

policyowner The person or business that owns an insurance policy.

Figure 1-1 Reinsuring the risk



insured The person whose life or health is insured under an insurance policy.

The **insured** is the person whose life or health is insured under the policy. This is the commonly accepted definition of *insured* in the United States and in the province of Quebec. In all other jurisdictions in Canada, the person who is insured by a life insurance policy is referred to as the *life insured*. To eliminate confusion in this text, we'll use the term *insured* to mean the person whose life or health is insured by a policy. The policyowner and the insured may be, and often are, the same person. If, for example, you apply for and are issued an insurance policy on your life, then you are both the policyowner and the insured and may be known as the *policyowner-insured*. If, however, your mother applies for and is issued a policy on your life, then she is the policyowner and you are the insured. When one person purchases insurance on the life of another person, the policy is known as a **third-party policy**.

third-party policy An insurance policy that one person purchases on the life of another person.

If the event insured against occurs while the insurance policy is in force, the insurer pays the policy benefit. Life insurance policy proceeds are usually paid to the policy's **beneficiary**—the person or party the policyowner named to receive the policy benefit. Health insurance policy benefits are usually paid either to the insured person or to the hospital or doctor that provided the covered medical care services to the insured.

beneficiary The person or party the owner of an insurance policy names to receive the policy benefit if the event insured against occurs.

Insurable interest requirement

We noted earlier that only pure risks are insurable; insurance is intended to compensate an individual or a business for a financial loss, not to provide an opportunity for gain. At one time, people used insurance policies as a means of making wagers. For example, they purchased insurance policies on the lives of people who were completely unrelated to them, and in that way, created a possibility of financial gain for themselves if the insured people died.

The practice of purchasing insurance as a wager is now considered to be against public policy. As a result, laws in all states and provinces require that, when an insurance policy is issued, the policyowner must have an **insurable interest** in the risk that is insured—the policyowner must be likely to suffer a genuine loss or detriment should the event insured against occur. For example, a property insurance company would not sell a fire insurance policy on a particular building to a person who does not own the building because that person would not suffer an economic loss if the building were destroyed by fire. In property insurance, ownership of property is one way in which an insurable interest in the property is established.

insurable interest The likelihood that a policyowner or beneficiary of an insurance policy will suffer a genuine loss or detriment if the event insured against occurs.

THE INSURABLE INTEREST REQUIREMENT IN LIFE INSURANCE. The presence of insurable interest must be established for every life insurance policy to ensure that the insurance contract is not an illegal wagering agreement. If the insurable interest requirement is not met *when a policy is issued*, the policy is not

valid. The presence of an insurable interest for life insurance usually can be found by applying the following general rule.

> An insurable interest exists when the policyowner is likely to benefit if the insured continues to live and is likely to suffer some loss or detriment if the insured dies.

Insurance companies screen every application for life insurance to make sure that the insurable interest requirement imposed by law in the applicable jurisdiction will be met when the policy is issued. In other words, the insurer must determine whether the person who will be the owner of the life insurance policy—typically, the applicant for insurance—has an insurable interest in the proposed insured. If the insurer determines that the proposed policyowner does not meet the insurable interest requirement, then the insurer will not issue the policy.

In addition, each insurance company screens all applications to ensure that those applications meet the company's own underwriting guidelines, which frequently include insurable interest requirements that go beyond the requirements imposed by law. Thus, in most situations in which the insurable interest requirement imposed by the applicable jurisdiction is met, the insurer may refuse to issue the policy if its own, more stringent insurable interest requirements are not met.

To understand how insurable interest requirements are met, we need to consider two possible situations: (1) an individual purchases insurance on his own life and (2) an individual purchases insurance on another's life. In both cases, the applicant for life insurance must name a beneficiary. Let's look at each of these situations.

All persons are considered to have an insurable interest in their own lives. A person is always considered to have more to gain by living than by dying. Therefore, an insurable interest between the policyowner and the insured is presumed when a person seeks to purchase insurance on his own life. Insurable interest laws do not require that the named beneficiary have an insurable interest in the policyowner-insured's life. In other words, the laws allow a policyowner-insured to name anyone as beneficiary.

Most insurance company underwriting guidelines, however, require that the beneficiary also must have an insurable interest in the life of the insured when a policy is issued. As a result, insurance companies typically inquire into the named beneficiary's relationship to the proposed insured and may refuse to issue the coverage if the beneficiary does not possess an insurable interest in the proposed insured's life. An exception exists in the state of California, where laws now permit a person to purchase insurance on her own life and to name anyone she wants as beneficiary, even if the beneficiary has no insurable interest in her life. As a result, insurers that issue

"HOW CAN YOU SAY I DON'T HAVE AN INSURABLE INTEREST IN SANTA'S CONTINUED SURVIVAL?"

policies subject to California law are prohibited from declining to issue a life insurance policy solely because the named beneficiary has no insurable interest in the proposed insured's life.

In the case of a third-party policy, laws throughout Canada and in most U.S. jurisdictions require only that the policyowner have an insurable interest in the insured's life when the policy is issued. Most insurance company underwriting guidelines and laws in some U.S. jurisdictions, however, require that both the policyowner and the beneficiary of a third-party policy must have an insurable interest in the insured's life when a policy is issued.

Certain family relationships are deemed by law to create an insurable interest between an insured and a policyowner or beneficiary. The natural bonds of affection and financial dependence that generally exist between certain family members make this a reasonable assumption. In these cases, even if the policyowner or beneficiary has no financial interest in the insured's life, the bonds of love and affection alone are sufficient to create an insurable interest. According to laws in most jurisdictions, the insured's spouse, mother, father, child, grandparent, grandchild, brother, and sister are deemed to have an insurable interest in the life of the insured. (See Figure 1-2, which illustrates the family relationships that create an insurable interest.)

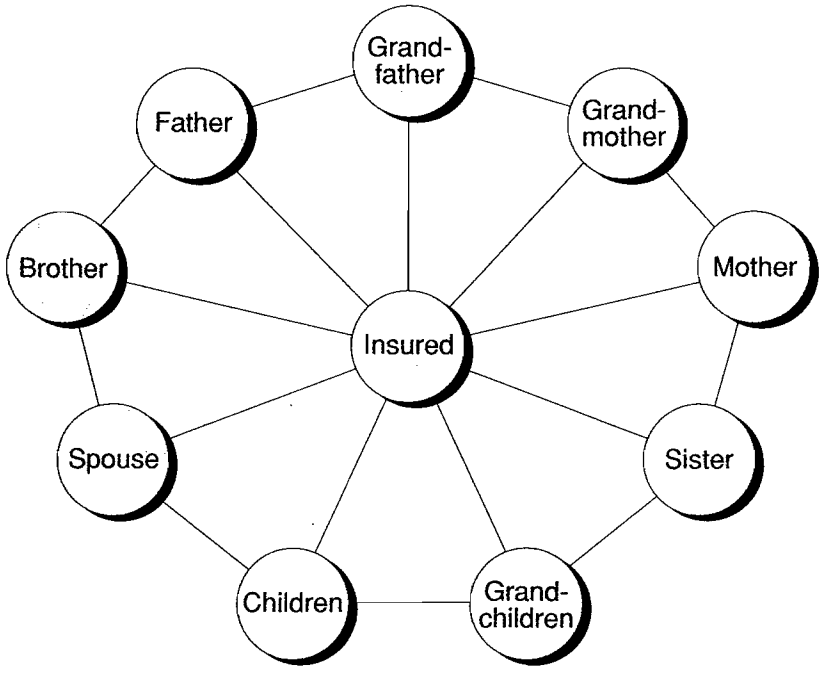
An insurable interest is *not* presumed when the policyowner or beneficiary is more distantly related to the insured than the relatives described above or when the parties are not related by blood or marriage. In these

cases, a financial interest in the continued life of the insured must be demonstrated in order to satisfy the insurable interest requirement. For instance, if Mary Mulhouse obtains a $50,000 personal loan from the Lone Star Bank of Vermont, the bank would have a financial and, consequently, an insurable interest in Mary's life. If Mary should die before the loan were repaid, the bank could lose some or all of the money it lent her. Similar examples of financial interest can be found in other business relationships.

The insurable interest requirement must be met before a life insurance policy will be issued. After the life insurance policy is in force, the presence or absence of insurable interest is no longer relevant. Therefore, a beneficiary need not provide evidence of insurable interest in order to receive the benefits of a life insurance policy.

THE INSURABLE INTEREST REQUIREMENT IN HEALTH INSURANCE. The insurable interest requirement also must be met when a health insurance policy is issued. For health insurance purposes, the insurable interest requirement is met if the applicant can demonstrate a genuine risk of economic loss should the proposed insured require medical care or become disabled. Because of the nature of health insurance, applicants rarely seek health insurance on someone in whom they have no insurable interest. Typically, people seek health insurance for themselves and for their dependents. As a contract of

Figure 1-2 Family relationships that create an insurable interest



indemnity, a health insurance policy provides coverage to pay for medical expenses that the insured has incurred or to replace a disabled insured's lost income. Applicants are generally considered to have an insurable interest in their own health. Additionally, for disability income insurance purposes, businesses have an insurable interest in the health of their key employees.

EXAMPLE Image, Inc., is a small company that contracts with other companies to conduct seminars for their management staffs. Sarah Smithers works for Image, Inc., as their primary seminar leader. Because Sarah's expertise and teaching skills are essential to the success of the business, Image, Inc., has applied for disability income coverage on Sarah.

ANALYSIS Image, Inc., would be unable to meet its scheduled seminar commitments if Sarah were ill or injured and, thus, unable to conduct seminars. As a result, Image, Inc., has a financial interest in Sarah's continued good health. This financial interest creates the necessary insurable interest for Image, Inc., to purchase disability income coverage on Sarah.

Assessing the degree of risk

After the insurance company has established that the insurable interest requirement is met, the company next turns to assessing the degree of risk that the company will assume if it agrees to issue the policy. An insurance company cannot afford to assume that each proposed risk represents an average likelihood of loss. Not all individuals of the same sex and age have an equal likelihood of suffering a loss. Further, those individuals who believe they have a greater-than-average likelihood of loss tend to seek insurance protection to a greater extent than do those who believe they have an average or a less-than-average likelihood of loss. This tendency, which is called **antiselection**, *adverse selection*, or *selection against the insurer*, is a primary reason that insurers need to carefully review each application to assess properly the degree of risk the company will be assuming if it issues the requested policy. As we discuss more fully later in this text, the premium rates that an insurance company establishes are based in large part on the amount of risk the company is assuming for the policies it issues. If the company consistently underestimates the risks that it assumes, its premium rates will be inadequate to provide the promised benefits.

antiselection The tendency of individuals who believe they have a greater-than-average likelihood of loss to seek insurance protection to a greater extent than do those who believe they have an average or a less-than-average likelihood of loss.

The process of identifying and classifying the degree of risk represented by a proposed insured is called **underwriting** or *selection of risks*, and the insurance company employees who are responsible for evaluating proposed

underwriting The process of identifying and classifying the degree of risk represented by a proposed insured.

risks are called *underwriters*. Insight 1-1 describes the careers of four underwriters. Underwriting consists of two primary stages: (1) identifying the risks that a proposed insured presents and (2) classifying the degree of risk that a proposed insured represents.

Insight 1-1 Four Underwriters on Underwriting

Underwriters perform a function that is unique to the insurance industry and, as a result, are often misunderstood by those outside the industry, as well as those inside the industry who work in other functional areas. How does a career in underwriting begin? What qualities make a good underwriter? How are underwriters trained?

Four underwriting professionals answered those questions, among others, in an article which appeared in the March 1995 issue of LOMA's *Resource* magazine. Their career paths show several points of entry into the underwriting field.

Cynthia J. Louderbough, FALU, FLMI, ChFC, CLU, a vice president with United Companies Life Insurance Company, worked her way up from an entry-level position at a small company and has been in underwriting since 1977. Christopher Graham, FALU, FLMI, is senior vice president—new business and claims—with National Life Insurance Company of Vermont. In 1980, when he was the supervisor of reinstatement and premium billing in policyholder service, Graham chose to become an underwriter trainee. Frederick D. Krisher, AALU, FLMI, entered the underwriting field in 1963, right out of college. He is now assistant vice president and chief underwriter with Ohio Life Insurance Company. Willis R. Oakes, Jr., FLMI, HIA, started his career in individual insurance administration, then accepted the opportunity to join the underwriting department in 1982. He is vice president—administration, individual health—with Trustmark Insurance Company.

When Louderbough evaluates applicants for underwriting positions, she looks for "strong organizational skills, the desire to learn new things, and medical-related experience, such as claims processing." She says that good communication skills are important. Graham, Krisher, and Oakes also emphasize the importance of communication skills, along with decision-making and analytical skills. In addition, Oakes says that his company looks for experience and strength in customer service.

Although the subject matter is different, underwriters learn their profession much the same way anyone else might learn a profession: through a combination of on-the-job training, mentoring, and professional or industry education, including LOMA's FLMI program. The unique attributes of underwriting that make it interesting can also be challenging to beginning underwriters, making training especially important.

Graham, Krisher, and Oakes say that their companies use a mentoring process to train new underwriters. A trainee is assigned to work with an experienced underwriter, who will help the trainee learn the underwriting process by working with actual cases. The trainee may also spend time with clerical staff, gaining exposure to the entire process from application to policy issue. Trainees receive additional training in medical terminology, anatomy, and physiology, emphasizing diseases and disorders along with corresponding underwriting actions. The trainee also receives instruction in financial underwriting.

Louderbough says, "Beginning underwriters often find it difficult to remember all the different factors that can affect a risk, including medical, non-medical, financial, avocation(al), etc. Trainees also have to remember that separating people into risk classes is not predicting what will happen to them."

"Often the most difficult thing for a beginning underwriter to master is the ability to look at an application and the attendant medical and financial reports and develop the best possible underwriting decision for that applicant," says Oakes. "Inexperienced underwriters have a tendency to use underwriting manuals as if they were rule books, rather than using the manuals as guidelines for developing a decision, which takes into consideration all the facts presented."

Graham says that one concept difficult for beginning underwriters to grasp is that "underwriting is more of an art than a science. All insurance applicants are individuals and, therefore, have unique qualifications. While all will end up categorized by their assessed mortality, getting to the proper assessment sometimes requires a focus beyond the obvious."

Insight 1-1 Four Underwriters on Underwriting (continued)

"(The) point at which the underwriter has just the right amount of information with which to make a proper mortality assessment . . . (is) a floating point based on experience and confidence, and finding it is an art. . . . Acting prematurely can sometimes result in an incorrect assessment. . . .

". . . an underwriter's job is to put business on the books, not keep it out. Using their experience and knowledge to help agents overcome obstacles, underwriters help bring the underwriting process to its logical end."

Krisher agrees with Graham, saying, "Knowing the appropriate amount of information needed to make a good decision is important."

These underwriters find their careers rewarding, even though challenging at times. Krisher says, "I enjoy underwriting because it is always different. No two cases are ever the same."

"The most rewarding part of being an underwriter is feeling that I am part of the solution," says Graham. "In some ways, it's like being the jigsaw puzzle piece that brings two important parts of the whole together. When you find that piece and drop it into place, the satisfaction is immediate. We are also fortunate that our risk selection process involves human beings, as this makes each application different, unique, and . . . challenging."

Source: Adapted from Stephanie M. Crumley, ACS, "Learning More About Underwriting," Resource (March 1995), pp. 88–91.

IDENTIFYING RISKS. As we noted earlier, insurance companies cannot predict when a specific individual will die, become injured, or suffer from an illness. Insurers, however, have identified a number of factors than can increase or decrease the likelihood that an individual will suffer a loss. The most important of these factors are physical hazards and moral hazards. A **physical hazard** is a physical characteristic that may increase the likelihood of loss. For example, a person with a history of heart attacks possesses a physical hazard that will increase the likelihood that the person will die sooner than will a person of the same age and sex who has a strong heart. A person who is overweight has a physical characteristic that is known to contribute to health problems, and those health problems may result in the economic loss associated with higher-than-average medical expenses. Underwriters must carefully evaluate proposed insureds to detect the presence of such physical hazards.

physical hazard A physical characteristic that may increase the likelihood of loss.

Underwriters also must consider the effects of moral hazards on the degree of risk represented by a proposed insured. **Moral hazard** is the likelihood that a person involved in an insurance transaction may act dishonestly in that transaction. For example, an individual who has a confirmed record of illegal or unethical behavior is likely to behave similarly in an insurance transaction, and an insurer must carefully consider that fact when evaluating such an individual's application for insurance. The individual may be seeking insurance for a dishonest reason or planning insurance fraud. Underwriters also evaluate the moral hazards presented by individuals who provide false information on their applications for insurance. In these cases, it is likely that the applicants are trying to obtain insurance coverage that they might not otherwise be able to obtain. When

moral hazard The likelihood that a person involved in an insurance transaction may act dishonestly in that transaction.

"You'd think an underwriter would know what 'risk' is!"

Reprinted with permission of Phil Interlandi and Bituminous Casualty Corporation.

underwriters evaluate applications for insurance, they take a variety of steps to identify proposed insureds who present these moral hazards.

CLASSIFYING RISKS. After identifying the risks presented by a proposed insured, the underwriter can classify the proposed insured into an appropriate risk category. The purpose of classifying risks into categories is to enable the insurer to determine the equitable premium rate to charge for the requested coverage. People in different risk categories are charged different premium rates. Without these premium rate variations, some policyowners would be charged too much for their coverage, while others would be paying less than the actual cost of their coverage.

FAST FACT Of all individual life insurance policies issued in Canada during 1993, 97% were issued on a standard or preferred basis; 3% were issued on a substandard basis. Approximately 3% of all applications for individual life insurance were declined. The percentages were similar in the United States.[2]

Underwriters generally classify proposed insureds into at least three risk categories: standard risks, substandard risks, and declined risks. Many insurance companies have adopted a fourth risk category: preferred risks.

- Proposed insureds who have a likelihood of loss that is not significantly greater than average are classified as **standard risks**, and the premium rates they are charged are called *standard premium rates*. Most individual life and health insurance policies are issued at standard premium rates.
- Those proposed insureds who have a significantly greater-than-average likelihood of loss are classified as **substandard risks** or *special class risks.* Insurance companies use several methods to compensate

standard risks The risk category that is composed of proposed insureds who have a likelihood of loss that is not significantly greater than average.

substandard risks The risk category that is composed of proposed insureds who have a significantly greater-than-average likelihood of loss.

for the additional risk presented by insureds who are classified as substandard risks. In individual life insurance, insurers typically charge substandard risks a higher-than-standard premium rate, called a *substandard premium rate* or *special class rate*. In individual health insurance, insurers may either charge a higher-than-standard premium rate or modify the policy in some way to compensate for the greater risk. (We'll discuss these policy modifications in Section 3 of the text.)

- The **declined risk** category consists of those proposed insureds who are considered to present a risk that is too great for the insurer to cover. Applicants for disability income insurance coverage are also placed into the declined risk category if the insurer believes that the coverage is not needed to cover any income loss that would result from a disability. Few life or health insurance applications are declined.

declined risks The risk category that is composed of proposed insureds who are considered to present a risk that is too great for the insurer to cover.

- In addition, some life insurance companies classify proposed insureds who present a significantly less-than-average likelihood of loss as **preferred risks** and charge these preferred risks a lower-than-standard premium rate. Insurance company practices vary widely as to what qualifies a proposed insured as a preferred risk. For example, some insurance companies categorize their standard risks into two risk classifications based on their smoking habits. Insureds who otherwise present a standard risk and are nonsmokers are classified as preferred risks and are charged less-than-standard premium rates; insureds who otherwise present a standard risk but who smoke are classified as standard risks and are charged standard premium rates. This is just one example of how insurance companies may use the preferred risk classification to categorize insureds.

preferred risks The risk category that is composed of proposed insureds who present a significantly less-than-average likelihood of loss.

CHECK POINT 1C

1. Explain the purpose of the insurable interest requirement.
2. State the rule we can use to determine whether the insurable interest requirement is met for most life insurance policies.
3. What are the two primary stages in the underwriting process? Why must insurers classify the degree of risk that a proposed insured represents?

Key Terms

speculative risk
pure risk
risk management
self-insurance
policy
policy benefit

premium
personal risk
contract of indemnity
claim
valued contract
face amount
loss rate
probability
law of large numbers
mortality tables
morbidity tables
reinsurance
cede
retention limit
retrocession
applicant
policyowner
insured
third-party policy
beneficiary
insurable interest
antiselection
underwriting
physical hazard
moral hazard
standard risks
substandard risks
declined risks
preferred risks

Other Important Terms

policy proceeds
property damage risk
liability risk
property-casualty insurance company
property-liability insurance company
property insurance
liability insurance
risk pooling
face value
rates of mortality
rates of morbidity
ceding company
reinsurer
retrocessionaire
life insured
policyowner-insured
adverse selection
selection against the insurer
selection of risks
underwriters
standard premium rates
special class risks
substandard premium rate
special class rate

Endnote

1. For a complete discussion of risk management, see Arthur C. Williams, Jr., Michael L. Smith, and Peter C. Young, *Risk Management and Insurance*, Seventh Edition (New York: McGraw-Hill, Inc., 1995).
2. ACLI *1994 Life Insurance Fact Book*, p. 119; CLHIA *1994 Canadian Life and Health Insurance Facts*, p. 11.