UNIT –FIVE
ANALYSIS OF INSURANCE CONTRACTS

Introduction

Dear students, from your experience in the previous units I hope, you have had some fundamental concepts about risk and insurance. This chapter gives you insight about the parts of insurance contract, coinsurance and other insurance provisions; such as pro rata liability, equal share and primary and excess liability provisions

Objectives

At the end of this unit you should be able to:

- ♣ Understood the basic parts of insurance contract
- ♣ Describe contents of declaration in different types of insurance.
- ♣ Discuss the different insuring agreements.
- ♣ Explain the contents in the property insurance declarations.
- ♣ Describe "named-peril" and "all-risk" policy.
- ♣ Give brief description on the purposes of deductible.
- ♣ Discuss the different types of exclusions.
- ♣ Describe the reason for exclusion.
- ♣ List some common conditions to be fulfilled by the insured.
- ♣ Show how coinsurance works in life and health insurance.
- ♣ Describe the meaning of contribution of equal share and pro rata share liability
- ♣ Show how primary and excess insurance can prevent the duplication of policy benefits.
- ♣ Appreciate the need for reinsurance

5.1. Basic part of an insurance contract

Insurance contracts are complex legal documents that reflect both general rule of low and insurance lows (conditions). When buying an insurance contract, the buyer is expected to be paid for a covered loss, where he or she can collect and the amount paid is governed by insurance conditions /laws. This may consider the contract of insurance as technical document designed for a specific purpose. This contract, both the general rule of insurance laws, creates a binding agreement between parties, allowing one party to transfer an exposure to loss to another party. Despite their complexities, insurance contracts generally can be divided in to the following common elements:

1. Declarations
2. Insurance agreement
3. Deductibles
4. Definitions
5. Exclusions
6. Conditions
7. Endorsements or Riders

Although all insurance contracts do not necessarily contain all the above parts in the order given, such a classification provides a simple and convenient framework for analyzing most insurance contracts.

5.2.1. DECLARATIO

Declarations are statements that provide information about the property or life to be insured. This information is used for underwriting and rating purposes and for identification of property or life to be insured. This section usually appears on the first page of the policy. The information in life and property insurance declarations is listed below.

Contents of the Property Insurance

- Identification of the insurer
- Name of the insured
- Location of the properly
- Period of protection
- Amount of insurance
- Amount of the premium
- Size of the deductible (if any)
- Any other relevant information

Contents of the Life insurance

- Name of the insured
- Identification of the insurer
- The age of issue
- The premium
- The policy number
- The issue date of contract
- Any other relevant information

5.1.2 INSURING AGREEMENT

Insuring agreement as one basic part of insurance policy summarizes the major promises of the insurer. In other ward, the insurer agrees to do certain things, such as paying losses from insured perils providing certain services or agreeing to defend the insured in a liability low suit. The promise of the insurer and the conditions under which loses are paid are described in the insuring agreement.

There are two forms of insuring agreements in property and liability insurance

- "Named peril" coverage.
- "All- risk" coverage

Under the "***Named peril***" policy, only those perils specifically named in the policy will have coverage. If the peril is not named or listed in the policy, it means it is not covered. For example in homeowner policy, personal property is covered for fire, lighting, windstorm, and certain other named perils. Only losses caused by those perils are covered. Flood damage is not covered because flood as a cause of loss, peril, is not named in the policy.

In other case, under an "all-risks" policy all losses are covered except those losses specifically excluded. This type of insuring agreement is also known as an open perils policy, if the loss is not excluded, then it is covered. Insurance now days have deleted the word "all-risk" policy forms instead they uses the term called "risk of direct loss". The terminology is interpreted to mean that all losses are covered except those losses that are excluded.

"***All risk***" coverage is generally preferable than a named-peril policy. This is because the protection under all- risk is broader with fewer gaps in coverage. In addition greater burden of proof is placed on the insurer to deny a claim. The insured must prove that the loss is excluded. In contest under a named perils contract, the burden of proof is on the insured to show that the loss was caused by a named peril.

5.1.3. EXCLUSIONS

In this section, the insurance company states what losses are not covered. In other ward it is a list of perils, losses, property location, duration or time e.t.c that are exclude from coverage. The number of exclusions has a direct relationship to the breadth or narrowness of the insuring agreement. For example, if the policy is written on an all risk policy basis, the exclusions may be fewer. On the other hand named peril policy requires more exclusion to eliminate coverage for those perils that are uninsurable therefore exclusions are a basic part of contract and a knowledge which is essential to a thorough understanding of the agreement. As such there are three major four of exclusions.

Excluded perils

The contract may exclude certain perils, or causes of loss. Several examples can illustrate this type of exclusion. Under the typical homeowner's policy, the perils of flood, earth movement, and nuclear radiation are specifically excluded. In the physical damage section of a personal auto policy, collision is specifically excluded if the automobile is used as a public taxicab. Finally, in life insurance and disability income policies, the peril of war if often excluded.

Excluded losses

Certain types of losses may also be excluded. For example, in a homeowner's policy, earthquake losses are not covered without a special endorsement. In the personal liability section of a homeowner's policy, a liability lawsuit arising out of the negligent operation of an automobile is excluded. Nor are professional liability losses covered; a specific professional liability policy is needed to cover this exposure. Finally, under a health insurance policy that covers only accidents, losses due to sickness and disease are not covered.

Excluded property

The contract may also exclude or place limitations on the coverage of certain property. For example, in a homeowner's policy, certain types of personal property are excluded, such as automobiles, airplanes, animals, birds, and fish. In a liability insurance policy, property of others in the care, control, and custody of the insured is usually excluded.

Excluded location

The insuring agreement in property insurance makes it clear that the coverage applies only while the insured property is at a location specified in the declarations. Only few property insurance contracts give complete world wise protection. The rational for this exclusion is that property risk varies greatly depending on the location of the property and insurer wish to restrict their coverage to the areas that they have had an opportunity to inspect and approve. Similarly automobile insurance is usually limited to cover the auto while it is in a country where the policy is sold.

REASONS FOR EXCLUSIONS

Exclusions are inserted in the insurance contract because of one or more or the following reason.

- To eliminate losses arising from uninsurable losses.
- To eliminate extraordinary hazards from coverage
- To eliminate coverage’s where another policy is specifically designed to provide coverage
- To eliminate losses associated with the moral and moral hazard.
- To eliminate coverage’s not needed by the typical insured.

5.1.4. DEFINITION

Definition is a statement of the exact meaning of a word or the nature of something. Insurance policy typically contains a section or a page for definition. It will provide meaning for key words they consider important or subject to misinterpretation. Key words or phrases have quotation marks " " around them or are in bold face type. For example, the insurer is frequently referred to as "we", "our" or "us" the insured is also referred to as "you" and "your". The rational behind giving definitions is to describe clearly the meaning of key words or phrases so that coverage under the policy can be determined more easily.

The definitions may appear as a glossary found at the beginning of the policy, or elsewhere in the body of the text. In both Homeowner's and Personal Auto Policy, boldface type is used to alert the reader that a particular term has been defined by the insurer

Insurance contract typically contains a definition of insured under the policy. The contract must indicate the person or persons for whom the protection is provided. Several possibilities exists concerning the persons who are insured under the policy

5.1.5. DEDUCTIBLES

A deductible is a provision by which a specified amount is deducted from the total loss payment that otherwise would be payable. Deductibles typically are found in property, health, and automobile insurance contract. It is not applied in life insurance because the insured's death is a total loss. Also, a deductible generally is not used in personal liability insurance because the insurers must provide a legal defense, even for a small claim. Property, health & automobile insurance policies commonly provide for the insured to pay the first birr of an insured loss.

Purpose of Deductibles

1. To eliminate small claims
2. To reduce premiums
3. To reduce moral and morale hazard

A deductible eliminates small claims that are expensive to handle and process. It makes no economic sense for the insurer to incur Birr 200 of expenses to settle a Birr 50 claim. Hence, small losses can be better budgeted out of personal or business income.

Deductibles are also used to reduce premiums. Since small losses are eliminated, more of the premium birr can be used for the larger claims. The savings from reduced expenses and loss claims are reflected in lower premium rates. The concept of using insurance premium to pay for large losses rather than for small losses is often called the "large loss principle." The objective is to cover large losses that can financial ruin and individual and exclude small losses that can be budgeted out of the person's income.

Deductibles are used to reduce both moral and moral hazard, since the insured may not profit if a loss occurs. It encourages persons not to be dishonest and deliberately cause a loss in order to profit from insurance and also encourage them to be more careful with respect to the protection of their property and prevention of loss.

5.1.6. CONDITION

Conditions are provisions inserted in the policy that qualify or place limitations on the insurer's promise to perform. They explain many of the important relationships, rights, and duties between the insurer and insured. They also provide a framework for the insurance policy. If the policy conditions are not met, the insurer can refuse to pay the claim.

Common conditions in a contract include the following that are to be fulfilled by the insured on the occurrence of the losses.

Requirement to protect property after a loss

For example, undamaged property must be protected. If a fire on the roof exposes furniture to damage from the weather, the furniture should be removed to a warehouse. If property is not protected and suffers damage because of the lack of care, the insurer need not pay for the subsequent damage. Requiring protection of undamaged property reduces the morale hazard.

File a proof of loss with the company.

Prompt notice of loss must be given immediately. Police must be notified. Inventories must be completed. Insurer should be informed as early as possible. The purpose of immediate notice provision is to allow the insurer to investigate the claim promptly. If the insurer can investigate promptly, as is the insurer's right under the policy, the insured has fulfilled the requirement of the contract

Actively cooperate with the company in determining the amount of loss.

Insurers have a right to a complete inventory, signed and sworn to by the insured. Any substantial concealment or misrepresentation at this stage allows the insurer to void the contract. Cooperate with the company in the event of a liability lawsuit in fixing the house (in case the house is on fire).

5.1.7. ENDORSEMENTS AND RIDERS

Insurance contracts also contain endorsements and riders. The terms "endorsements and riders" are often used interchangeably and meaning the same thing. An endorsement is a written provision that adds to, deletes, or modifies the provisions in the original contract. The term "rider" is mostly used in life and health insurance policies to describe a document that amends or changes the original policy.

For example, when added to the standard fire policy, the extended coverage endorsement extends the fire insurance policy to certain additional specified perils. In life and health insurance, numerous riders can be brought in, such as:
Add an increase or decrease benefits. Waive a condition of coverage present in the original policy or amend the basic policy.

5.2. COINSURANCE

In this section you will have a read about one of the common provision in property insurance contract that requires the inured to maintain insurance on the property at a stated percentage of its actual cash value or replacement cost, called coinsurance. It is determined by multiplying the mount of the loss by the fraction derived from the amount of insurance carried and the amount of insurance required. If the coinsurance clause is not met the insured will be penalized.

Coinsurance is a contractual provision that often appears in property insurance contracts. This is especially true for commercial property insurance contracts. A coinsurance clause in a property insurance contract requires the insured to insure the property for a stated percentage of its insurable value / Sound value. Sound value means the actual cash value of the property; that is, the replacement cost less an allowance for depreciation. If the insurance requirement is not fulfilled the inured will be panelized for some amount at the time of loss, means, the insurer is not obligated to pay a full amount for a loss. If the insurer wishes to collect the full amount for a partial loss, the minimum amount required by the insurer to be purchased must be satisfied.
Under the provision of the coinsurance clause, the insured agrees to maintain insurance equal to a specified percentage of the clause of the property, Usually 90 or 80 % of the actual cash value in return for a reduced rate.
In more simple term, at the time of loss, the company will make payment on the basis of the following formula.

$$\frac{\textbf{Amount of insurance required}}{\textbf{Amount of insurance carried}} \times \textbf{amount of loss} = \textbf{Amount payable}$$

Where, Amount required is the minimum amount that must be purchased = (Coinsurance percent) x (Value of property)

Amount carried is the insurance amount that is actually purchased by insured

As long as the insured carries the insurance equal to the required percentage, all losses covered by the policy will be paid in full up to the face amount of the policy. If the insured purchases or carries less than the insurance amount required, the insurer will not pay the full amount. To illustrate, let us assume that the insured has purchased insurance coverage on birr 100,000 building, subject to an 80% percent coinsurance clause. In keeping with the requirement of the clause birr 80,000 insurance has been purchased. The event of a partial loss of the building, birr 50,000 the company will pay the full, birr 50,000, value of the partial loss. This is because the insured had purchased the required amount.

$$\frac{\textbf{Amount of insurance Carried birr 80,000}}{\textbf{Amount of insurance Required 80\% of 100,000}} \times \textbf{Actual loss} = \textbf{payment of loss}$$

$$\frac{\text{Birr } 80{,}000}{\text{Birr } 100{,}000 \times 0.8} \times \text{birr } 50{,}000 = \text{Birr } 50{,}000$$

Now let us assume that the insured purchases only a birr 60,000 insurance having the same circumstances and co insurance clause. The insurer is not obligated to pay the full amount of loss birr 50,000. This is because the insured doesn't satisfy the minimum purchase requirement, birr 80,000 insurance.

Mathematically it is computed as follows

$$\frac{\text{Birr } 60{,}000}{\text{Birr } 80{,}000} \times 50{,}000 = \text{Birr } 37{,}500$$

Let's add another example if there is a building with a 10,000 birr sound value written with a 90% coinsurance clause, 9,000 birr of insurance is required. The insured that carries at least this amount collects in full for any partial loss. But the insured, which carried half (below) of this amount, or 4,500 birr, collects only half of any partial loss. The insured that carries 6,000 birr collects two-thirds of any partial loss.

To determine whether an insured has met the coinsurance requirement on the dwelling, insurers use formula:

$$\frac{\text{Insurance carried}}{\text{Insurance required}} \times \text{Amount of Loss} = \text{Amount Payable by the insurer}$$

If the loss equals or exceeds the amount required under the clause (if the loss is nearly total), there is no penalty invoked by the coinsurance clause. Thus, if in the above case the loss were 9,000 birr at a time when the insured is carrying only 6,000 birr of insurance, substitution in the above formula yields the following;

$$\frac{6{,}000}{9{,}000} \times 9{,}000 = 6{,}000 \text{ birr}$$

The recovery is 6,000 birr, the amount of insurance carried, and there is no penalty other than the fact that the insured did not carry sufficient insurance to cover the entire loss.

Two important things should also be considered. First, a coinsurance clause requirement applies at the time of loss, and the mount of coverage required for compliance is based on the value of the property at the time of loss, not the value of the property when the insurance is purchased.

Second, the burden of maintaining the proper amount of insurance is on the insured, like updating the amount with the existing inflation, the insurance company does not check to see if the insured has kept the required amount with the increase in inflation or not until the loss takes place.

Let's assume the first example above i.e.
Amount of insurance required was 80% of the actual cash value i.e 80 % of 100,000=80,000
Amount carried is 80% of 100,000 which is equal to the amount required at the time of purchase of insurance not at the time of loss, 80,000 birr. Now assume that construction cost rises, increasing the value of the building, but the insurance continues to carry birr 80,000 in coverage. when the next birr 50,000 loss occurs, it is found that the actual cash value of the building is birr 200,000. Thus, to comply with the 80 percent coinsurance requirement, the insured should now carry birr 160,000 in coverage. In this case the insured will become coinsurer and suffers a penalty of the coinsurance deficiency. Mathematically

$$\frac{\text{Insurance carried (80,000 birr)}}{\text{Insurance required 80\% of 200,000}} \times \text{Actual loss} = \text{Amount of payment}$$

$$= \frac{80{,}000 \text{ birr}}{160.000 \text{ birr}} \times 50{,}000 \text{ birr} = 25{,}000 \text{ birr}$$

REASONS FOR COINSURANCE REQUIREMENT

What, do you think, is the reason for coinsurance requirements?

- To achieve equity in rating
- To make underinsurance unattractive to the insured
- To make the insured to pay a penalty based on the amount of underinsured

5.3. OTHER INSURANCE PROVISIONS

Most insurance contracts other than life and in most instance health insurance contracts , contains some clause relating to coverage by other insurance the provision applies usually when the coverage is provided by two or more insurers. The primary purpose of the restriction is that of preventing the insured from collecting for the same loss under two policies and there by profiting from the existence of duplicate insurance. The most common other insurance provision includes:

5.3.1. Pro rata liability provision
5.3.2. Contribution by equal share
5.3.3. Primary and excess insurance

5.3.1. PRO-RATA LIABILITY PROVISION.

One of the most common of the other insurance provisions is one that is known as a pro rata clause. The provision applies when two or more insurers or re insurer covers the same insurable interest in the property. Each insurers or the insurer and re insurer share of the loss income and expanses based on the proportion that its insurance bears to the total amount of insurance on the property.

An example will clarify the meaning. Let us assume that X has a dwelling with an actual cash value coverage from company A and birr 100,000 fire insurance from company B, and then suffers a fire loss of insurance company, which she has every intention of doing she would obviously profit from the existence of insurance. But under the provision of pro rate clause pay that proportion of the loss that its insurance bears to the total fire in insurance on the property.

Each company will pay birr 35,000 this will rather effectively prevent the insured from profiting from the existence of duplicate insurance

Assume that an agent place birr 300,000 of insurance with company A, birr 100,000 with company B, and birr 100,000 with company C, for a total of birr 500,000 if a loss occurs each company will pay only it's prorate share of the loss as can be seen below. Thus the insured would collect birr 100,000 for the loss, not birr 300,000

Company	prorate share		actual loss	contribution
Company A	birr 300,000 / birr 500,000	X	birr 100,000 =	Birr 60,000
Company B	birr 100,000 / Birr 500,000	X	birr 100,000 =	birr 20,000
Company C	birr 100,000 / Birr 500,000	X	Birr 100,000 =	birr 20,000
Total loss payment				birr 100,000

Table 5.2 coinsurance participation for 100,000 Birr loss.

5.3.2. CONTRIBUTION BY EQUAL SHARES

An alternative to the pro rata approach to apportionment is the equal shares method, which is frequently found in liability insurance contracts. With this method, each insurer share 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. For example, assume that the mount of insurance provided by Companies A, B, and C is Birr 100,000, Birr 200,000, and Birr 300,000 respectively. If the loss is Birr 150,000 each insurer pays an equal share, or Birr 50,000 (see Table 6.2 below). What if the amount loss was birr 500,000? See Table 6.3 below.

Amount of loss birr 150,000.

	Amount of insurance	*contributions by equal share*	*total paid*
Company A	birr 100,000	birr 50,000	birr 50,000
Company B	birr 200,000	birr 50,000	birr 50,000
Company C	birr 300,000	birr 50,000	birr 50,000
Total loss payment			**birr 15,000**

Table 5.2 Contribution by Equal Shares

Amount of loss birr 500,000

	Amount of insurance	**Contribution by equal share**	**total paid**
Company A	birr 100,000	Birr 100,000	Birr 100,000
Company B	birr 200,000	Birr 100,000+100,000	Birr 200,000
Company C	Birr 300,000	Birr 100,000 +200,000	Birr 300,000
Total loss payment			**birr 500,000**

Table 5.3 Contribution by Equal Shares

5.3.3. PRIMARY AND EXCESS INSURANCE PROVISION

Primary and excess insurance provisions are also applied when two insurers may be one re insurer, insures the same property. The primary insurer will pay the loss up to the maximum limit. The excess amount above the maximum limit will be paid by the other insurer or the re insurer.

Auto insurance is an excellent example of primary and excess insurance. For example, assume Mr. “x” and “y” has liability insurance converges from their own separate insurers. If Mr. X occasionally drives the car of Mr. Y. Mr. X’s policy has a liability insurance limit of birr 100, 000 per person for badly injury liability. Mr. Y policy has a limit of birr 500,000 per person for badly injury liability. The normal rule is that the liability insurance on the borrowed car is primary and any other insurance is considered as excess. Thus if the court orders Mr. X to pay damage of birr 750,000, Mr. Y’s policy is primary and pays the first 500,000 birr Mr. X’s policy is excess and therefore , pays the remaining birr 250,000

End