chapter 10

Business Insurance

10.1 MANAGE RISK

10.2 PRINCIPLES OF INSURANCE

10.3 PROPERTY AND VEHICLE INSURANCE

10.4 PERSONNEL AND LIABILITY INSURANCE

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Case STUDY

Providing Specialty Insurance

Insurance traditionally spreads the risk of financial loss across a large number of individuals or companies, each of whom faces a similar type of risk. Individuals and businesses may also face financial losses that are unique. A group of investors in a new movie may lose millions of dollars if production problems occur. An athlete's career and earnings will be lost if he or she suffers a major injury. The cargo of a large ship, a major entertainment event that is dependent on good weather, or a fundraiser that offers a large prize for a difficult accomplishment such as a hole-in-one at a golf tournament each presents a possible but reasonably unique risk for the investors or event planners. Those unique risks are difficult to insure and have resulted in the growth of the specialty risk market.

Lloyd's (also known as Lloyd's of London) is the largest source of specialty risk insurance in the world. Surprisingly, Lloyd's is not an insurance company or even an actual company by itself. Instead it is a market where companies and wealthy individuals invest money to insure unique risks. Insurance is provided through *syndicates* or groups of investors who pool their money to insure specific categories of risk. Today Lloyd's has 64 syndicates which specialize in areas such as aviation, catastrophes, and professional risks.

The organization began in 1688 when merchants, ship captains, and ship owners would gather at Edward Lloyd's coffee house in London. Since there was always a risk of loss to ships and cargos, groups formed to pool their money to cover potential losses. Rich investors called *names* were attracted to Lloyd's to speculate on marine insurance. They would put money into a pool that insured a specific ship and its cargo. They would make money if the cargo and ship were safe but would have to pay if loss or damage occurred. Until 1994, most of the capital for Lloyd's came from individual investors. Due to huge losses suffered in the early 1990s, Lloyd's began accepting *members,* or corporations, as investors. Today, members provide about 90 percent of the investment capital while names provide the remaining 10 percent. Among the companies that insure through Lloyd's syndicates are 85 percent of the Fortune 500 companies, the top seven pharmaceutical companies, and the 20 largest global banks. The organization accepted insurance premiums of £13.7 billion in 2005.

Think Critically

1. Why is it difficult and more expensive to get insurance for unique risks? Since premiums are likely to be high for specialty insurance, why would companies and individuals purchase that insurance?
2. Why would names and members want to participate in one of Lloyd's syndicates? What information would you want to have about the syndicate and the risks before you would become an investor?

10.1 Manage Risk

Goals

- Define risk and the types of risks faced by individuals and businesses.
- Describe the primary methods for managing risks.

Terms

- risk
- economic risk
- pure risk
- speculative risk
- natural risk
- human risk
- controllable risk
- uncontrollable risk
- risk management
- liability

Facing Risk

Each day when you walk out of your door, you face uncertainty and risk. In fact even as you sleep there are risks that can dramatically affect your life. Every business also faces risks that might be so serious that they could result in business failure. **Risk** is the chance or probability of harm or loss.

Individuals face risks that can affect health, income, and property, and can even result in death. Businesses face risks that can have a significant economic affect. Property and inventory can be damaged, lost, or stolen; personnel can become ill, injured, or even die; and the company's products or employees can cause damage to property or harm to people for which the business is liable. Risk carries with it the possibility of financial loss.

THE MEANING OF RISK

Sometimes the word uncertainty is used as a substitute for risk. When you are uncertain, you have doubt about a possible outcome. If you face a risk, there is a chance of a positive outcome and also a chance of a negative outcome. An **economic risk** has a potential financial impact. Some risks are not economic in that they have no direct or immediate financial impact. When you attend a social activity with friends you risk not enjoying yourself. If you forgo studying for an exam, you risk earning a poor grade. But if an employee becomes ill and cannot work for several weeks, the person faces a financial loss of wages that would have been earned. If a business' warehouse is destroyed by fire, the money invested in the building, equipment, and inventory is lost.

Economic risks are either pure or speculative. With a **pure risk** there is no opportunity for financial gain but only loss. If there is a chance that an employee will be injured on a job, there is no additional income that the person will receive because he or she remains healthy. The injury will result in financial loss due to the inability to work. Businesses that face the risk of fire earn no more money if the fire does not occur but suffer financially if property is damaged by fire.

A **speculative risk** has the possibility of either financial loss or gain. Investments carry speculative risks. By investing money where the value of

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Uncontrollable risks such as hurricanes cannot be influenced by human action, but the losses they cause can be reduced through planning and preparation.

the investment may rise or fall, the investor can make money or lose money.

Individuals and businesses are willing to take risks because of opportunities. An *opportunity* is the possibility for success. Financial success is one of the possible outcomes of a speculative risk. In addition to financial gain, success can be measured in nonfinancial ways. Recognition and personal satisfaction are viewed by most as successful outcomes that do not carry a financial reward. Both pure and speculative risks provide opportunities for nonfinancial benefits as well as for losses and disappointments.

teamwork

With your team brainstorm a list of risks team members and their families face on a regular basis. Classify them as natural, human, controllable, and uncontrollable. Discuss what can be done to reduce the losses that could result from each risk.

TYPES OF RISK

Risks to individuals and businesses have many sources or causes. **Natural risks** arise from natural events or are a part of nature. Hurricanes, floods, earthquakes, and ice storms are all natural risks that can result in damage and loss. **Human risks** result from the actions of individuals, groups, or organizations. Injuries suffered by negligent driving, losses from customer or employee theft, or fires that start from unsafe storage of products are results of human risks.

Some risks can be controlled while others cannot. **Controllable risks** can be reduced or avoided by thoughtful actions. Most human risks are controllable. Defensive driving, employee safety programs, and the upkeep and maintenance of buildings can reduce accidents and injuries. **Uncontrollable risks** cannot be influenced by human action. Natural events such as floods and hurricanes cannot be stopped, although careful planning and preparation can reduce the losses that result from many natural risks.

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What is the difference between a risk and an opportunity?

Managing Risk

Since risk can be expected in almost all activities, efforts should be made to anticipate what risks are most likely to occur and then attempt to reduce the risk and minimize the loss that might be suffered. The process of systematically identifying potential risks and making plans to reduce the impact of the risk on individuals and companies is known as **risk management.** Because most businesses face a large number of risks, many of which can cause significant financial harm or even result in business failure, they employ specialists with the responsibility of planning and coordinating risk management programs. Risk management deals primarily with pure rather than speculative risk. Financial managers are responsible for decision-making about speculative risks or the investment decisions of a business.

RISK MANAGEMENT PROGRAMS

Risk management specialists work at all levels of the business to identify the potential risks the business might face, determine the financial impact each risk may have on the business, develop plans and programs to prevent controllable risks and reduce the financial impact of uncontrollable risks, and provide the necessary resources and training needed to manage the risks. Risk management programs today deal with the security of computer systems, property protection, employee health, and plans to respond to the negative effects of natural and man-made disasters.

The primary sources of risk faced by companies fall into three categories—property risks, personnel risks, and liability risks. Property risks are potential damage or loss to property owned, leased, and used by a business. If a business is responsible for the property of other businesses, that also is a source of property risk. For example, if a company supplies raw materials to a manufacturer, disruption of the supply or quality problems with the raw materials can result in financial loss for the manufacturer as well as the supplier.

Personnel risks include factors that can affect the health, life, or earnings of individuals associated with the business and the role employees play in the work of the organization. If key executives are unable to work due to illness or even die, the business is likely to be disrupted until a new executive is in place. Employee illness, injury, or death can result from poorly maintained equipment, unsafe working conditions, or lack of safety procedures. Large-scale layoffs or retirements can affect production and productivity. The costs of health care, life insurance, disability payments, and retirement are all costs to the business and can affect profitability.

Businesses are responsible for controlling their risk by providing safe equipment and working conditions.

Liability means an individual or business is responsible to others for negligence. Negligence can result from an action taken or from a failure to act. If people are injured or their property damaged due to the negligence of a business, they can make a financial claim against the business. The injury or damage can result from the use of the business' property or products or the actions of company personnel.

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In a recent year, 83 percent of the top global financial services firms admitted their computer systems had been compromised. Forty percent of the companies reported that the breaches resulted in significant financial losses to their organization totaling an estimated $456 million.

DEALING WITH RISK

People responsible for managing risks go through a careful process of determining the most effective way to deal with each type of risk faced by a business. They choose from four different methods.

Avoid the Risk Some risks can actually be avoided. If there is a chance that one market, group of customers, or type of product presents a particular risk to the business, it may be decided to avoid that choice and select one that doesn't pose the same risk. If a foreign country has an unstable economy, a business can choose to avoid operations in that country. If a particular manufacturer of production equipment has a poor safety record, new equipment can be purchased from another supplier.

Transfer the Risk A common way to avoid a particular risk is to transfer the risk to another company. Rather than assuming the expense and difficulty associated with a credit system, a company may choose to provide credit through a credit specialist or contracted credit card system. Product transportation and storage or information management and security present several types of risks. Using other companies to provide those services transfers much, although not all, of the risk away from the business.

Insure the Risk If the likelihood and amount of a financial loss from a risk can be reasonably predicted, the risk can be insured. By purchasing insurance, the company pays a small percentage of the possible loss to an insurer for protection against the larger loss if the risk occurs. The greater the likelihood of the risk or the larger the possible loss, the more expensive the insurance will be. Taking steps to reduce the possibility or cost of the loss can reduce the insurance costs.

Assume the Risk A company may decide that it will assume the risk rather than choosing one of the other alternatives. If a risk is quite unlikely to occur or if the possible financial loss is relatively small, the company may decide to assume the possible loss because it will do little harm to the business if it occurs. If the cost to the business to insure or transfer the risk is high, it may be more feasible for the company to assume the risk itself. Some companies recognize that a certain amount of equipment will wear out, become damaged, or fail. Rather than insuring equipment for damage, the company may set aside funds each year that can be used to replace equipment. If the company decides to assume a risk, careful risk management planning must be completed to avoid serious financial loss.

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What are the four methods a business can use to deal with risks that it faces?

10.1 Lesson Assessment

UNDERSTAND CONCEPTS

Determine the best answer for each of the following questions.

1. A ____?____ risk has the possibility of either a financial loss or a gain.
   a. pure
   b. speculative
   c. natural
   d. human
2. Which of the following is *not* one of the primary sources of risk faced by companies?
   a. property
   b. personnel
   c. liability
   d. financial
3. Using a financial services company to offer customer credit is an example of ____?____ the risk.
   a. avoiding
   b. transferring
   c. insuring
   d. transferring
4. **True or False?** Controllable risks can be reduced or avoided by thoughtful actions.
5. **True or False?** Risk management deals with both pure and speculative risks.

MAKE ACADEMIC CONNECTIONS

6. **Government** Identify one federal department or agency that provides assistance or support to businesses in the areas of risk assessment and risk management. Write a short report that describes the type of risks that are the focus of the department or agency and what assistance is provided to businesses.
7. **Research** Go to the library and review the business section in two weeks of a large newspaper or several monthly issues of a business magazine such as *Business Week* or *Fortune*. From your readings, identify ten risks various businesses faced. Construct a table with four headings—Avoid, Transfer, Insure, Assume. Classify each of the companies and risks you identified in your readings under the appropriate heading to describe how the business dealt with the risk. Present your classifications to other students and justify your decisions.
8. **Law** Businesses are at risk of liability claims filed by customers who use the company's products. Review newspaper articles or search the Internet to locate information on a product liability lawsuit filed against a business. Based on the information you collect, write a report summarizing the case including the type of product, the alleged problem or defect with the product, the damage claimed by the person(s) filing the lawsuit, and the amount of damages requested. Summarize the result of the lawsuit and the reasons for the decision. Based on your study of the case, offer recommendations on what the business might have done to reduce or eliminate the risk that led to the lawsuit.

10.2 Principles of Insurance

Goals

- Identify and define important insurance terms and concepts.
- Understand insurance company organization and operations.
- Describe the key parts of an insurance policy.

Terms

- insurance
- policy
- insured
- insurer
- peril
- policyholder
- insurable interest
- premium
- reinsurance
- deductible
- coinsurance

Insurance Basics

The assets of a business are essential. If assets are damaged or destroyed, the business will be unable to continue the work that relies on those assets until they are replaced. Not only will the business need the money to repair or replace whatever has been damaged or destroyed, it will lose potential income from the affected operations until the assets have been restored. Business assets include property, vehicles, equipment, materials and supplies, products, and personnel. The assets vary in cost and importance to business operations. Minimal damage to assets causes little harm and can be repaired quickly at a low cost. Significant damage can totally destroy a key part of business operations and will be expensive and time consuming to replace.

Risk management procedures identify each business asset and determine the importance of each to the business, its cost, and the requirements and time to repair or replace. Risk management also assesses the financial impact of the loss of the asset on business operations. Based on that analysis, decisions will be made on how the business will respond to loss of the asset. For assets where there is a reasonable chance that damage or loss will occur and result in a financial risk the company would not be able to afford, the business should consider purchasing insurance.

INSURANCE TERMS

Insurance is a contract providing financial protection against a specified loss. Insurance is based on three principles.

1. Some risk facing an individual or organization is transferred to others.
2. Risks are pooled or shared among a large group of individuals or companies.
3. Risk for any one individual or business is reduced by controlling the uncertainty of the loss. Purchasing insurance trades a potentially large but uncertain loss for a smaller but certain payment.


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Perils that can be insured include fire and vehicle accidents.

Insurance is implemented through a legal contract, or **policy.** The **insured** is the person or business covered by the insurance policy. The **insurer** is the company that assumes the risk and agrees to pay losses covered by the policy. Insurance policies are written to cover losses that result from perils. A **peril** is the cause of a loss. Examples of perils that can be insured are fire, vandalism, vehicle accidents, and personal injury. The **policyholder** is the individual or organization to whom the policy is issued. The policyholder is often but not always the insured. In order to purchase insurance the policyholder must have an insurable interest in the covered loss. An **insurable interest** means that the insured will suffer a financial loss if the insured event occurs. The policyholder is charged a **premium**, which is the amount paid to the insurer to keep the insurance policy in force.

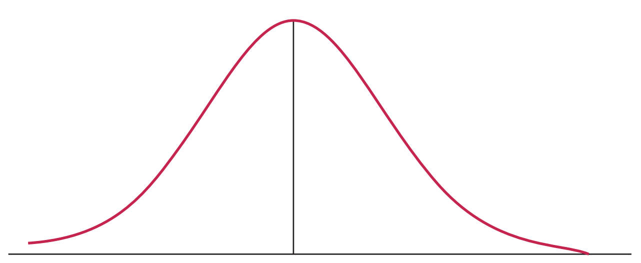
WHAT CAN BE INSURED

The availability of insurance is based on the proposition that the insurer can accurately predict the amount of losses that will be suffered by all of those who are insured for a particular type of loss in a given period of time. It is impossible to predict whether any one business may have a fire that damages a building in a given year. But if thousands of businesses of a certain type and in a particular geographic area are grouped together, accurate estimations can be made of the amount of fire damage that will be suffered during a year.

The accuracy of predictions regarding the amount of losses that will occur among all of the businesses insured for a particular peril is very important. Without the ability to estimate the amount of losses they will need to pay, insurance companies may not accumulate enough money from premiums to pay for all of the losses suffered and make a profit. Companies use principles of statistics to estimate losses. The companies employ *actuaries,* highly trained mathematicians who gather and analyze data and determine risk factors in order to establish premium rates.

Actuaries apply the law of large numbers which means that when very large numbers of an event are considered, they will tend to form a normal distribution. You may be familiar with the view of a normal distribution which is often referred to as a bell curve, as shown in Figure 10-1. Using statistics and data about the amount of losses that have occurred in prior years, actuaries predict the total amount of losses that will result from a particular peril among all policyholders. For example, if an insurance company issues 10,000 fire insurance policies to businesses, their calculations may estimate that 800 businesses will have losses from fires in the next year and the average loss will be valued at $6,800.

FIGURE 10-1 **A Bell Curve**



In order for a risk to be insurable, the following conditions need to exist.

- A large number of individuals or businesses must be facing the same type of risk and be willing to purchase insurance. In order to be able to predict the amount of losses and spread the risk across a large number of individuals or groups, insurance companies have to sell a large number of policies.
- The losses from the perils that are insured must be accidental and uncertain. People cannot take advantage of insurance companies by purchasing insurance and then causing a loss in order to collect money. Insurance fraud is a major problem for insurance companies. It is estimated that fraudulent claims add as much as 25 percent to insurance rates.
- The actual loss must be identifiable. In order to be paid for a loss by the insurance company, the insured must be able to document that the loss occurred as a result of the peril for which the insurance was purchased. The dollar value of the loss must also be identifiable.
- The probability of loss cannot be too high and the peril cannot be of a type that may affect a large percentage of insured at the same time. If most businesses suffer losses regularly or at the same time, too much money will be required to pay for the losses. For example, insurance companies become concerned if they sell a large number of the same type of insurance policies in an area that is subject to natural disasters such as hurricanes, earthquakes, or floods. The result could be that almost all policyholders will have claims at the same time if a natural disaster hits that area. To protect themselves against those large losses, insurance companies use a process known as reinsurance. With **reinsurance**, an insurance company sells some of its risk to other

insurance companies. The process spreads the risk across more companies and more policyholders.

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List the conditions that must exist in order for a risk to be insurable.

Insurance Companies

In order to offer insurance in the United States, companies must meet requirements and regulations established by each state and by the federal government. Every state has a department of insurance and an insurance commissioner. That department licenses any business that wants to sell insurance in the state and identifies the types of insurance the company is approved to sell. In order to obtain a license, the company must provide information that it has adequate capital for the amount and type of insurance it will sell. Most states also require companies to deposit a minimum amount of securities in order to make sure policyholders' claims can be paid. Finally, states regulate the rates that insurance companies can charge for various types of insurance. In some instances, the rates charged are reviewed to make sure they are adequate to cover potential losses and not exorbitant or discriminatory. In other cases, states actually set the rates that can be charged for types of insurance.

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In 2004, $1,097,836 million in premiums were paid for insurance in the United States. 45 percent of the premiums were for life insurance while 55 percent were paid for all types of non-life insurance.

OWNERSHIP STRUCTURES

Insurance companies are generally organized in two types of ownership

Insurance agents work with customers to determine the amount and type of insurance they need.

structures. *Stock companies* are private corporations that sell insurance as a profit-making venture. The stock is publicly traded, so it is owned by its stockholders and operated by the board of directors and corporate management.

The second form of ownership is a mutual company. A *mutual company* is a nonprofit corporation owned by its policyholders. Since the mutual company is a nonprofit business, any income in excess of expenses is returned to the policyholders in the form of dividends or lower premiums.

Stock companies are the major providers of life and health insurance and of property insurance to businesses. Mutual insurance companies lead in sales of property and vehicle insurance for individual consumers.

INSURANCE OPERATIONS

Insurance companies complete several different activities as a part of their insurance operations. The major activities are rate making, selling, underwriting, investing, and claims processing.

Rate Making The insurance process begins when an insurance company determines the types of insurance it will sell, the types of customers it plans to serve, and the rates it will charge. Rate making establishes the amount per unit of value that will be charged for insurance based on the type of insurance and factors that can affect the frequency and amount of losses. Rates are established by actuaries who carefully review large amounts of data on past loss experiences, specific factors that have increased or diminished losses, and the financial position of the company. Rates must also be set within the guidelines and regulations of the state in which the insurance is sold.

Selling The company must sell an adequate number of insurance policies in order to collect sufficient premiums to pay claims, finance operations, and make a profit. Insurance is typically sold by agents. An *insurance agent* is a person licensed by the state and given authority by the insurer to sell its insurance. An *exclusive agent* is employed by the insurance company and sells only that company's policies. An *independent agent* is self-employed or works for an insurance sales company and represents several insurance companies. Agents work with customers to determine the amount and type of insurance to be purchased. They then write the application and submit it to the insurance company for underwriting. Some simple insurance policies are sold through direct mail or the Internet. In those instances, a customer completes an insurance application and submits it directly to the insurance company for approval often without the need for an agent.

Underwriting Underwriting is the most important part of the insurance process from the viewpoint of the insurer. Each insurance application is carefully reviewed to make sure all information needed to make a decision is available and accurate. In some cases, information is verified through credit agencies, private and public records, or independent investigations. The purpose of underwriting is to determine if the application fits the criteria that make the insurance a reasonable risk. Underwriters will reject applicants if there is evidence that the applicant is likely to have a much higher than average level of loss based on the information reviewed.

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Customers who have suffered losses expect insurance companies to be prompt and fair in processing claims.

Investing Insurance companies receive income from policyholders in the form of premiums paid. Policies are written for a specific period of time, often a year, and the premium is paid in advance. The amount of money collected from premiums alone is normally not enough to ensure payment of all losses. Insurance companies frequently pay more in claims than they receive in premiums for a particular time period. Funds that are received for premiums as well as other types of income are carefully invested in a variety of securities. The regulation of insurance companies restricts how some of the funds can be invested. The companies also need to have adequate liquid assets to pay claims as they occur. Insurance companies have a large amount of assets to invest. Wise decisions by expert investment specialists can contribute to profitability and allow the company to remain competitive in its insurance rates.

Claims Processing When a policyholder suffers a covered loss, the insurance company follows an established process to settle the claim. Claims that involve damage to property usually are handled by an adjuster. An *adjuster* works for the insurance company and determines the extent of a loss and the liability of the insurer. An adjuster can be either an employee of the insurance company or an independent adjuster who works for a fee. Claims for health and life insurance usually are handled by specialists in the claims department who review information and make decisions about payments. Claims processing must be done carefully to make sure that losses are paid according to the conditions of the insurance policy. Some insurance companies develop a reputation of being reluctant to approve settlements. Customers expect insurance companies to be both prompt and fair in processing claims. A negative reputation will spread and will affect the amount of business the company will do in the future. Clear information to customers when an insurance policy is purchased and professional customer service at the time a claim is made will help to increase customer satisfaction.

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What is the difference between rate making and underwriting?

The Insurance Policy

An insurance policy is a legal contract between the insurer and the insured. As such it must be carefully prepared to make sure it is a legally enforceable agreement and that the coverage provided by the policy is clear. A standard insurance policy contains declarations, the insuring agreement, conditions, and exclusions. There are a number of other provisions of insurance policies that define the coverage offered.

COMMON PARTS OF A POLICY

The *declarations* contain identifying information about the insured and the insured property, the insurance company, agent, type of insurance, the dates and times the insurance is in effect, and the amount of the premium. If others hold an interest in the policy or property, they will be identified as well. A policy number is assigned to each insurance policy.

The *insuring agreement* forms the basis of the insurance contract. It identifies the individuals, activities, or property that are insured, the perils that will be covered, and the actions that must be taken by the insured and the insurer to maintain the insurance and to compensate the insured in the event of a loss.

Conditions identify the stipulations or requirements that must be met in order for the insurance to remain in effect and losses to be paid. Some conditions are standard protections for the insurance company such as a statement that any fraud or misrepresentation by the insured will result in an invalid contract. Other standard conditions are information on how a policy can be cancelled by either party, whether rights in the contract can be assigned to others, and the conditions that must be met to maintain property, report losses, and provide proof of loss.

Exclusions provide specific limitations on the coverage provided. They identify perils that are not covered, limitations on the use of property or activities of the insured, or types of property or losses that will not be covered. For example a life insurance policy may exclude the insured from certain particularly dangerous activities. A property insurance policy may exclude losses caused by flooding from a storm but will cover water damage resulting from a burst water pipe in a building.

Special provisions are added to many insurance policies to control costs. The policy may identify limits on the amount the insurance company will pay to the insured. The limits may be a maximum that will be paid for one loss or a total amount for all losses in a specific time period.

Many property and health insurance policies include a deductible. A **deductible** is an identified amount of a loss that must be paid by the insured before the insurer pays. For example, an automobile policy may have a $500 deductible. If an insured vehicle has $450 of damage, the insured must pay the full amount. If the damage is $1,500, the insured is responsible for the first $500 (the deductible) and the insurance company will pay the remaining $1,000.

With **coinsurance**, the insured and insurer share the risk by paying a defined amount of the costs. Coinsurance is applied in different ways depending on the type of insurance. In health insurance, the insured may pay a specific dollar amount for a covered procedure such as $10 for a visit to a doctor or $15 for a prescription. The insurer than pays the remaining

teamwork

Discuss with team members how you would make the decision whether to accept a higher deductible to an insurance policy in return for a lower annual premium. How does the decision provide an example of risk management?

amount of the covered costs. The coinsurance may be stated as a percentage of the cost. The insured may be required to pay 20 percent and the insurer 80 percent. Depending on the terms of the policy, the coinsurance requirement may apply to each claim or it may have a maximum amount that the insured is required to pay during the term of the insurance. With property insurance, a coinsurance provision requires the insured to pay a percentage of the loss only if the property is underinsured in relation to its actual value. This practice discourages purchasing less insurance than is needed to cover the full value of the property if loss occurs.

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Describe the four common parts of an insurance policy.

a question of ethics

Insurance Fraud

The Coalition Against Insurance Fraud reports that insurance fraud in the U.S. is an $80 billion-a-year business. They divide fraud into two categories—hard fraud and soft fraud. Hard fraud occurs when crooks set out to deliberately fake an accident, injury, theft, or other loss to collect money illegally from insurance companies. Soft fraud occurs when normally honest people fudge the truth to an insurance company to reduce a premium, cover a deductible, or get a larger settlement. They justify their actions by saying that everyone does it, insurance costs too much, or the insurance companies won't notice a small amount. Examples of soft fraud include

- A car owner includes previous damage to the car after an accident so insurance will cover that repair
- A body shop owner inflates the cost of repair so the customer doesn't have to pay the insurance deductible
- Following a burglary, the homeowner adds items to the list of stolen property that really aren't missing to obtain a larger settlement
- A doctor submits to an insurer a more serious diagnosis of a patient than actually exists in order to receive a larger reimbursement
- A person who slips and falls at a store exaggerates the injury in order to obtain money from the store's insurance company

In a study by Accenture, almost 25 percent of respondents say it is okay to defraud insurance companies. About one in 10 people support submitting claims for items that aren't lost or damaged or for personal injuries that didn't occur. Almost the same number state they would engage in insurance fraud if they could get away with it.

Think Critically

1. From an ethical or moral viewpoint, what if any difference exists between hard fraud and soft fraud? Justify your answer.
2. While the vast majority of Americans do not condone insurance fraud, why do you think many persons believe fraud is acceptable and would be willing to commit insurance fraud?

10.2 Lesson Assessment

UNDERSTAND CONCEPTS

Determine the best answer for each of the following questions.

1. A(n) ____?____ means that the insured will suffer a financial loss if the insured event occurs.
   a. peril
   b. insurable interest
   c. risk
   d. none of the above
2. The business activity in which each insurance application is carefully reviewed to make sure all information needed to make a decision is available and accurate is known as
   a. rate making
   b. claims processing
   c. investing
   d. underwriting
3. With ____?____ the insured and insurer share the risk by paying a defined amount of the costs.
   a. dividends
   b. deductibles
   c. coinsurance
   d. premiums
4. **True or False?** Insurance transfers some risk faced by an individual or organization to others.
5. **True or False?** An insurance salesperson can actually represent several insurance companies rather than just one.

MAKE ACADEMIC CONNECTIONS

6. **Government** Use the Internet to locate information on the department of insurance for your state. Describe five services the department provides to consumers and businesses. Identify three ways the department regulates insurance companies in your state.
7. **Math** The table identifies the deductible included in an insurance policy and the loss suffered by the insured. Calculate the amount of the loss that must be paid by the insured and the insurer in each case.

	Amount of Deductible	Amount of Loss
a.	$250	$825
b.	$500	$450
c.	$1,000	$2,420

8. **Critical Thinking** Due to the number of hurricanes that have hit Florida in recent years, many insurance companies have decided not to renew policies for property owners who have filed large claims and to raise rates by as much as 300 percent for renewals of those who didn't file claims. Property owners believe this is unfair since hurricanes are natural disasters. Write a letter to the Insurance Commissioner of Florida to support the decisions of the insurance companies or to argue that the insurance companies should be prevented from taking those actions.

10.3 Property and Vehicle Insurance

Goals

- Describe common types of business property insurance.
- Identify the main provisions of commercial vehicle insurance.

Terms

- coverages
- self-insurance

Insuring Property Risks

Property is a major asset of most businesses. Business operations depend on a variety of types of property that the business owns or rents and even the property of others that is used to support business operations. Because property risks are common to many businesses, the risks can be identified, and damage or loss of property can have a negative financial impact on the business, insurance is available to provide protection against those risks. The common types of property insurance are comprehensive property, business owners, title, transportation, credit, and crime. There are also some more specialized and newer types of property insurance coverage. In addition, within each type a variety of **coverages** (the monetary limits and risks covered by an insurance policy) are available.

Each business will not need and likely cannot afford to purchase each type of property insurance. Planning comprehensive affordable insurance coverage and determining how to minimize risk is an essential part of risk management. Purchasing insurance alone is not adequate to reduce risk and will not be the most cost effective strategy for businesses.

COMPREHENSIVE PROPERTY INSURANCE

Because businesses face so many types of property risks, it would be inefficient to obtain a separate insurance policy for each type of risk. The insurance industry created a comprehensive business property insurance package called the *Commercial Package Policy (CPP)*. Each business can select the appropriate coverage needed but the total set of coverages will be written within one insurance contract with one premium amount.

CPP Coverage Figure 10-2 on the next page lists the full set of perils that can be insured in a Commercial Package Policy. There are of course limitations and exclusions for insurability of each of the perils.

In general, CPP provides protection for all buildings owned by the business and any fixtures and equipment that are considered to be a permanent part of the business. Coverage can be carried on rented buildings to the extent that the building's owner does not provide insurance. The personal property of the business can be insured under the policy as well as the personal property of others that is used in or controlled by the business.

FIGURE 10-2

Commercial Package Policy

Types of Perils Insurable Within a Commercial Package Policy	
fire	lightning
explosion	windstorms
hurricanes	tornadoes
hail	smoke
damage by aircraft	damage by vehicle
riot or civil unrest	looting and vandalism
piped water or steam	sprinkler damage
sinkholes	volcanoes
falling objects	snow, ice, and sleet

Coverage can be obtained to restore or replace important business records and papers located within the business' buildings or temporarily located off-premises. It is even possible to insure outdoor equipment used by the business and business landscaping. Many of the coverages have limitations on the maximum amount that can be insured and the perils that are covered, as well as important conditions and exclusions. Some coverages are very expensive and are chosen only because of special circumstances or the type of critical business operations that must be maintained.

Special Coverages Several important coverages are available to businesses that provide assistance if there is damage or failure of important equipment or machinery. *Business income insurance* compensates the business for some of the income that is lost if the business cannot operate for a period of time due to a covered peril. *Extra expenses* that the business incurs to maintain or reestablish operations can also be covered. For example, if a business has to rent or purchase a large generator due to a power failure, that cost may be covered. *Consequential damage coverage* pays for damages to the business that occur after another incident but related to it. In the situation above where the business suffers a power failure, if inventory was damaged as a result of that problem (a supermarket could not maintain the appropriate temperature in coolers and freezers), consequential damage coverage could pay for some losses.

BUSINESS OWNERS POLICY

Small businesses may not see the CPP as appropriate or affordable for insuring their operations. A special property insurance policy has been developed for the unique circumstances of small businesses. It is known as the *business owners policy*. The intent of the business owners policy is the same as the CPP in that it offers comprehensive coverage in one policy. It also allows each business to tailor the policy to the specific characteristics and conditions of the business. Common coverages under the business owners policy are business and personal property, crime (burglary, robbery, employee or customer theft, forgery, employee dishonesty), and lost income. Most policies for small businesses also include business liability coverage.

teamwork

Before studying the information on property risks, brainstorm with team members all of the ways business property can be damaged or destroyed. Then check your list against the perils discussed in the lesson. Discuss how each of the perils could affect business operations.

f.y.i.

A report of the U.S. Bureau of Labor Statistics revealed that the insurance industry provided 2.3 million jobs in 2005. From 1996 to 2005 the total number of people employed in the insurance industry averaged 2.1 percent of total U.S. employment.

Business owners policies are usually written with a requirement that insurance must be carried for at least 80 percent of the current value of the property insured in order to receive full payment for losses. If coverage is lower than that requirement, payments for losses will be adjusted accordingly. This provision is similar to coinsurance.

TITLE INSURANCE

Title insurance protects a real estate purchaser against losses due to a defect in the *title,* or the owner's legal interest in the property. Land and buildings have a long life and are often passed from owner to owner. While legal contracts and public records document the transactions, there may be errors in those records that create ownership problems requiring the new owner to pay expenses to correct the problems. A previous owner may not have had full title, there may have been fraud involved in a sale or transfer of property, or a lien may have been placed on the property. A *lien* is a claim against the property as security for a debt owed by the owner. When real estate is purchased, the public records are carefully reviewed and an attorney prepares a report on the validity of the title. If that review fails to uncover an existing problem, the new owner may suffer financial damages.

Title insurance offers protection in two ways. The insurer helps with the defense of the insured in legal proceedings related to the legitimate title to the property. Title insurance also covers losses incurred due to the purchaser relying on the accuracy of the title. Most title insurance policies contain exclusions or possible defects in a real estate title that are not covered. Title insurance is purchased at the time the real estate contract is completed and remains in effect until the property is sold or the title transferred.

TRANSPORTATION INSURANCE

Transportation insurance is one of the oldest forms of business insurance. Whenever goods and materials are moved from one place to another, there is a risk of delay, damage, or theft. Any of those problems can result in financial loss to the businesses that are sending and receiving the goods as well as the company responsible for transportation. Transportation insurance protects against damage, theft, or complete loss of goods while they are being shipped.

Transportation companies are held responsible for losses to shipments while the goods are under their control. As long as they are not negligent in handling, packaging, and transporting the goods, it may be difficult to get a full settlement for losses suffered. Because so many products are now shipped internationally, the transportation laws of several countries may be involved in disputes over losses. To provide protection in those events, it is wise for businesses to purchase transportation insurance. Transportation insurance can be purchased by the transportation company, the buyer, the seller, or others who have a financial interest in the shipment or the assets used as a part of the distribution process.

Transportation insurance is divided into two main categories. *Marine insurance* covers shipment on oceans and inland waterways including rivers and lakes. Insurance is purchased by transportation companies to cover the actual vessel, the cargo, the income earned for shipping, and expenses arising from liability issues. *Inland marine insurance* covers all transportation over land via trains, trucks, and other vehicles as well as storage of products during transit. It also can be used to insure structures that are essential to transportation such as bridges, tunnels, and even communications towers and antennas. Policies can be purchased that cover a specific shipment or all designated types of shipments for a given period of time.

NET Bookmark

The Insurance Information Institute provides information about insurance for businesses and individuals. Access thomsonedu.com/school/busfinance and click on the link for Chapter 10. Find out some of the issues involved in insuring a small business.

www.thomsonedu.com/school/busfinance

CREDIT INSURANCE

Businesses that make extensive use of credit may consider the use of credit insurance. *Credit insurance* pays off the balance of outstanding loans in the event of death or disability of a debtor. Businesses may require credit applicants to purchase insurance on the amount of a loan, particularly for real estate loans and mortgages when the amount borrowed is close to the actual value of the real estate. This type of insurance is known as private mortgage insurance (PMI). Many retailers that sell merchandise using installment credit offer credit insurance to their customers. If credit insurance is included in the sales contract, for example when a car is purchased, the terms and cost of the insurance to the customer must be fully disclosed. Credit card companies also offer credit insurance policies to cardholders that pay off account balances under certain conditions. *Trade credit insurance* pays for losses suffered when payment is not made by businesses that purchased on credit. In order to encourage international trade, the U.S. government offers export credit insurance to businesses selling goods overseas and making foreign investments.

The federal government insures some types of loans made by private investors through special programs designed for students, small businesses, and veterans, among others. Cities and other government units that issue bonds may purchase insurance against the value of bonds they are issuing that will pay the bondholders in the event of default. The insurance improves the security of the bonds and may result in a higher bond rating and lower cost to the issuer.

CRIME INSURANCE

Crime affects individuals and businesses. All bear the burden of crime, including very high costs. Estimates of the annual cost of crime in the U.S. range from $450–$675 billion dollars. Specific costs to businesses include private security, lost wages and personnel costs, stolen and damaged property including any lost through fraud and embezzlement, and higher taxes resulting from increased costs for the criminal justice system.

Insurance cannot cover all of the costs of crime. Many of the risks related to crime must be controlled and reduced through careful risk management. However, several types of crime insurance are available to businesses. *Burglary, robbery, and theft insurance* covers crimes committed by people that are not owners or employees of the business. Burglary refers to unlawful taking of property from inside the business. Robbery is illegally taking property from another person through force or violence. Theft is a broader term that describes all types of stealing. It can include forgery of checks, negotiable instruments, and other valuable documents.

Bonds are similar to insurance in that they provide protection against a risk associated with the work provided by one business to another. The company performing the work provides a bond guaranteeing reimbursement of losses suffered by the customer from the failure to perform as agreed. A *fidelity bond* provides protection for losses resulting from dishonest employees. A *surety bond* protects against losses resulting from the failure to complete any part of a contract according to the specified conditions. It is often used in construction to make sure a building is completed on schedule or meets specified construction standards.

checkpoint ✓

Identify six types of property insurance and the purpose of each.

Vehicle Insurance

Most businesses own or lease at least one and often many vehicles. Some businesses such as transportation businesses, retailers, manufacturers that ship their own products, and producers such as farmers and timber companies have fleets of trucks and specialized vehicles. Many of those vehicles are expensive, have high maintenance and repair costs, and are crucial to the operation and profitability of the company. There are a number of risks associated with the ownership and operation of vehicles.

Some large companies assume some or all of the cost of risks associated with their vehicles through self-insurance. **Self-insurance** is the advance budgeting of funds to meet the estimated cost of losses. A self-insurance program is risky because losses do not occur on a regular schedule. The amount of losses can be very high in one time period and lower in another.

Businesses often depend on the use of specialized vehicles that must be insured for damage and liability.

With self-insurance, the company must pay all costs whether there are adequate funds reserved or not. One method of balancing that risk is to use self-insurance for more predictable types of losses and purchase insurance for losses that are likely to fluctuate or that may have very high costs.

The components of an automobile insurance policy are similar for individuals and businesses. Policies written to cover business automobiles and other vehicles are called *commercial vehicle insurance* or *business auto coverage*. The common components of a vehicle insurance policy are described in Figure 10-3.

FIGURE 10-3

Vehicle Insurance Policy Coverages

Coverage	Description
collision	Pays for repairs to the insured's vehicle required as a result of a collision with another vehicle no matter who was at fault.
comprehensive	Pays for repairs to the insured's vehicle required as a result of damages resulting from causes other than collision, including fire, hail, vandalism, and theft.
bodily injury liability	Pays the insured's legal defense costs and claims against the business and authorized vehicle operators if the vehicle injures or kills someone.
property damage liability	Pays the insured's legal defense costs and claims if the vehicle damages another's property. Does not cover damages to the business' property or vehicle.
medical payments (personal injury protection)	Pays medical expenses resulting from an accident for the vehicle operator and other occupants. May pay for covered personnel injured while riding in vehicles not owned by the business.
uninsured or underinsured motorist	Pays for costs related to injuries or property damage to authorized drivers and occupants in the business' vehicle caused by an uninsured, underinsured, or hit-and-run driver.

Some aspects of commercial vehicle insurance differ from individual auto insurance policies. Liability costs are a particularly important issue for businesses, especially those that operate large vehicles transporting expensive cargos, vehicles that carry people such as taxis and busses, or vehicles carrying hazardous materials. Such companies will usually have separate liability insurance polices or comprehensive liability coverage as a part of a Commercial Package Policy. The amount of liability coverage may be as high as $5 million or more.

A unique insurance issue is posed by transportation companies that ship goods and materials via semi-trailer. Often the trailer of one company is exchanged with another company's trailer to be transported to a different destination. Normally insurance only extends to the vehicles and cargo identified in the company's insurance policy. A trailer interchange agreement resolves that problem. The trailer interchange agreement is a written arrangement whereby trucking firms exchange the use of their trailers. Under the agreement the company's insurance provides coverage for physical damage to non-owned equipment while in the control of the business.

checkpoint ✓

What is the difference between collision, comprehensive, and property damage liability coverage in a vehicle insurance policy?

technology topics

Protect My Car

Vehicle theft is one of the major crimes affecting both businesses and individuals. It also is a major cost to insurance companies. The financial impact in terms of insurance premiums, out-of-pocket repair costs, and new car costs has now passed $7.5 billion. The National Insurance Crime Bureau recommends a layered approach to reducing vehicle theft that combines basic security procedures with new technology. Here are the layers they recommend.

Layer 1 Common Sense Always remove your keys, close your doors, lock your vehicle, and park in a well-lit public area.

Layer 2 Warning Device Use a visible or audible device that warns thieves the vehicle is protected. It may be an alarm, lockable device on the steering wheel, identification markers, or window etchings.

Layer 3 Immobilizing Device Prevent thieves from hotwiring your car with a smart key, kill switch, or fuel disabler.

Layer 4 Tracking Device A tracking device emits a signal when a vehicle is stolen so it can be located and recovered quickly by police. Most vehicles with the devices are recovered while those without are not.

Experts believe that this combination of theft prevention procedures and technology would put a major dent in the number of vehicles stolen and the cost of vehicle theft.

Think Critically

1. If your auto insurance policy provides protection against vehicle theft, why should you be concerned about reducing the amount of theft that occurs nationwide?
2. Do you believe consumers and businesses should encourage auto manufacturers to install all of the technology recommended by the National Insurance Crime Bureau in every car manufactured so most vehicle theft could be prevented? What if it added $300–$500 to the cost of each vehicle?

10.3 Lesson Assessment

UNDERSTAND CONCEPTS

Determine the best answer for each of the following questions.

1. **True or False?** Businesses can obtain comprehensive insurance coverage on buildings they own but not for those they rent.
2. A special property insurance policy developed for the unique circumstances of small businesses is
   a. title insurance
   b. commercial package policy
   c. business owners policy
   d. business income insurance
3. ____?____ insurance pays off the balance of outstanding loans in the event of death or disability of a debtor.
4. The vehicle insurance coverage that pays for repairs to the insured's vehicle resulting from damages not due to collision is
   a. property damage liability
   b. medical payments
   c. uninsured motorist
   d. comprehensive
5. ____?____ is the advance budgeting of funds to meet the estimated cost of losses.

MAKE ACADEMIC CONNECTIONS

6. **History** Natural disasters result in high losses to property and life around the world. They also contribute to higher costs of insurance when companies provide coverage in the affected areas. Use the Internet to identify up to ten major natural disasters that have occurred throughout the world. On a map of the world, locate and mark each natural disaster. Identify the type of disaster and its estimated cost.
7. **Math** The Bowman Co. is considering self-insuring its vehicles rather than purchasing an insurance policy. It examined three years of losses and listed the costs of vehicle repairs for the three years.
   a. What is the minimum and maximum annual cost of repairs?
   b. What is the average annual cost of repairs for the three years?
   c. If the company wants a one-year balance in the self-insurance account that is 10 percent higher than the highest annual cost of repairs, how much should it save each month?

Year 1	\$3,584	\$1,215	\$794	\$5,820
Year 2	\$2,505	\$13,582	\$1,035	
Year 3	\$450	\$4,267	\$6,024	\$1,995

8. **Writing** Crime is a major expense to many businesses. The costs result from paying for losses as well as prevention and security. You are working with a small retailer in your community to help them learn more about reducing the impact of crime. Conduct research and prepare a two-page report to the owner making recommendations on new types of security technology that are available and other measures they can take to reduce various types of crime. Make sure to cite the sources of information you use to prepare your report.

10.4 Personnel and Liability Insurance

Goals

- Describe important personnel risks and how they are insured.
- Identify the types of insurance for business liability risks.

Terms

- beneficiary
- criminal liability
- civil liability

Providing Personnel Protection

The people who work for a business are certainly a very important asset. They contribute their time and skills to complete the work of the business. Well-trained and motivated employees are an important resource for reducing the risks facing a business by working safely, conserving materials, maintaining equipment, and identifying and reducing hazards and risky procedures. Businesses make a major investment in employees. In addition to salaries and wages, training costs for each employee can be quite high. While the amount spent on training per employee averages just $1,500 per year, the costs can reach $5,000–$10,000 for specialized skills and management personnel. In addition, the average cost of employee benefits is more than 30 percent of the wages and salaries paid. Data from the U.S. Department of Labor's most recent report of employee compensation for private employers in the U.S. is shown in Figure 10-4 on the next page.

REQUIRED INSURANCE BENEFITS

The Old Age, Survivors', and Disability Insurance (OASDI) program was enacted by the federal government in 1935. Better known as *Social Security,* its purpose was to provide a minimum income benefit for retirees when they reached age 65, as well as financial support for workers who became disabled and for the surviving spouse and children in the event of the death of a worker. The program was expanded in 1965 with the addition of Medicare and Medicaid, which provide health insurance, health care, and prescription drug benefits for retired persons, low-income families, and people with certain disabilities. Social Security programs are funded by a combination of employer and employee contributions. In 2006, the contribution rate for employers and employees was 6.20 percent of earnings up to a maximum wage of $94,200. The employer and employee contribution rate for Medicare/Medicaid was 1.45 percent of all earnings. Self-employed persons are responsible for the entire contribution or a total of 15.3 percent of earnings.

FIGURE 10-4

Average Costs of Wages and Benefits for Each Employee

	Goods-Producing Businesses		Service-Providing Businesses	
Total Compensation	$29.36	100.00%	$24.05	100.00%
Wages and Salaries	$19.44	66.20%	$17.31	72.00%
Total Benefits	$9.92	33.80%	$6.74	28.00%
Overtime and Bonuses	$1.16	4.00%	$0.63	2.60%
Life Insurance	$0.06	0.20%	$0.04	0.20%
Health Insurance	$2.47	8.40%	$1.54	6.40%
Disability Insurance	$0.12	0.40%	$0.08	0.40%
Retirement	$1.48	5.00%	$0.77	3.20%
Social Security	$1.34	4.60%	$1.16	4.80%
Medicare	$0.32	1.10%	$0.29	1.20%
Unemployment Insurance	$0.25	0.80%	$0.18	0.70%
Workers' Compensation	$0.87	3.00%	$0.38	1.60%

Unemployment Insurance Two other required benefit programs are unemployment insurance and workers' compensation insurance. *Unemployment insurance* makes payments to workers during periods of unemployment that are beyond the workers' control. Unemployment insurance programs are administered by each state. Benefits are paid out of funds accumulated from payroll contributed by each employer. Each state establishes its own rules for the program under federal guidelines. Generally, unemployment insurance can be received until the person obtains new employment or for up to 26 weeks. Insurance payments are based on the average amount of the employee's earnings during the previous year.

In most states, the rate each employer pays for contributions to the unemployment fund is based on the company's unemployment history. Employers who have had a higher rate of employee layoffs will pay a higher rate than those with very low layoff rates. Employer contribution rates are based on a percentage of each employee's wages. Many states cap the maximum amount of wages on which unemployment fund contributions must be made. Example rates for selected states are shown below.

	Minimum Rate	Maximum Rate
Arkansas	0.8%	6.7%
Maryland	0.6%	9.0%
Missouri	1.3%	4.12%
California	1.6%	6.2%

Workers' Compensation Insurance Medical care, rehabilitation, and lost wages for injured workers as well as death benefits for the dependents of persons killed in work-related accidents are provided by *workers' compensation insurance*. Accidents and illness in business is a serious and expensive problem. A larger volume of insurance is sold for workers' compensation than any other type. The Bureau of Labor Statistics identifies the occupations that have the greatest number of injuries and illnesses. The most recent data is reported in Figure 10-5. Vehicle accidents are the largest cause of occupational deaths.

teamwork

Review and discuss the list of occupations in Figure 10-5. Why do you believe those at the top of the list are most dangerous? Are you surprised by any of the occupations that are in the top ten?

FIGURE 10-5

Top Ten Occupations with the Largest Number of Injuries and Illnesses

Occupation	Number of injuries and illnesses (000)	Percent of total injuries and illnesses
Nonconstruction laborers	89.3	7.1%
Heavy truck drivers	63.6	5.1
Nursing aides, orderlies	51.9	4.1
Construction laborers	37.9	3.0
Light truck drivers	37.2	3.0
Janitors and cleaners	33.6	2.7
Retail salespersons	33.2	2.6
Carpenters	30.5	2.4
Stock clerks, order fillers	24.3	1.9
Maintenance and repair	21.1	1.7
Total, top 10 occupations	422.6	33.6
Total, all occupations	1,259.3	100.0%

Workers' compensation insurance was established as a part of the federal Occupational Safety and Health Act (OSHA) in 1970. Authority to administer the programs was given to each state. In most states, employers are given three choices of how to provide coverage for their employees.

1. Purchase insurance from a private insurance company
2. Purchase insurance from a state or federal insurance fund established under the law
3. Self-insure through contributions to their own fund

EMPLOYEE HEALTH INSURANCE

The percentage of businesses offering health insurance to their workers has declined steadily recently. As the costs of health care increase much faster than the rate of inflation or the cost of business, the percentage of businesses offering the benefit dropped from almost 70 percent to 60 percent in just five years. Large businesses continue to offer health insurance, with nearly 98 percent reporting that they provide coverage. To respond to rising costs, many of those plans have increased the amount that must be paid by employees, reduced coverage, and increased the copayments and deductibles employees pay for medical services.

Health insurance provides payment for expenses related to preventive health care and the treatment of illness and disease. There are two common types of health insurance plans—fee-for-service and managed care. *Fee-for-service insurance* makes payments to doctors and hospitals for each service rendered to the patient. Employees have more freedom in choosing their health care service providers under this plan. *Managed care insurance* is designed to reduce costs by restricting employee choice of doctors and hospitals, negotiating fees for services, and requiring pre-authorization for non-emergency services.

Managed Care Plans Two types of managed care plans are PPO (preferred provider organizations) and HMO (health maintenance organizations). A PPO has arrangements with a network of doctors, hospitals, and other providers who have agreed to accept lower fees from the insurer for their services. An employee can select services within the network and will be charged a small copayment for services. If the employee goes outside the network, there will be higher copayments as well as the requirement to pay any costs higher than those negotiated in the network.

An HMO provides a full range of health services but they must be obtained from the providers that are affiliated with the HMO. Usually employees are assigned or select a primary care physician who makes decisions about the services patients receive and refers them to specialists in the HMO when needed.

Some employers offer other types of insurance as a part of health benefits. Common insurance plans include

- **Catastrophic Coverage** pays for costs of long-term or particularly expensive health care beyond the coverage of typical health plans
- **Medicare Supplement** private insurance that pays for gaps in Medicare coverage
- **Long Term Care** pays costs of nursing care in-home or at special facilities for those unable to care for themselves due to an extended illness or disability
- **Disability Insurance** provides supplementary income for those with short- and long-term disabilities that prevent them from working
- **Dental And Vision Care** contributes to the cost of dental and vision treatment

If these supplementary insurance plans are offered, most employers require employees to pay much of the costs. By negotiating group rates with insurers, the cost of the employer-sponsored plans are usually lower than if the employee obtained an individual plan.

LIFE INSURANCE

Life insurance provides for payment of a sum of money to a beneficiary upon the death of the insured. A **beneficiary** is a person or organization designated to receive the proceeds of the insurance policy. Many companies provide a specified amount of life insurance to full-time or permanent employees. Others offer the opportunity for employees to purchase life insurance but the employee must pay all or most of the cost of the policy. Insuring the lives of key executives of a business is a common practice and f.y.i.

Of the total amount of money paid in liability claims in the U.S., 22 percent was paid for direct economic losses suffered, 25 percent for non-economic losses (pain and suffering), 17 percent for attorney fees of the plaintiff, 16 percent for defendants' legal expenses, and 25 percent for court costs and administrative fees.

the company is named as the beneficiary. The insurance proceeds provide money to help with management transition upon the death of the executive.

Employers offer group life insurance plans that make individual coverage less expensive. Group plans also provide access to insurance for people who might not be able to qualify due to existing health conditions. Generally employees must elect to enroll in group insurance plans soon after beginning employment. If they choose not to participate, they cannot later decide to enroll without meeting higher eligibility requirements.

Most life insurance provided by employers is term insurance. *Term insurance* covers the insured for a specific period of years and does not accumulate any value beyond the death benefit. Because the insurance has a limited life and is not used as an investment tool, it is a lower-cost form of insurance. Often the term insurance provides accidental death and dismemberment (AD&D) coverage. That coverage pays a higher death benefit if death results from an accident. It will also pay specified smaller amounts to the policyholder in the event of dismemberment such as the loss of use of an arm or leg, hearing, or sight.

Alternatives to term insurance are ordinary and universal life insurance. *Ordinary* or *whole life insurance* provides permanent coverage for the life of the policyholder as long as premiums are paid. The policy accumulates a small cash value over time. With *universal life insurance,* part of the premium buys term insurance coverage that will be paid if the insured dies. The rest of the premium is invested in high-yield securities as a savings tool for the policyholder.

RETIREMENT PLANS AND PENSIONS

As people expect to live into their 80s and even their 90s, they are increasingly concerned about the income they will need after retirement. Most believe that Social Security and personal savings will not be adequate to provide the standard of living they want and to pay for increasing health care and medical costs in old age. Employers can offer retirement and pension plans to employees to aid them with their long-term financial planning. In the past large companies developed private pension funds and paid a large percentage of employee contributions into those plans. With rising business costs and pension costs much higher than predicted, many private plans have been dramatically modified or even dropped.

A traditional pension plan is designed to pay benefits to the employee for a prescribed number of years after retirement. Regular contributions are made to the plan by the employer and employee based on a percentage of wages and salaries. Pension plan managers invest the funds to increase their value in order to meet the amount needed to pay retirement benefits. A *defined contribution pension plan* does not guarantee an employee a fixed level of benefits upon retirement. Instead, the employer contributes a fixed amount to an account set up for the employee and benefits are determined by the amount of contributions and the performance of the investments. A *defined benefit plan* promises the employee a fixed or determinable monthly payment upon retirement. This more traditional form of pension requires the employer to contribute adequate funds to provide the promised benefit, resulting in higher than anticipated costs for many companies.

Newer forms of employer-sponsored retirement plans try to reduce the direct costs to the employer but provide employees with incentives for savings. Many of the plans are no longer managed by the business but use financial planners and investment firms to develop and manage the retirement funds. The federal government has provided a number of tax incentives in qualified investment plans designed to encourage employer and employee contributions. Examples of those plans are

- Deferred profit-sharing, stock bonus, or stock-ownership plans in which employers share profits in the form of cash or stock or allow employees to purchase stock on a tax-deferred basis.
- 401(k) savings plans in which employees can invest money in qualified savings and investment plans on a pre-tax basis. The amount of savings is deducted from the employee's salary before income tax is withheld.
- Individual retirement accounts (IRAs) allow employees to supplement their retirement savings by additional contributions to private plans selected by the employee. The savings can be made through payroll deduction.

Each of the retirement plans that are approved for special tax treatment has restrictions and requirements that must be met in terms of who can invest, the maximum amounts that can be contributed, and how and when funds can be withdrawn.

checkpoint ✓

Why are employers willing to contribute 30 percent or more of the cost of employee salaries and wages to pay for benefits?

The Need for Liability Insurance

One of the greatest risks to a business is liability. In its broadest sense, liability means being legally responsible. More specifically, when a business has a legal liability it is responsible for paying others because of negligent actions. That liability extends to harm and damage resulting from the use of a business' products and services, from actions of business personnel or those acting under the direction of the business, and that occur in and around the property of the business. The results of business liability appear in the settlement of court cases for millions of dollars. Even if those large settlements are not enough to drive the business into bankruptcy, they will have a major effect on the long-term financial performance of the company as well as the image and reputation of the business in the eyes of customers and the public.

Two types of penalties can be applied in liability cases. **Criminal liability** results from breaking a law. People guilty of crimes may serve prison sentences and pay fines. Recent public examples of business criminal liability are the convictions of Enron, Tyco, and WorldCom executives. **Civil liability** results from negligent acts against individuals or organizations. Individuals or organizations bring a lawsuit against others

Professionals can purchase special liability coverage for the unique activities of their business.

for damages suffered from negligent actions. When a civil judgment is made against a person or a business, the penalty is payment of damages to those who were harmed. It will also usually require that the negligent actions be stopped.

MANAGING LIABILITY RISKS

Because business liability can result in financial costs in the millions of dollars, companies must be proactive in managing those risks. The process of managing liability means identifying all possible areas of potential liability for the business, the particular products, people, activities, and actions (or lack of action) that can contribute to liability, and taking direct action to reduce and remove any liability problems. These actions will include product design, development of specific service procedures, careful employee training, developing and enforcing safe operating procedures, providing clear product information, and quick and effective responses when harm or injuries occur.

Companies often purchase liability insurance that provides coverage for the areas and activities where the business has liability exposure. Liability insurance can be very expensive for areas where damages can affect hundreds of people or the costs can be in the millions of dollars. Companies must not avoid purchasing adequate liability insurance because of the cost. Taking actions to reduce the probability of negligence or limit the effects of damage can help reduce the costs of liability insurance. But if liability is reasonably possible, insurance will be needed to avoid a liability judgment that can financially ruin the business.

TYPES OF LIABILITY INSURANCE

Several liability coverages have already been identified in the discussions of property and vehicle insurance. Workers' compensation is also a type of liability insurance, as are elements of health and life insurance. Almost every type of business insurance offers liability coverage as a part of the basic policy or as an optional coverage. In developing a liability insurance plan, risk managers should carefully review existing insurance policies to determine existing coverages and their costs. Then any new coverage should avoid duplication or provide the same coverage at a lower cost so that the liability coverage in the specialized policy can be removed or reduced.

Commercial General Liability Commercial general liability (CGL) insurance provides very broad coverage to people and property and the types of actions and activities of a business that typically provide liability exposure. The actions of owners, executives, and employees acting on behalf of the business are covered. Even stockholders of corporations acting in their official roles and vendors performing required work of the organization can be included.

Other liability coverages in a CGL include damages resulting from

- The use of the company's products and services
- Any contracts entered into on behalf of the business
- Harm or injury to property or people caused by personnel, products, or assets of the business
- The business' advertising or other communications

Commercial Liability Umbrella Insurance Companies with liability exposures in the millions of dollars can also purchase an umbrella liability policy. An *umbrella policy* is a separate policy providing a higher limit of coverage over and above any other basic liability policies an insured may have. If each liability policy owned by a business carried coverage for millions of dollars, the cost would be prohibitive. The likelihood of having a large claim against each of those types of risks is not great, but it is possible that one area may suffer a very large loss. An umbrella policy picks up coverage above the limits of the underlying or specialized policies at a lower cost that having the coverage in each policy. Usually the specialized policies are required to have coverage of $500,000–$1 million. The umbrella policy then extends the liability coverage as high as $100 million or more.

Other Liability Insurance Several other types of liability insurance policies are available to provide coverage for special circumstances or unique activities and operations of a business. Examples are shown in Figure 10-6.

FIGURE 10-6

Special Business Liability Coverages

Directors and officers	Protects the directors and officers of corporations for wrongful acts in connection with management.
Employment practices	Cover claims for harassment, discrimination, or wrongful termination of employees.
Cyberspace liability	Protects businesses that use online technology for actions resulting from libel, slander, copyright or trademark infringement, and errors.
Professional liability	Protects professionals such as accountants, attorneys, and architects from negligent acts, errors, or omissions in performing their professional services.
Medical malpractice	Covers physicians, dentists, and other medical practitioners for their actions or the actions of others under their supervision for their professional actions and the results. Coverage is also extended to the insured's business since many doctors are a part of a professional practice association.

checkpoint

How does an umbrella liability policy benefit a business?

business in action

Responding to Instant Messaging

Instant messaging (IM) is the communication method of choice for many computer users, but it causes headaches for businesses. Businesses are not only concerned about lost productivity from non-business use of IM, but more seriously about the business risks posed by its use. Publicly available IM services open unsecured electronic access into the organization that is quickly being attacked by hackers, virus-writers, and spammers. Research by FaceTime Security Labs shows that security incidents involving the use of chat, IM, and P2P networks were up 2,200 percent between 2004 and 2005.

Some businesses respond by banning the use of IM by employees. But that presents two problems. First, it is almost impossible to enforce the ban since IM programs can be easily downloaded onto any computer and the software is able to bypass most firewalls and security systems. Second, IM is a proven productivity enhancement tool for business. 70 percent of large businesses using IM and 84 percent of mid- and small-sized businesses report significant improvement in communications and cost reductions due to decreased phone usage. Banning IM reduces the security risks faced by the businesses but puts them at a competitive disadvantage with businesses that embrace the new technology.

Businesses face risk management issues when dealing with IM. If companies attempt to ban the use of the technology they risk upsetting employees, customers, and business partners and creating an environment where policies will be violated and increased monitoring of employees will be needed. On the other hand, if companies embrace the use of IM but don't recognize and deal with the major security threats opened up by the technology, they will face the likelihood of data theft and attacks on information technology systems.

Risk management personnel are installing new comprehensive instant communication tools on their computer systems and on each employee's computer. The new tools offer vast improvements over publicly available IM, integrating video and desktop tools for conferencing and collaboration. Most importantly they offer significant security protection that can be controlled by the business. While the initial cost may be high, it allows employees access to the use of IM while greatly reducing potential security threats and costs.

Think Critically

1. Why would banning the use of IM reduce employee productivity if it reduced the amount of time employees spend on non-business communication?
2. Do you believe the communications of individual employees through IM and e-mail present security risks to a business? Why or why not? Recommend policies a business could implement to make sure the use of IM and e-mail by employees does not harm the business.

10.4 Lesson Assessment

UNDERSTAND CONCEPTS

Determine the best answer for each of the following questions.

1. ____?____ provides medical care, rehabilitation, and lost wages for injured workers as well as death benefits for the dependents of persons killed in work-related accidents.
   a. unemployment insurance
   b. Social Security
   c. workers' compensation
   d. Medicare
2. Which of the following is *not* one of the penalties that can be applied in the case of liability?
   a. a fine
   b. a jail sentence
   c. payments to those who suffer damage
   d. All of the above are penalties for liability
3. A separate policy providing a higher limit of coverage over and above any other basic liability policies an insured may have is a(n)
   a. umbrella policy
   b. all causes policy
   c. malpractice policy
   d. general conditions policy
4. **True or False?** Businesses can choose not to offer Social Security benefits to their employees.
5. **True or False?** Businesses are unable to reduce the liability risks they face so they should carry liability insurance for every risk they face.

MAKE ACADEMIC CONNECTIONS

6. **Math** A business located in Missouri has a total payroll of $8,563,928. If they are required to pay worker's compensation on the first 8 percent of their payroll costs, what would be the minimum and maximum amount they would have to contribute based on the information in the lesson?
7. **Critical Thinking** Spend some time thinking about your daily activities at home, school, on your job if you are employed, and in your community. List 10 risks you regularly face that can result in personal harm, damage to your property, or personal liability for your actions. Prepare a table in which you list each of the risks, the possible perils related to each risk, actions you can take to reduce each risk, and the type of insurance that you could purchase (if any) to provide financial protection.
8. **Law** Based on the potential major negative consequences a terrorist attack could have on the U.S. economy, the federal government passed the Terrorism Risk Insurance Program. Use the Internet to research the law and develop a short computer presentation summarizing the purpose of the program and the help it provides to businesses and insurance companies.

Chapter 10 Assessment

Summary

10.1 MANAGE RISK

1. Risk is the chance or probability of harm or loss. Individuals face risks that can affect health, income, property, and can even result in death. Businesses face risks that can have a significant economic effect.
2. Natural risks arise from natural events or are a part of nature. Human risks result from the actions of individuals, groups, or organizations. Risks can be avoided, transferred, insured, or assumed.

10.2 PRINCIPLES OF INSURANCE

3. Insurance is based on three principles. (1) Some risk facing an individual or organization is transferred to others. (2) Risks are pooled or shared among a large group of individuals or companies. (3) Risk for any one individual or business is reduced by controlling the uncertainty of the loss.
4. Insurance companies can be stock companies or mutual companies. Their major activities are rate making, selling, underwriting, investing, and claims processing. An insurance policy is a legal contract between the insurer and the insured. A standard insurance policy contains declarations, the insuring agreement, conditions, and exclusions.

10.3 PROPERTY AND VEHICLE INSURANCE

5. Property risks to businesses can be identified and insurance is available to provide protection against those risks. The common types of property insurance are comprehensive property, business owners, title, transportation, credit, and crime.
6. Automobile insurance policies are similar for insurance purchased by individuals and businesses. Policies covering business vehicles are called commercial vehicle insurance or business auto coverage.

10.4 PERSONNEL AND LIABILITY INSURANCE

7. The federal government requires business to provide Social Security, unemployment, and workers' compensation insurance. Two common types of health insurance plans are fee-for-service and managed care. Life insurance pays a beneficiary upon the death of the insured. Employers offer retirement and pension plans to employees to aid long-term financial planning.
8. Companies must be proactive in managing liability risks. They can purchase liability insurance that provides coverage for the areas and activities where the business has liability exposure. Commercial general liability insurance provides broad coverage to people and property. An umbrella policy provides coverage beyond other policies.

Develop Your Business Language

Match the terms listed with the definitions. Some terms will not be used.

1. An individual or business is responsible to others for negligence
2. Can be reduced or avoided by thoughtful actions
3. A chance of financial gain or loss
4. A person or organization designated to receive the proceeds of the insurance policy
5. The individual or organization to which the policy is issued
6. A contract providing for financial protection against a specified loss
7. Results from breaking a law
8. The insured and insurer share the risk by paying a defined amount of the costs
9. Cannot be influenced by human action
10. No opportunity for financial gain but only loss
11. The chance or probability of harm or loss
12. The cause of a loss

a. beneficiary
b. coinsurance
c. controllable risk
d. coverages
e. criminal liability
f. deductible
g. economic risk
h. insurance
i. insured
j. insurer
k. liability
l. natural risk
m. peril
n. policy
o. policyholder
p. premium
q. pure risk
r. risk
s. self-insurance
t. speculative risk
u. uncontrollable risk

Review Concepts

13. A word that is used as a substitute for risk is ____?____.
    a. peril
    b. insurance
    c. uncertainty
    d. opportunity
14. Purchasing insurance trades a potentially large but uncertain loss for a smaller but certain ____?____.
    a. gain
    b. risk
    c. result
    d. payment
15. Which of the following must exist for a risk to be insurable?
    a. only a small number of individuals or businesses can face the risk
    b. losses from the risk must be both accidental and uncertain
    c. the cost of the losses cannot be estimated
    d. all of the above must exist
16. The part of the insurance policy that forms the basis of the contract between the insured and the insurer is the
    a. exclusions
    b. conditions
    c. insuring agreement
    d. declarations
17. ____?____ life insurance covers the insured for a specific period of years and does not accumulate any value beyond the death benefit.
    a. term
    b. AD&D
    c. ordinary
    d. universal

Chapter 10 Assessment

Think Critically

18. Do you believe a pure risk poses greater problems for a business than a speculative risk? Why or why not?
19. If you were the risk manager for a company, how would you go about attempting to identify all of the risks facing a business? How would you decide which risks should be insured and which should not?
20. What is meant by the insurance concept that risks are pooled or shared? How does each business benefit from pooling risks? Are there any disadvantages to a business from pooling its risks with others?
21. Use Figure 10-1 to describe how a bell curve represents the number and amount of damages that are likely to result from the number of fires that occur in a large number of businesses over several years.
22. Why do insurance companies need to identify both conditions and exclusions in an insurance policy? Why should businesspeople purchasing insurance make sure they clearly understand the conditions and exclusions?
23. Discuss the advantages and disadvantages to a young employee of the following options for retirement planning: (1) relying on Social Security only, (2) relying on a personal investment plan, (3) combining Social Security with a personal investment plan.
24. Choose a business and describe examples of situations where the business might need business income insurance and consequential damage coverage.

Business Financial Calculations

25. Using the information from the FYI in Lesson 10.2, calculate the total value of life insurance premiums and non-life insurance premiums sold in the U.S. in 2004.
26. A health insurance policy has a coinsurance clause that requires the insured to pay the first $250 of charges and 20 percent of additional charges up to a maximum total payment of $1,250. The bills for health care are

January 5	$120	March 30	$45
April 18	$375	June 20	$63
August 25	$560	October 2	$190
November 1	$35	December 20	$95

Calculate the amount the insured must pay for each of the bills. Then determine the total amount of the health care costs and the percentage paid by the insured and by the insurer.

27. John Eros is a carpenter and his wife Janell works as a bank teller. John earns a rate of $23.22 before overtime and benefits and Janell earns a rate of $18.50. Using the percentages shown in Figure 10-4, calculate the amount of compensation John and Janell would earn for each of the benefits listed in the figure. What is the total compensation for each person?

Analyze Cases

Use the case from the beginning of the chapter, Providing Specialty Insurance, to answer the following questions.

28. Why are the types of significant and unique losses described in the case such as a one-time entertainment event or the production of a movie difficult to insure?
29. What makes Lloyd's different in both organization and operations from traditional insurance companies? Why would a wealthy individual or corporation want to participate in a syndicate?
30. Insurance is offered to provide protection for pure risk, meaning there is no opportunity for financial gain. Do you believe the investments of the Lloyd's syndicates are pure risks or speculative risks? Justify your answer.
31. Why do you believe most of the investment capital in Lloyd's syndicates today comes from corporations rather than names?
32. What type of risks would you expect the Fortune 500 companies, global banks, and pharmaceutical firms to insure through Lloyd's that they would not be able to insure through traditional insurance policies?

Portfolio Activity

COLLECT examples that illustrate the variety of types of insurance policies and plans used by businesses.

CREATE a visual to illustrate a business dealing with a variety of risks through a comprehensive risk management program including insurance.

CONNECT your visual to other items already in your class portfolio or relate it to an important concept you have learned in another class. Make the connection by preparing a one-minute presentation on the importance of insurance to businesses, employees, and others.

Stock Market Activity

Financial and other business risks are common in every organization. These uncertainties regularly affect the financial performance and stock value of a company. Attempts to reduce or eliminate risks through insurance will influence an investor's decision to buy, sell, or hold a stock.

Use Internet and library resources to research the company you have been studying (or select a different company).

1. Identify common risks the company may encounter. Point out both internal (company) risks and external (economic, social, political) risks of the business.
2. Explain actions that might be taken to reduce or eliminate these risks.
3. Describe how various risks may have affected the market value of the company's stock over the past 12 to 18 months.

Planning a Career in Insurance

Insurance is a broad industry with many types of jobs and career opportunities. The industry is changing dramatically as new types of insurance products are developed, insurance is offered as part of a broad set of finance and investment products and services, and the Internet and other technology is used more extensively to deliver and support insurance sales and service activities.

Insurance jobs are found in two basic types of businesses. Insurance carriers are the large companies that offer policies and carry the risk of insurance that is sold. Insurance agents and brokers sell insurance, process applications, and are often the main contacts with customers.

Employment Outlook

- Technology that allows direct sales and information processing using the Internet and other technologies is reducing the demand for sales and customer service personnel.
- The growing demand for new insurance products and the blurring of insurance and investment services is increasing the demand for people with technology skills and careers in medical and health insurance and financial services related to investments and insurance.

Job Titles

- Customer service representatives
- Appraisers
- Adjusters
- Investigators
- Loss control specialists
- Underwriters
- Actuaries

Needed Skills

- Clerical and administrative personnel may need only a high school diploma with technical and math skills
- Insurance specialists require a college degree
- An aptitude for mathematics is required
- Strong customer service and communication skills are important
- Most advanced jobs require specialized coursework, degrees, or licenses in insurance products, procedures, and legal requirements

What's It Like to Work as an Actuary?

Actuaries are one of the smallest career areas in insurance but the most important. Actuaries work in all parts of the economy although mostly in financial services, including insurance companies, banks, and retirement funds.

Actuaries spend their time identifying and studying risk and its impact on financial resources. They gather and analyze data on the occurrence of risks, the costs of damage from those risks, and ways to minimize risk. Actuaries are responsible for deciding if specific risks are insurable, the conditions and exemptions of coverage, and the cost of insuring the risk. They monitor the profitability of insurance companies and recommend corrective action. They ensure that insurance companies have set aside enough funds to pay claims. They provide advice on how to invest the insurance companies' assets.

What about you? What type of insurance career is most appealing to you? What will you have to do to prepare for a career in the insurance industry?

BUSINESS PRESENTATION MANAGEMENT EVENT

The Business Presentation Management Event challenges individuals to use current desktop technologies and software to prepare and deliver an effective multimedia presentation.

You will design a computer-generated multimedia presentation for Worldwide Insurance about managing business risks through property, vehicle, liability, and other types of insurance. The presentation must be on the contestant's computer hard drive or on CD-ROM. No VCR or laserdisc may be used for this presentation. Charts and other graphics must be used in this presentation. All text and graphic materials must follow the organization's graphic standards and make proper use of the organization's logo and/or name. All contestants are responsible for securing a release form from any individual whose name, photograph, or other information is included in the presentation. No photographs, text, registered trademarks, or names may be used without permission. Although a work may be freely accessible on the Internet and contain no statement of copyright, the law protects these works.

Fifteen minutes will be allowed for preparation and setup of the presentation. The presentation shall last a minimum of seven (7) minutes and a maximum of ten (10) minutes. Up to five (5) minutes will be allowed each contestant for questions from the judges. The contestant must make effective use of current multimedia technology in the presentation. Presentations will be evaluated for effective use of space, color, and text as design factors.

Performance Indicators Evaluated

- Demonstrate knowledge of multimedia software and components.
- Demonstrate effective oral communication skills.
- Apply technical skills to create a multimedia presentation which enhances the oral presentation.
- Use the best typography, functional graphics, charts, graphs, and color for an effective presentation.
- Develop the stated theme for the presentation.
- Understand the topic presented.

Go to the BPA web site for more detailed information.

Think Critically

1. How can a multimedia presentation heighten the need for the product or service being advertised?
2. What information about insurance should be included?
3. Who is the target market for this presentation?
4. What is the advantage of a multimedia presentation over an informative brochure?

www.bpa.org