

# PROPERTY INSURANCE

## Section 1

### Insurance Terms and Related Concepts

#### **Insurance**

Insurance is an economic device transferring risk from an individual to a company. Insurance is a financial product that helps individuals and businesses protect themselves from financial losses. At its core, insurance works by pooling risks. By spreading the risk among many, the insurance company can provide financial protection to each individual without any one person bearing the full burden of a catastrophic loss.

#### *Law of Large Numbers*

The foundation of insurance is built on a key principle in statistics: the Law of Large Numbers. This law states that as the size of a group of insured people (the “pool”) increases, the actual results will become more predictable and stable, aligning closely with the expected outcome.

#### **Insurable interest**

Insurable interest is a right or relationship regarding the subject matter of the insured contract such that the insured can suffer a financial loss from damage, loss, or destruction to it.

For life insurance insurable interest must only exist at the time of policy application. Let’s look at an example. Twenty years ago Sandy purchased a \$250,000 life insurance policy on her husband Danny, naming herself as the primary beneficiary. Five years ago, Sandy and Danny divorced. Last month, Danny died. Sandy would receive the \$250,000 death benefit from Danny’s policy because she had an insurable interest in Danny when at the time of policy application.

For property and casualty insurance, insurable interest must exist both at the time of policy application and at the time of loss. For example, ten years ago Tom and Rita purchased a home in Malibu insuring the property with a homeowners policy. In 2022 they sold this house. In 2025, the house was destroyed in a fire. Tom and Rita have no coverage for this property since they no longer have insurable interest in the house (they no longer own the house).

## **Risk management key terms**

### **Risk**

Risk is the uncertainty of loss.

#### *Pure versus Speculative Risk*

Pure risk refers to situations where only the possibility of loss or no loss exists - there is no opportunity for financial gain. Examples of pure risk include natural disasters, theft, or accidents. Insurance is typically designed to cover pure risks because they are more predictable and measurable.

On the other hand, speculative risk involves a chance of either loss or gain. This type of risk is commonly associated with investments, such as stocks, real estate, or new business ventures. Unlike pure risks, speculative risks are generally not insurable because they involve a level of uncertainty that is not easily quantifiable.

### **Elements of insurable risk**

Several elements must be present for a risk to be considered insurable. These elements serve as criteria to determine if an insurance company can provide coverage for a particular risk.

#### *Measurability*

The potential loss must be measurable in terms of frequency and severity. This means that insurance companies must be able to estimate both how often a particular kind of loss might occur and the financial impact it would have. Without accurate data, it is difficult to set appropriate premiums and reserves.

#### *Accidental and Unintentional*

The loss must be accidental and unintentional from the perspective of the insured. If a loss is intentional, it does not qualify as an insurable risk. This criterion helps prevent moral and morale hazards, where the insured might otherwise have an incentive to cause or not prevent a loss.

#### *Definite and Measurable*

The loss must be definite and measurable. This means the event that causes the loss must be clearly identifiable, and its financial impact must be calculable. For example, the death of an individual is definite and measurable, whereas a gradual decline in business due to market conditions may not be.

#### *Exposure - Large Number of Similar Exposure Units*

There must be a large number of similar exposure units to allow for the pooling and spreading of risk. This principle is based on the law of large numbers, which states that the larger the sample size, the more predictable the loss patterns will be. This helps insurers to more accurately predict and manage potential losses. For a risk to be insurable, there must be a large number of similar exposure units, such as homes, cars, or individuals, which allows insurers to predict and pool losses.

#### *Affordable Premiums*

The cost of insurance must be economically feasible for both the insurer and the insured. If the premiums are too high, it may not be practical for people to purchase insurance, and if they are too low, the insurer may not be able to cover the potential losses.

#### *Catastrophic Loss Limitation*

The potential loss must not be catastrophic to the insurer. Insurers avoid covering events that could result in extremely large losses affecting a significant portion of their policyholders at the same time. Examples include natural disasters like earthquakes or hurricanes, which require special consideration and reinsurance to manage effectively.

## **Hazard**

Hazards are conditions or situations that increase the likelihood of a loss occurring.

### *Physical*

A physical hazard in property and casualty (P&C) insurance is a tangible condition that increases the risk of property damage or loss. Physical hazards can affect the physical condition of people or property. Faulty wiring in a house and slippery floors are both physical hazards.

### *Moral*

A dishonest person is a moral hazard.

### *Morale*

A morale hazard is an increase in the probable frequency or severity of loss due to an insured peril that arises from an indifference on the part of the insured to the loss occurring.

Most often this indifference is caused by the mere fact that insurance will cover the loss. Morale hazard, as contrasted with moral hazard, does not reflect on the character or integrity of the insured but on the insured's attitude. For example, an insured that would not intentionally set fire to its vacant building would not be as motivated to protect the building from fire if insurance existed to cover the loss. A person who is careless because they have insurance represents a morale hazard.

**Peril**

A peril is a cause of loss. Perils include fire, windstorm, and collision. Insurable risks must be caused by identifiable and definable perils.

**Loss**

For a risk to be insurable, the potential loss must be significant enough to warrant insurance coverage. Losses must also be accidental and unintentional, as insurance is not designed to cover deliberate acts.

In property and casualty (P&C) insurance, a loss is a financial reduction in the value of an asset or property due to an insured event. Losses can be caused by accidents, natural disasters, or other risks.

*Direct*

Direct loss refers to the immediate damage caused by a peril, such as a house burning down in a fire. A dwelling property basic form (DP-1) only covers direct loss.

*Consequential or indirect loss*

Consequential or indirect loss refers to additional losses that occur as a result of the direct loss, such as loss of rental income due to the house being uninhabitable. Dwelling property broad form and special both include coverage for indirect loss under coverage D – loss of use. All homeowners policies include coverage for indirect losses.

### **Methods of handling risk**

There are several methods employed to handle risk in the insurance industry:

#### *Avoidance*

Avoidance involves not participating in activities or situations that could lead to potential loss. For example, a business might avoid operating in areas prone to natural disasters to prevent possible damage.

#### *Retention*

Retention means accepting the risk and dealing with any potential loss internally, often through setting aside funds specifically for this purpose. This is common in situations where the risk is relatively low or infrequent.

#### *Sharing*

Sharing involves distributing the risk among multiple parties. This can be seen in partnerships or cooperative arrangements where the financial impact of a loss is spread across all involved entities.

#### *Reduction*

Reduction aims to lessen the probability or severity of a potential loss. This can be accomplished through preventive measures such as installing fire sprinklers in a building to reduce the risk of fire damage.

#### *Transfer*

Transfer involves shifting the risk to another party, typically through insurance. By purchasing an insurance policy, an individual or business transfers the financial burden of a potential loss to the insurer, who agrees to cover the costs in exchange for premiums paid.

### **Adverse selection**

Adverse selection is the social phenomenon whereby persons with a higher than average probability of loss seek greater insurance coverage than those with less risk.

### **Classification of Insurers**

The classification of insurers is a framework used to categorize insurance companies based on their ownership, licensing status, and operational scope. Understanding these classifications helps in identifying the type of insurer and the regulatory environment they operate within. The classification of insurers is crucial for understanding the diversity and functionality of the insurance market, ensuring that policyholders can choose the most suitable type of coverage for their needs.

#### *Mutual*

Mutual insurers are companies owned by their policyholders. Profits made by mutual insurers are often returned to policyholders in the form of dividends or reduced premiums.

#### *Stock*

In contrast, stock insurers are owned by shareholders who may or may not be policyholders. Profits in stock insurers are distributed to shareholders as dividends.

#### *Admitted*

Admitted insurers are licensed and authorized to operate in a particular state and must adhere to state regulations.

#### *Non-admitted*

Non-admitted insurers, on the other hand, are not licensed in the state but can provide insurance under specific circumstances, often through surplus lines brokers.

Insurers are also classified based on the location of their home office.

#### *Domestic*

Domestic insurers have their home office in this state.

#### *Foreign*

Foreign insurers have their home office in another state.

#### *Alien*

Alien insurers have their home office in another country (outside of the United States).

### **Reinsurance**

Reinsurance is a method where insurers transfer a portion of their risk to other insurers to manage large exposure better. This allows primary insurers to stabilize their finances and protect themselves against significant losses.

## **Loss Valuation**

Loss valuation in insurance refers to the process of determining the amount of compensation an insurer should pay to the policyholder in the event of a covered loss. Accurate loss valuation is crucial for both the insurer and the insured to ensure that claims are settled fairly and promptly. Various methods are used to evaluate losses, each catering to different types of coverage and policy specifications.

### *Actual cash value*

Actual cash value is the property's replacement cost minus depreciation.

### *Replacement cost*

Replacement cost is the cost of replacing property without a reduction for depreciation.

### *Market value*

Market value is the fair value or the price that could be derived from the current sale of an asset.

### *Stated/agreed value*

Stated value insurance covers a vehicle for the amount the policyholder says it's worth, while agreed value insurance covers a vehicle for the amount both the policyholder and the insurer agree on.

### *Salvage value*

Salvage value is the estimated value of an asset at the end of its useful life. It's also known as residual value or scrap value. In property insurance, salvage value (e.g., scrap value) will be subtracted from any loss settlement if the insured retains the damaged property.

### *Functional replacement cost*

Functional replacement cost refers to the cost to replace damaged property with a new property that is functionally equivalent to the damaged property, without necessarily being identical. This means the replacement property performs the same role or function, even if it is not an exact duplicate. This type of replacement cost is often used in scenarios where exact materials or craftsmanship are no longer available or practical, allowing for more modern or cost-effective alternatives to be considered.

## **Indemnity**

Indemnity is a legal agreement that requires one party to compensate another party for losses incurred. It can also refer to a type of insurance that covers losses and damages.

To indemnify means to pay. Property and Casualty policies follow the principle of indemnity, a general legal principle related to insurance that holds that the individual recovering under an insurance policy should be restored to the approximate financial position he or she was in prior to the loss. Indemnity is the legal principle limiting compensation for damages to be equivalent to the losses incurred.

## **Proximate cause**

Proximate cause refers to the primary event or series of events that directly lead to an insured loss. It is the direct cause that sets in motion a chain of events, which ultimately results in the damage or loss covered by an insurance policy.

**Deductible**

The deductible is a portion of the insured loss (in dollars) paid by the policyholder. Property claims are subject to a deductible. The higher the deductible, the lower the premium. Having a deductible eliminates small claims.

**Limits of liability**

A policy's limits of liability are the most that the policy will pay. The limits are found on the declarations page (first page of the policy). On a homeowners' policy cost of defense is in addition to limits.

**Coinsurance/insurance to value**

Coinsurance is a clause contained in most property insurance policies to encourage policyholders to carry a reasonable amount of insurance. If the insured fails to maintain the amount specified in the clause (usually at least 80%), the insured shares a higher proportion of the loss. The co-insurance clause is also referred to as the 80% clause. When an insured carries adequate limits (meets the co-insurance clause) the dwelling policy broad form will include replacement cost coverage on the dwelling.

**Vacancy and unoccupancy**

In general, case law defines the term vacant as "completely empty" – meaning a lack of both people and personal property. Stated another way, vacancy can also be defined as "substantially empty of personal property necessary to sustain normal occupancy." A property is vacant when the insured and the contents are gone.

The term unoccupied means that the property has been left in a state where the property still contains all items and possessions as if the owners were to return at any time. A property is unoccupied when the insured is gone, but there are still contents in the property.

Property policies contain vacancy exclusions but not unoccupancy exclusions. So, determining whether a property is vacant or merely unoccupied is important when a claim arises. Vacant properties have a greater chance of vandalism, undiscovered damage, and theft and can adversely affect property insurance claims.



## **Liability**

Liability insurance protects individuals and businesses from the risk of being held legally liable for the actions causing injury or damage to others. It covers legal costs and any payouts for which the insured would be responsible if found legally liable. Liability insurance is crucial for safeguarding financial stability in the face of potential lawsuits and claims. Liability contracts are between two parties and pay benefits to a third. Dwelling policies do not include liability coverage. Homeowners policies include both property coverage and liability coverage.

There are several types of liability insurance, including personal liability, which covers individuals for incidents like bodily injury or property damage occurring on their property; and professional liability, also known as errors and omissions insurance, which protects professionals against claims of negligence or inadequate work. Furthermore, product liability insurance defends against claims related to the manufacturing or sale of products that cause harm.

While both absolute and strict liability hold a defendant liable without requiring proof of intent or negligence, the key difference is that absolute liability offers virtually no defenses, meaning the defendant is always liable regardless of the circumstances, whereas strict liability may allow for certain defenses like contributory negligence or unforeseeable circumstances depending on the jurisdiction.

### *Absolute/Strict*

Absolute liability imposes responsibility on a party without the need to prove negligence or fault. This type of liability is often applied in cases involving inherently hazardous activities, where the potential for harm is significant regardless of the precautions taken. For instance, if a company is engaged in the transportation of hazardous materials and an accident occurs, the company may be held strictly liable for any resulting damages, even if it follows all safety protocols.

Strict liability torts can fall into three common categories. These include product liability claims, animal attacks, and abnormally dangerous activities. The owner of a dog will always be held strictly liable/absolutely liable for the animal's actions. Strict liability may allow for certain defenses, such as contributory negligence depending upon the jurisdiction.

### *Vicarious*

Vicarious liability, on the other hand, occurs when one party is held responsible for the actions of another party. This is commonly seen in employer-employee relationships, where an employer can be held liable for the negligent actions of their employees performed within the scope of their employment. For example, if an employee causes an accident while driving a company vehicle during work hours, the employer may be held vicariously liable for any damages arising from the incident.

Vicarious liability, or imputed liability, is an indirect liability for the actions of another person, such as a subordinate or child.

## **Negligence**

Negligence is the failure to act a reasonable person would in the same set of circumstances.

## **Occurrence**

In property and casualty insurance, an occurrence is a broader term than an accident. An occurrence is any unexpected event that causes bodily injury or property damage while your policy is active. Occurrences often happen over a period of time, such as a flood, fire, or slow gas leak. An accident is a type of occurrence that is caused by a specific, external, and violent event. Accidents are sudden and unforeseen, resulting in a loss.

### **Binders**

An insurance binder is a temporary contract between an insured and their insurance provider that proves that they have purchased homeowners insurance coverage. The binder is a placeholder for a formal insurance policy. It provides full coverage while the insured awaits a more formal issuance.

A homeowners insurance binder will contain all of the details of a new insurance policy and act as proof of insurance for a potential mortgage lender.

An insurance binder is different from an insurance declaration page, which summarizes the coverage provided by the insurance company. When the declaration page becomes available, that's usually when the binder expires, because there is no longer a need for this "temporary" proof of insurance coverage.

### **Endorsements**

A property insurance endorsement, also known as a rider, is an amendment to an insurance policy that adds or modifies coverage. Endorsements can be added to homeowners, renters, auto, and life insurance policies.

### **Warranties**

Warranties in insurance contracts are specific promises made by the insured, relating to the insured risk. Courts interpret warranties strictly, often requiring precise compliance. Breach of warranty can void the policy, making accurate and truthful declarations by the insured crucial.

### **Representations**

Representations are statements made by the insured during the application process that influence the insurer's decision to provide coverage. Legal interpretations of representations determine whether inaccuracies can void a policy, depending on whether they were made with intent to deceive or were material to the risk assessment.

### **Concealment**

Concealment involves the insured's failure to disclose material information that affects the insurer's risk assessment. Courts scrutinize instances of concealment to determine if the nondisclosure was intentional and material to the underwriting process, potentially voiding the policy if proven.

### **Deposit Premium/Audit**

In property and casualty insurance, a deposit premium, also known as an estimated premium, is an initial payment made by the policyholder to secure coverage at the policy's inception. This premium is based on an estimate of the insured's exposure to risk during the policy period, such as projected revenues or payroll. Periodic audits are conducted to compare the estimated exposure with the actual exposure. Following the audit, adjustments are made to the premium amount, resulting in either a refund or an additional charge to the policyholder.

### **Certificate of Insurance**

A Certificate of Insurance (COI) is a document used in property and casualty insurance to provide evidence of insurance coverage. It summarizes the key details of an insurance policy, including the types of coverage, policy limits, and effective dates. Typically issued by an insurance company or broker, a COI is often required by third parties, such as landlords, clients, or contractors, to verify that the policyholder has adequate coverage in place for specific risks. The certificate does not confer any rights or change the terms of the policy but serves as a convenient proof of insurance.

### **Fair Credit Reporting Act**

The Fair Credit Reporting Act (FCRA) is a federal law enacted in 1970 to promote the accuracy, fairness, and privacy of consumer information contained in the files of consumer reporting agencies. The FCRA regulates the collection, dissemination, and use of consumer information, including credit information, ensuring that individuals are treated fairly by such agencies. It provides consumers with the right to access their credit reports, dispute inaccurate or incomplete information, and obtain a free credit report annually from each of the three major credit reporting agencies: Equifax, Experian, and TransUnion.

Furthermore, the FCRA imposes requirements on businesses that furnish information to credit reporting agencies and on those that use credit reports in making decisions, such as lenders, employers, and landlords. Violations of the FCRA can lead to penalties, including statutory damages, punitive damages, and legal fees.

### **Cancellation**

Most property and casualty policies are written for a period of one year. Cancellation occurs during the policy period. An insurer must provide advance written notice relating to a policy's cancellation. State law may prohibit cancellation by the insurer on certain types of policies. When a policy is canceled by the insurer, the insured is owed a pro-rata premium refund. If the insured cancels the policy, the refund will be short-rate (the insurer can keep some extra money for the inconvenience).

### **Nonrenewal**

Nonrenewal occurs at the policy anniversary date. Either the insurer or the insured can choose to non-renew the policy. The insurer must provide advance written notice to the insured in the case of non-renewal. There is no premium refund owed in the case of nonrenewal.

**Blanket versus specific insurance**

Blanket insurance provides coverage for multiple properties or multiple types of property under a single policy, offering a broad scope of protection. This can include various buildings or locations, ensuring that all assets are protected under one umbrella. For example, a business owner with several locations might opt for blanket insurance to cover all properties simultaneously.

In contrast, specific insurance, also known as scheduled insurance, covers a particular piece of property or location. This type of insurance requires separate policies for each asset, offering tailored coverage for individual properties based on their unique risks and values. An example would be insuring a high-value piece of jewelry separately from other possessions.

While blanket insurance can simplify the management of multiple assets and potentially lower overall premiums, specific insurance allows for more precise coverage and claims handling, ensuring that each asset is adequately protected according to its specific needs.

## **Underwriting**

### *Purpose*

Underwriting is a critical function in the property insurance industry, involving the evaluation and selection of risks to determine the terms and conditions under which coverage is provided.

### *Process*

The process begins with the submission of an insurance application, which includes detailed information about the property to be insured.

The underwriter reviews this information to assess the level of risk associated with insuring the property. Key factors considered include the property's location, construction type, occupancy, and any safety features installed. Additionally, the underwriter examines historical loss data and the property's susceptibility to natural disasters or other perils.

### *Results*

Based on this assessment, the underwriter decides whether to accept or decline the application. If accepted, the underwriter determines the appropriate coverage limits, deductibles, and premiums. This decision-making process ensures that the insurance company can adequately cover potential claims while maintaining profitability and competitiveness in the market.

## **Rate Development**

### *Types*

Rate development in property insurance involves a meticulous process where insurers determine the premium rates for policies. This process begins with the collection of extensive data on various risk factors, including historical loss data, property characteristics, and environmental risks.

Actuaries play a crucial role in this process by applying statistical methods to analyze the data and predict future claims. They consider factors such as the location of the property, its construction and occupancy type, the presence of safety features, and the property's vulnerability to natural disasters.

### *Components*

Once the risks are evaluated, insurers develop base rates and adjust them to reflect individual property characteristics. This adjustment process ensures that the rates are fair and adequate to cover potential losses while remaining competitive in the market.

### *Basis*

The final rates are then reviewed and approved by regulatory authorities to ensure compliance with legal and industry standards.