Chapter 10

Analysis of Insurance Contracts

After studying this chapter, the student has to be able to answer the following questions:

- What is the definition of insurance contract and what are its contents?
- What are the contents of insurance contract? In other words, what are the basic parts of an insurance contract?
- Describe the common types of deductibles that appear in insurance contract ,including – straight deductible - calendar year deductible
- Explain how coinsurance works in a property insurance
- Explain how coinsurance works in a health insurance
- Explain how losses are paid when more than one insurance contract cover the same loss.
- What are the general requirements of insurance contract?

10.1-Introduction

In fact, *insurance contract(policy)* is a legal contract. It is similar to other civil legal contracts i.e. *lease contract*. Since, the lease contract is written under terms of which you agree to pay rent to the owner and the latter agrees to provide the apartment in turn. Moreover, the lease contract includes provisions as the date when you can occupy the apartment, the date when the rent is due, the term of rent and conditions under which, the lease contract can be cancelled … etc.

So, ***the insurance contract*** is like lease contract has indicated terms in the contract. By these terms, both insurance company and policyholder can know *their rights and their duties* toward each other. Hence, we can say "*purchasing insurance policy is not much fun*", but it gives you *financial security towards a risk*, in spite of it is a piece of a paper.

Hence, insurance contract has the following elements:

- *The first party* is insurer or insurance company who pays or promises to pay the loss, if the risk occurs.

- *The second party* is insured who pays the premium
- *Sum insured* is the payment that is paid by insurer, if the risk occurs.
- *The premium* is the payment that is paid by insured to the insurer in exchange of transfer the risk to the latter.
- *Period contract* is the agreed period between insurer and insured through it, the insurance still in force.
- *Insurance policy* is a written evidence for existing an agreement between insurer and insured and it includes provisions and duties of each party toward the other,

The contract is an *agreement enforceable by law*. For any such agreement to be legally enforceable, all contracts including insurance policy must have the following requirements:

- Offer and acceptance
- Competent parties
- Legal purpose
- Consideration

Before, Discussion of the previous requirements of insurance contract, the following question may be raised about insurance contract:-

What are the contents of insurance contract?. In other words, what are the basic parts of an insurance contract?

The answer the insurance contract is composed of four basic parts:

I) ***Declarations***: The declarations are the statements made by insured. These statements represents information about the location of the property insured, the name of policyholder and other matters relating to identification of the person or property insured.

Declarations is usually in the first page of the policy.

For example in *property insurance contract* , it contains name of the insured, location of property, period of protection, amount of insurance, premium and deductible information

II) ***Definitions*** : Insurance contracts typically contain a page or section of definitions For example, the insured is referred to as “you” and “your” and the insurer is referred to as “we” or “our”

III) Insuring agreement: It summarizes the major promises of the insurer.
There are two basic forms of an insuring agreement (coverage) in property insurance are:

- Named perils coverage, where only those perils specifically named in the policy are covered
- Open-perils, or special coverage, where all losses are covered except those losses specifically excluded

IV) Exclusions: In this part, the insurance company determines what it will not do. The number of excisions depending upon the policy. If the policy is written on a named-risk basis, the exclusions may be few, but if the policy is written on open-risk basis, the exclusions will be more to eliminate coverage for risks that are uninsurable.

- Insurance contracts contain three major types of exclusions
  - *Excluded perils*, e.g., flood, intentional act
  - *Excluded losses,* e.g., a professional liability loss is excluded in the homeowners policy
  - *Excluded property*, e.g., pets are not covered as personal property in the homeowners policy

Why are Exclusions Necessary? The answer is:

Some perils are not commercially insurable e.g., catastrophic losses due to war

Extraordinary hazards are present e.g., using the automobile for a taxi

Coverage is provided by other contracts e.g., use of auto excluded on homeowners policy

Moral hazard problems e.g., coverage of money limited to $200 in homeowners policy

Attitudinal hazard problems e.g., individuals are forced to bear losses that result from their own carelessness

Coverage not needed by typical insureds e.g., homeowners policy does not cover aircraft

v) ***Conditions***: In this part, the duties and rights of both parties (insurance company and insured) should be illustrated in detail. Conditions are provisions in the policy that qualify or place limitations on the insurer's promise to perform. If policy conditions are not met, insurer can refuse to pay the claim.

vi) ***Miscellaneous Provisions***: Insurance policies contain a variety of miscellaneous provisions e.g., in property and casualty insurance ***Miscellaneous Provisions*** include, cancellation, subrogation, grace period, misstatement

10-2- *Some terminologies or additionals may be added in insurance contract*

Sometimes , ***insurance contract*** contains the following ***terminologies or additionals*** such as ***:-***

A- Endorsements and Riders

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

B- Deductibles

A deductible is a common policy provision that require the insured to pay part of th loss. A deductible is a provision by which a specified amount is subtracted from the total loss payment that otherwise would be payable.

Notices:-

1- ***Deductibles*** are found in property ,health and auto insurance .

2- ***Deductibles*** is not used in life insurance because the insured`s death is always a total loss . Also ***Deductibles*** is not used in personal liability insurance because the insurer must provide a legal defense ,even for a small claim.

The purpose of a deductible is to:

1. Eliminate small claims that are expensive to handle and process
2. Reduce premiums paid by the insured
3. Reduce moral hazard and attitudinal (morale)hazard

Examples for Deductibles

- ***Deductibles*** in **property insurance**

The following ***Deductibles are commonly found in*** in **property insurance** contracts - a straight deductible - aggregate deductible

- *Deductibles With a straight deductible*, the insured must pay a certain amount before the insurer makes a loss payment e.g., *an auto insurance deductible*
- *An aggregate deductible* means that all losses that occur during a specified time period , usually a policy year, are accumulated to satisfy the deductible amount , For example, if the aggregate deductible in the policy $10,000 , and the losses are $1000 and $2000 over the policy year ,the insurer does not pay anything because the deductible is not met ,but if there is a third loss $8000 over the policy year ,the insurer will pay just $ 1000 only.
-
- ***Deductibles*** in **Health insurance**
- The following ***Deductibles are commonly found in*** in **Health insurance** contracts - A calendar-year deductible - An elimination (waiting) period
- *A calendar-year deductible* is a type of aggregate deductible that is found in individual medical expense and group medical insurance contracts

- *An elimination (waiting) period* is a stated period of time at the beginning of a loss during which no insurance benefits are paid

e.g., disability income contracts that replace part of a disabled worker's earnings Typically have elimination periods of 30, 60, or 90 days, or longer periods.

C- Coinsurance

Coinsurance is *a contractual provision* that often appears in property insurance contracts, in particular, commercial property insurance contracts

So, ***what is the meaning of Coinsurance?***

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

Notice : the insurable value of the property is the actual cash value or replacement cost .The *coinsurance formula is as follow :-*

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

An example: a building its value $1,000,000 and the owner has insured it for only $600,000 . If 80% *coinsurance clause* is present in the policy. So, the required amount of insurance based on actual cash value will equals $ 800, 000 (80% × 1,000,000). If a $100,000 loss occurs, the amount of recovery will equal (600000/800000) × 100000 = $75,000 only because the *coinsurance requirement is not met.* Consequently, the insured must charge the remaining amount of the loss.

The purpose of coinsurance

- The fundamental purpose of coinsurance is to achieve equity in rating
- A property owner wishing to insure for a total loss would pay an inequitable premium if other property owners only insure for partial losses

- If the coinsurance requirement is met, the insured receives a rate discount, and the policyowner who is underinsured is penalized through application of the coinsurance formula as indicated in both Figure 10.1 and Figure 10.2

Figure 10.1 Insurance to Full Value

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

2 total losses	=	$ 400,000
30 partial losses at $20,000 each	=	$ 600,000
Total fire losses paid by insurer	=	$1,000,000
Pure premium rate	=	$\frac{\$1,000,000}{\$400,000,000}$
	=	25 cents per $100 of insurance

Figure 10.2 Insurance to Half Value

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

2 total losses ($400,000)		
Insurer pays only	=	$200,000
30 partial losses at $20,000 each	=	$600, 000
Total fire losses paid by insurer	=	$800,000
Pure premium rate	=	$\frac{\$800,000}{\$200,000,000}$
	=	40 cents per $100 of insurance

Coinsurance in Health Insurance

Health insurance policies frequently contain a coinsurance clause . This clause requires the insured to pay a specified percentage of covered medical expenses in excess of the deductible.

The purposes of coinsurance in health insurance are

- To reduce premiums and
- To prevent overutilization of policy benefits

D- Other-insurance Provisions

In effect , Other-insurance Provisions may be added ***to Insurance Contract*** , in particular, in property and casualty insurance and Health Insurance . These provisions apply when more than one contract cover the same loss. The purpose of *other-insurance provisions* is to prevent profiting from insurance and violation of the principle of indemnity.

Some important *other-insurance provisions* in property and casualty insurance include 1- *The pro rata liability provision 2- contribution by equal shares 3- primary and excess insurance provision*

1- *a pro rata liability provision* applies when 2 or more policies of the same type of cover the same insurable interest in the property . By virtue of it, each insurer's share of the loss is based on the proportion that its insurance bears to the total amount of insurance on the property (see Figure 10.3) , but if the *pro rata liability provision* not present , the insured will collect $ 100000 from each insurer.

Figure 10.3 Pro Rata Liability Example

Company A	$\frac{\$300,000}{\$500,000}$	or .60 × \$100,000 = \$ 60,000
Company B	$\frac{\$100,000}{\$500,000}$	or .20 × \$100,000 = \$ 20,000
Company C	$\frac{\$100,000}{\$500,000}$	or .20 × \$100,000 = \$ 20,000
	Total loss payment	= \$100,000

2-Contribution by equal shares, often appears in liability insurance contracts. Each insurer shares equally in the loss until the share paid by each insurer equals the lowest limit of liability under any policy, or until the full amount of the loss is paid (see **Figure 10.4)**

Figure 10.4 Contribution by Equal Shares (Example 1)

Amount of Loss = $150,000

	Amount of Insurance	*Contribution by Equal Shares*	*Total Paid*
Company A	$100,000	$50,000	$50,000
Company B	$200,000	$50,000	$50,000
Company C	$300,000	$50,000	$50,000

But if the amount of loss = $500 company B charge $100 more and company C charge $100 more . In the case amount of loss = $600 , company C charge again $100 more.

Figure 10.5 Contribution by Equal Shares (Example 2)

Amount of Loss = $500,000			
	Amount of Insurance	*Contribution by Equal Shares*	*Total Paid*
Company A	$100,000	$100,000	$100,000
Company B	$200,000	$100,000 + $100,000	$200,000
Company C	$300,000	$100,000 + $100,000	$200,000

3- Primary and excess insurance provision. This provision applies in *auto insurance* . By virtue of it, the primary insurer pays first, and the excess insurer pays only after the policy limits under the primary policy are exhausted

Another example for Primary and excess insurance is *The* coordination of benefits provision in *group health insurance* is designed to prevent overinsurance and the duplication of benefits if one person is covered under more than one group health insurance plan.

10.3-The general requirements of insurance contract

The transfer of risk from individual to the insurance company is accomplished through *insurance contract* that is enforceable by law. Hence, the insurance law is derived from the general law. Insurance contract should have some requirements to be binding legally; these requirements may be summarized as follows:

I) ***There must be an agreement based upon an offer and acceptance***. It is worthwhile to mention that *offer and acceptance* are very necessary and essential requirements to create any contact. Hence, to create a legal enforceable insurance contract, there must be a definite offer by one party (the buyer of insurance) and this offer must accept in its exact terms by the other party (insurance company or agent). That is, the acceptance takes place when agent binds coverage or when the policy is issued. Hence, when you call any an insurance agent for insurance on your house and the agent say "*you are covered*", you have made **an offer** to buy and the agent has accepted on behalf of his company. This acceptance is called ***a binder***. A binder is a temporary insurance contract that is in effect until replaced by a formal written policy.

A notice: The offer may be verbal, as in the previous case, or it may be in the form of a written application

The agent's authority to act on behalf of an insurance company takes two forms either.

Express Authority or *implied authority*.

Express authority is authority that is specifically granted by agreement. **Implied authority** is the incidental authority required or reasonably necessary to execute the express authority.

In conclusion, the offer will be by one party and acceptance of the offer by another party.

A **notice**: In **life insurance,** the agent does not have the power to bind the insurer. Furthermore, the application of life insurance is always in writing, and the applicant must take approval from insurer before the life insurance is in force.

II) ***There must be consideration***: Any contract requires consideration. So, this question may be raised, *what is consideration?* Consideration is *the price* that each party demands for agreeing to carry out the contract. Consequently, the consideration given by the insured is *the first premium* (or promise to pay) plus agreement to abide by conditions specified in the policy. But, the consideration given by insurance company is *its promise to indemnify the insured* according to the terms of the policy in case of loss plus providing certain services such as loss prevention and safety services.

III) ***Insurance contract must have a legal purpose:*** Any contract must have legal purpose. If it is does not, to enforce, the contract will be contrary to public interest. Any contract by government employee to sell secret information to an agent of an enemy country, for example, would be have an illegal purpose and would be unenforceable. Also, any contract in which a person agreed to commit murder for a specified amount would be unenforceable because its purpose is not legal. Likewise, an insurance contract that encourages to cover losses caused by the insured'own arson would be illegal, contrary to public interest and thus unenforceable.

IV) ***The two parties must be legally competent to make insurance contract***: The fourth requirement of a valid insurance contract is *the legal competence of parties*. The legal competence means the ability to inter into a binding contract. Consequently, in insurance contract, the parties must be capable of entering a contract in the eyes of the law. Most people are competent to contract except *insane person*, *intoxicated persons* are not competent. Also, *Minor* may enter into contracts, but such contracts may be voided (or terminated). If the minor reached the age 18 for example (depending upon the country) he may ratify the contract or reject it.