Property and Casualty Insurance Concepts Simplified

The Ultimate 'How to' Insurance Guide for Agents, Brokers, Underwriters and Adjusters

Christopher J. Boggs, CPCU, ARM, ALCM, LPCS, AAI, APA, CWCA, CRIS

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- Table of Contents
- Chapters 1 and 2 and 3 from the book

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Property and Casualty Insurance Concepts Simplified: The Ultimate 'How to' Insurance Guide for Agents, Brokers, Underwriters and Adjusters

By Christopher J. Boggs, CPCU, ARM, ALCM, LPCS, AAI, APA, CWCA, CRIS

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Chapter 1
How to Read an Insurance Policy

When did you last read the entire commercial general liability policy, commercial property policy or any insurance policy from beginning to end just as a refresher? Rarely does any insurance practitioner, even hard core ones, undertake to read an entire policy; generally there is a specific answer being sought or problem being researched requiring review of only individual parts of the form and its applicable endorsements to develop an answer or opinion.

Insurance professionals realize that answering a coverage question or providing an opinion without first reviewing the policy (and applicable endorsements) is errors and omissions quicksand. But once the complete policy is in-hand, certain "rules" can be applied in reading the form to make finding the needed answer easier and quicker. These are not short-cuts to reading the policy, just pointers to make finding the most correct answer easier.

Twelve Rules for Reading an Insurance Policy

1. Ascertain who qualifies as an insured. If the person or entity suffering or causing the loss, injury or damage is not an insured, there is no need to go any further - there is no coverage. Remember, there are four levels of insureds: 1) named insured(s); 2) additionally listed (named) insureds; 3) automatic insureds; and 4) additional (endorsed) insureds.
2. Annotate the policy form by highlighting the areas changed by an endorsement and list which endorsement changes that section. When reading that part, apply the endorsement wording directly.
3. Compare the forms and endorsements listed on the declarations page with the forms and endorsements attached to make sure the entire policy is available. This includes confirming the edition dates match.
4. Read the ***Insuring Agreement*** first to make sure the loss or occurrence is contemplated. This is the broadest the coverage is ever going to be - so start here.
5. After the insuring agreement, read the exclusions. In most liability and special form property policies, coverage is created

when not excluded. Treat named peril property policies and the "personal and advertising injury" section of the commercial general liability policy differently, read the list of covered perils (that which causes a loss) first, then the exclusions.

6. Read the exceptions to the exclusions. Exceptions give coverage back in specific amounts. As is discussed in Chapter 2, "Six Reasons the Loss is Excluded," it's easier for the carrier to give coverage back by exception than to delete coverage using a long list of exclusions.
7. When the policy refers to another section, read that section immediately.
8. Pay attention to the conjunctions used in a list. "And" is inclusive; "or" is exclusive. If there is a list of five qualifiers, the use of "and" means that all five must be satisfied. "Or" means that if any of the five apply, coverage is granted or excluded (or what ever the list provides).
9. Pay attention to key words and phrases. There are certain key words that must be underlined or highlighted when reading the policy. These words and phrases create, delete or alter coverage and limits (this may not be an all-inclusive list):

    - "Not" as in "does not apply to…" or "does not include…." This changes or limits whatever grant or denial of coverage preceded it.
    - "Greater than…," "lesser than…," "Greater of…," "lesser of…," "no more than," "the most…," "all" or any other quantifying phrase. "The insured receives the 'lesser of'…" is a quantifying phrase indicating that of the up coming values, the insured will get the least or lowest amount.
    - "Unless," "except," "only if…" or "subject to…" each connotes a change in condition, added requirement or an alternative.
    - "However" discounts everything before it. This is a qualifying term that creates coverage or condition parameters.
    - "Includes," as the name suggests, is an inclusive term that broadens the provision to which it applies.

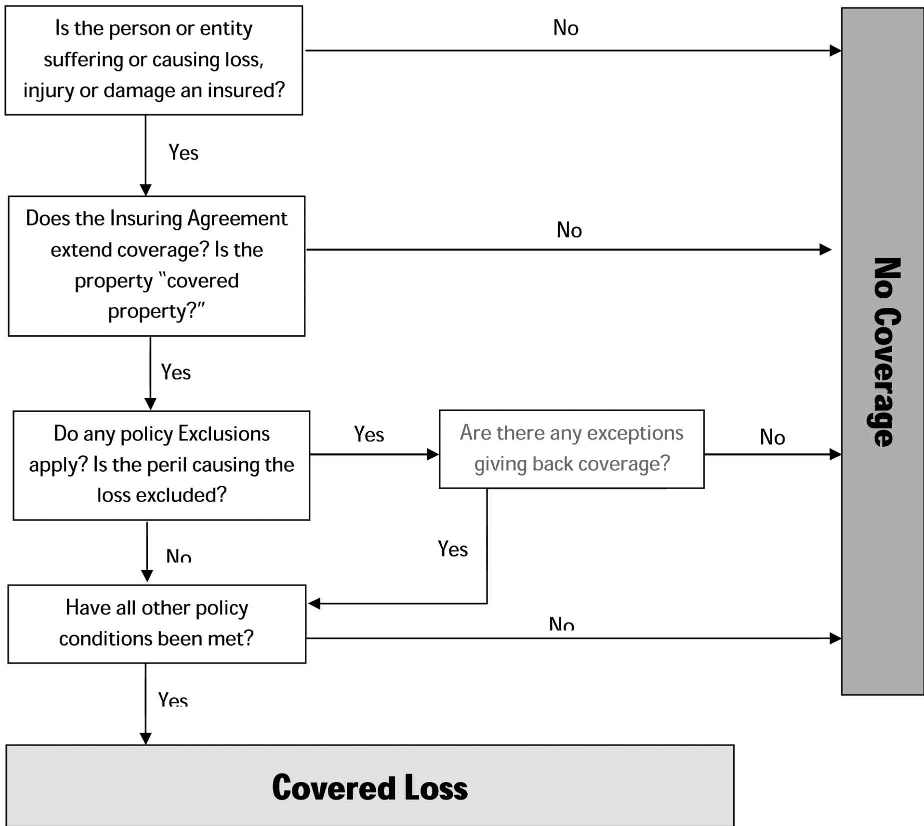
- "Must" and "regardless." There is no alternative and surrounding circumstances are of no consideration in meeting the requirement.
- "First" is an order of sequence term. Some policy provisions list the order of events or actions. Particular attention must be given to the order of events prescribed by these sequencing terms.

10. Read and understand the definitions of specifically defined terms. The insurance carrier desires to control the meaning of certain words and phrases and does so by specifically defining them in the policy. Such definitions can limit or explain the breadth of protection. Words not defined are given their common, everyday meaning.
11. Understand and make sure all the policy conditions have been met. Failure to meet the policies conditions can result in the denial of coverage.
12. Confirm the coverage limits are adequate for the loss.

Does Coverage Exist

Applying these policy-review rules will allow quicker coverage determinations, subject, of course, to the specific situation and surrounding laws. Exhibit 1.1 is a loss/claims worksheet to guide the user through the policy to determine the availability of coverage.

Exhibit 1.1



Chapter 2
Six Reasons the Loss is Excluded

Insurance was created as a mechanism to protect insureds against the financial consequences of an unforeseen, potentially catastrophic **individual** loss. The number of covered perils has expanded and contracted over time to match the changes in exposure's severity, frequency and ultimate costs; but the original concept of protecting the insured's financial condition has not changed. However, insureds are not protected against every possible source of financial loss.

Traditional insurance policies contain a list or description of incidents, causes or results not covered. This is true whether a property or liability form; and regardless whether the insured is a commercial or personal lines client. Exclusions always exist, and there is a reason for each one.

Exclusion Categories

To understand the six reasons for each exclusion first requires knowledge of the three broad categories of exclusions. The three categories of exclusions are: 1) excluded "perils;" 2) excluded "hazards;" and 3) excluded "property." A "peril" is the actual cause of the damage resulting in financial loss (i.e. fire); a "hazard" is anything that increases the likelihood that a financial loss or "peril" will occur (i.e. frayed wires (the hazard) may cause a fire (the peril)). "Property" can be tangible or intangible.

Excluded perils and excluded hazards are not equal in their ultimate effect on the insured. ***"Excluded perils"*** can generally (but not always) be remedied either by an exception to the exclusion, an endorsement or the purchase of a separate policy. Conversely, ***"excluded hazards"*** are almost always absolute with little possibility of plugging the hole created by the exclusion or broadening any coverage that may be given by an exception to the exclusion.

To understand the six reasons for exclusions first requires knowledge of the three broad exclusionary categories. Insureds can purchase earthquake coverage; but even difference in condition (DIC) forms exclude war, leaving the insured no reasonable recourse. Earth movement is the

peril, the cause of the loss; whereas war or military action simply increases the chance that something is going to happen - the war itself doesn't cause a loss, it's just a hazard that increases the chance of a loss.

Some exclusions walk the line between "excluded peril" and "excluded hazard." The "***Ordinance or Law"*** exclusion is an example. Ordinance or law is a "peril" because the enforcement of building codes actually does cause a financial loss; but it's also a hazard because the condition of being "out of code" increases the amount of loss and the possibility that a peril will occur.

"Excluded property" is somewhat self-explanatory. Under the commercial property form, for example, there is no coverage for money; and under the general liability form there is no coverage for the property of others in the insured's care, custody or control (with some exceptions). Both are "property"-related exclusions.

Why is it Excluded?

From the three broad exclusionary categories flow the six reasons for exclusions. Nearly all policy exclusions arise from one of the following:

1. The peril, hazard or property is better covered elsewhere;
2. The loss or damage is catastrophic in nature;
3. The loss or damage is not accidental or unforeseen;
4. The insurance carrier is willing to provide coverage; they just want more information and more premium;
5. The insurance carrier wants to control the amount of coverage granted; or
6. The loss results from a "speculative" or business risk.

The Peril, Hazard or Property Can be Better Covered

Some exclusions exist because there is a more appropriate coverage form available to provide the needed protection. Money loss is excluded in the commercial property form because this exposure is better covered under a **crime policy**; likewise, the use of an auto is excluded under the commercial general liability policy because **the auto policy** is the more appropriate place for coverage.

Property and liability forms both contain exclusions existing simply because the particular form was not created for that specific exposure. It

is incumbent upon the agent to cover those exposures with the appropriate policy.

The final reason for the use of separate policies is the threat of adverse selection (see definition). Some perils and hazards are such that only those in danger of suffering such loss are willing to pay for the coverage. If only a small number of insureds buy the coverage, the insurer would not have the ample funds to pay the potential losses; which would require higher premiums - resulting in fewer insureds (thus begins the adverse selection spiral). Some of these excluded losses also fall under the catastrophic loss exclusion.

The Loss or Damage is Catastrophic in Nature

Insurance was not designed to respond to community disasters, only to individual “disasters.” Certain perils and hazards have the potential to result in wide-spread damage the industry is not structured to handle; nor is the consuming public willing to pay the additional premium to finance coverage for catastrophic losses in their policies.

Two “adverse selection” exclusions, as discussed in the previous section, within the commercial property form also fall under the “catastrophic” loss category. Flood and earthquake damage can be insured by purchasing other coverage, but damage by these perils is considered catastrophic so coverage is not provided in the property form.

The Loss or Damage is not Accidental or Unforeseen by the Insured

An “insurable loss” is one that is accidental, unforeseen, definite in time and place and is measurable. Intentional acts of the insured or intended results are excluded in nearly every insurance policy, property or liability. Also falling outside the definition of “insurable loss” are losses that are likely to or will happen, damage specifically controllable by the insured and known events.

- *Exclusions for losses that are likely or will happen:* Wear and tear to property is going to happen, as does general deterioration; the insurance company is not going to insure something guaranteed to happen (the policy would then be a warranty rather than insurance).
- *The insured can control the loss:* This eliminates coverage for intentional acts; damage over long periods of time; and failure

to care for the property (not maintaining heat to keep water pipes from freezing). An example from the CGL is the violation of SPAM laws.

- *Exclusion for known or previously occurring events:* This eliminates coverage for losses that the insured knew about prior to the policy period or began prior to coverage being enacted.

Insurance Carrier Wants More Information and Premium

Endorsements are available to remove or narrow the breadth of some policy exclusions, allowing the insured to customize coverage to fit its needs. Insurance policies are, to some extent, written with the "average" insured in mind; not doing this would increase premiums for all insureds - even when some have no need for the additional coverage. Other-than-average insureds with special exposures or needs have the option to endorse away various exclusions.

Additionally, before granting extended coverage insurance carriers often want more information about the insured plus some additional premium. This allows some level of policy customization for unique insureds while maintaining an appropriate premium for the risk but without discriminating unfairly against insureds which do not need the same breadth of coverage.

Insurance Carrier Wants to Control the Amount of Coverage Granted

As an example, the commercial property policy specifically excludes loss caused by collapse; but then it gives back some coverage for loss caused by collapse under the "Additional Coverage" section. Excluding coverage only to give it back under another section (or even in the same section) seems to perpetuate the public's perception that insurance is confusing. But this method is not as counterintuitive as it first appears.

Excluding coverage and giving some of it back allows the insurance carrier to dictate the exact amount of coverage they are willing to offer. They control the breadth of coverage. Compare that with trying to give the coverage outright then limit it with exclusions; there is no way that all possible situations could be imagined leading to confusion and likely court involvement.

Taking coverage away and giving it back in pre-determined amounts makes far more sense and reduces the potential for confusion. This tactic is used in property and liability coverage forms.

Speculative or Business Risk Exclusions

"Pure risk" has only two possibilities, something bad happens or nothing happens. There is no possibility for gain; the insured enjoys a "zero-sum year" or suffers financial loss. Pure risk, also known as absolute risk, is insurable. Its counterpart is "speculative risk."

"Speculative risk" (or "business risk") involves the chance of loss, of no change or gain. Insurance is not designed to protect the insured from a bad investment or bad business decision.

Examples of speculative risk exclusions include the CGL's product recall exclusion (which can be covered by endorsement) and the commercial property policy's special cause of loss exclusions "voluntary parting" and "delay, loss of use or loss of market."

Conditional Conclusion

The insurance contract is a conditional contract; excluded perils, excluded hazards and excluded property are part of the conditions. When viewed in the light of reason, policy exclusions are not unreasonable - even if the insured thinks they are.

Without many of the exclusions contained in property and liability policies, premiums would be prohibitively high and fewer viable carriers would be available to accept the risk.

Compare this list of six reasons to any property or liability policy when explaining coverage and exclusions to the insured. The list can also be used to uncover the insured's exposures that require other coverage forms or customizing endorsements.

Chapter 3
Insurance Premiums Are Only a Small Part of the Insured's Total Cost of Risk

So many insureds complain about the price of their insurance. Rarely does a client say, *"That premium seems fair; the insurance company is getting adequate premium to cover its exposure and I'm getting the protection I need."* No, the most often heard complaint is, *"I can't believe I have to pay out all this money. The insurance company is killing me; can't we get the premium down?"*

Carriers such as GEICO, Progressive and now Allstate are playing to the belief that insurance is all about the premium/price. But is it the price or the cost the insured needs to calculate? Insureds must understand or be taught that the premium (price) is only part of their **"Total Cost of Risk."**

Every insured is subject, in varying degrees, to the "total cost of risk" concept, from the personal lines client up to the largest Fortune 500 Corporation. Six "costs" in addition to the premium combine to develop the insured's true cost of risk: 1) Deductibles/Self-Insured Retentions; 2) The cost of uninsured and/or self-insured losses; 3) Legal costs; 4) Loss control and safety costs; 5) Claims management; and 6) Opportunity costs.

Deductibles and Self-Insured Retentions

Premium savings is often accomplished by increasing the deductible or self-insured retention. But any price savings must be weighed against the "out-of-pocket" cost directly related to the deductible. The Price:Cost comparison is easy with smaller clients that have relatively few losses. A small commercial client, for example, may enjoy a premium savings of $2,000 by going from a $1,000 property deductible to a $5,000 property deductible; but one loss could "cost" the insured $3,000 more than staying with the lower deductible.

The Price:Cost comparison is complicated when the premium difference is in the multiple-thousands of dollars range. Successfully calculating the true cost savings requires an analysis of the loss history and the development of loss projections. While there is no guarantee that what happened in the past (as all losses (past and future) are random events),

will occur in the future it's the only way to develop some comparison.

Larger corporations are major proponents of high deductible programs because there is the immediate premium savings (as seen on the balance sheet). But when compared to the actual cost of loss experience such plan may be more expensive (but the cost may be spread over multiple accounting periods).

Basically, premium savings are eaten away by the cost of deductibles and self-insured retentions.

Uninsured and Self-Insured Losses

In an effort to cut the insurance price, insureds may intentionally or worse, unintentionally self-insure certain risks. Intentional self-insurance requires careful study of loss frequency and more importantly loss severity before implementation. Unintentional self insurance is what happens when price is the main concern and coverages are chopped to lower the premium.

Any out-of-pocket expense related to self-insurance is part of the insured's total cost of risk. Like the use of deductibles/self-insured retentions, these may push the cost of risk beyond the pre-change price of insurance.

Legal Costs

Defending uninsured or self-insured events or losses can be expensive. The cost of defense counsel can devour any premium savings previously enjoyed. Legal cost as part of the total cost of risk is, on one side, a function of the two previous decisions.

On its other side are the legal costs incurred to avoid a financial loss. This includes the cost to develop proper contractual risk transfer mechanisms and employee manuals (just two examples).

Loss Control and Safety Costs

In an effort to avoid or reduce loss, some insureds may invest in loss control and safety. This includes safety devices such as sprinkler systems and safety equipment like safety glasses and fall protection. Granted, some of these are required by regulation, but such costs arise out of the

inherent risk of the operation and are thus part of the "total cost of risk."

Claims Management

Losses subject to a self-insured retention, self-insured losses and uninsured losses must be managed by someone. This someone may be an internal employee designated as the claims administrator or it may be an outside administrator - often known as a third party administrator (TPA).

Although the expense of the internal employee may be captured under a separate line item - payroll expense - the cost is still a part of the total cost of risk. TPA expense is also a part of the cost.

Without either of these individuals available, the cost of a single loss could escalate beyond what it should be (especially in workers' compensation), catapulting the total cost of risk far above the price of traditional insurance.

Someone has to manage claims, and the cost associated make up part of the total cost of risk.

Opportunity Cost

A somewhat subjective cost is the opportunity cost. In order to manage a non-traditional (or even traditional) insurance program requires that resources be taken from other areas of the operation. These are monetary and time resources.

The insured can choose to pay a higher premium to allow the insurance company to pay their personnel to do the work; or they can choose to do some parts of it themselves. This comes back to a price:cost analysis.

Payroll and time costs are a factor in the total cost of the insured's risk.

Price vs. Cost

Insureds can ALWAYS find a lower price - but at what COST? Understanding the Total Cost of Risk concept is important to both insureds and agents. Being able to distinguish between the two can save insureds in the long run.

Don't misunderstand, there is a place for alternative programs and

even some price comparison among the less sophisticated coverages; but don’t ever let the insured, or yourself, be fooled into thinking that insurance is all about price.

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