

## 5.3.2: Definitions and Types of Insurance

### Learning Objectives

1. Know the basic types of insurance for individuals.
2. Name and describe the various kinds of business insurance.

Certain terms are usefully defined at the outset. **Insurance** is a contract of reimbursement. For example, it reimburses for losses from specified perils, such as fire, hurricane, and earthquake. An **insurer** is the company or person who promises to reimburse. The **insured** (sometimes called the assured) is the one who receives the payment, except in the case of life insurance, where payment goes to the beneficiary named in the life insurance contract. The **premium** is the consideration paid by the insured—usually annually or semiannually—for the insurer’s promise to reimburse. The contract itself is called the **policy**. The events insured against are known as **risks** or **perils**.

Regulation of insurance is left mainly in the hands of state, rather than federal, authorities. Under the McCarran-Ferguson Act, Congress exempted state-regulated insurance companies from the federal antitrust laws. Every state now has an insurance department that oversees insurance rates, policy standards, reserves, and other aspects of the industry. Over the years, these departments have come under fire in many states for being ineffective and “captives” of the industry. Moreover, large insurers operate in all states, and both they and consumers must contend with fifty different state regulatory schemes that provide very different degrees of protection. From time to time, attempts have been made to bring insurance under federal regulation, but none have been successful.

We begin with an overview of the types of insurance, from both a consumer and a business perspective. Then we examine in greater detail the three most important types of insurance: property, liability, and life.

### Public and Private Insurance

Sometimes a distinction is made between public and private insurance. Public (or social) insurance includes Social Security, Medicare, temporary disability insurance, and the like, funded through government plans. Private insurance plans, by contrast, are all types of coverage offered by private corporations or organizations. The focus of this chapter is private insurance.

### Types of Insurance for the Individual

#### Life Insurance

Life insurance provides for your family or some other named beneficiaries on your death. Two general types are available: **term insurance** provides coverage only during the term of the policy and pays off only on the insured’s death; **whole-life insurance** provides savings as well as insurance and can let the insured collect before death.

#### Health Insurance

Health insurance covers the cost of hospitalization, visits to the doctor’s office, and prescription medicines. The most useful policies, provided by many employers, are those that cover 100 percent of the costs of being hospitalized and 80 percent of the charges for medicine and a doctor’s services. Usually, the policy will contain a deductible amount; the insurer will not make payments until after the deductible amount has been reached. Twenty years ago, the deductible might have been the first \$100 or \$250 of charges; today, it is often much higher.

#### Disability Insurance

A disability policy pays a certain percentage of an employee’s wages (or a fixed sum) weekly or monthly if the employee becomes unable to work through illness or an accident. Premiums are lower for policies with longer waiting periods before payments must be made: a policy that begins to pay a disabled worker within thirty days might cost twice as much as one that defers payment for six months.

#### Homeowner’s Insurance

A homeowner’s policy provides insurance for damages or losses due to fire, theft, and other named perils. No policy routinely covers all perils. The homeowner must assess his needs by looking to the likely risks in his area—earthquake, hailstorm, flooding, and so on. Homeowner’s policies provide for reduced coverage if the property is not insured for at least 80 percent of its

replacement costs. In inflationary times, this requirement means that the owner must adjust the policy limits upward each year or purchase a rider that automatically adjusts for inflation. Where property values have dropped substantially, the owner of a home (or a commercial building) might find savings in lowering the policy's insured amount.

### Automobile Insurance

Automobile insurance is perhaps the most commonly held type of insurance. Automobile policies are required in at least minimum amounts in all states. The typical automobile policy covers liability for bodily injury and property damage, medical payments, damage to or loss of the car itself, and attorneys' fees in case of a lawsuit.

### Other Liability Insurance

In this litigious society, a person can be sued for just about anything: a slip on the walk, a harsh and untrue word spoken in anger, an accident on the ball field. A personal liability policy covers many types of these risks and can give coverage in excess of that provided by homeowner's and automobile insurance. Such umbrella coverage is usually fairly inexpensive, perhaps \$250 a year for \$1 million in liability.

## Types of Business Insurance

### Workers' Compensation

Almost every business in every state must insure against injury to workers on the job. Some may do this through self-insurance—that is, by setting aside certain reserves for this contingency. Most smaller businesses purchase workers' compensation policies, available through commercial insurers, trade associations, or state funds.

### Automobile Insurance

Any business that uses motor vehicles should maintain at least a minimum automobile insurance policy on the vehicles, covering personal injury, property damage, and general liability.

### Property Insurance

No business should take a chance of leaving unprotected its buildings, permanent fixtures, machinery, inventory, and the like. Various property policies cover damage or loss to a company's own property or to property of others stored on the premises.

### Malpractice Insurance

Professionals such as doctors, lawyers, and accountants will often purchase malpractice insurance to protect against claims made by disgruntled patients or clients. For doctors, the cost of such insurance has been rising over the past thirty years, largely because of larger jury awards against physicians who are negligent in the practice of their profession.

### Business Interruption Insurance

Depending on the size of the business and its vulnerability to losses resulting from damage to essential operating equipment or other property, a company may wish to purchase insurance that will cover loss of earnings if the business operations are interrupted in some way—by a strike, loss of power, loss of raw material supply, and so on.

### Liability Insurance

Businesses face a host of risks that could result in substantial liabilities. Many types of policies are available, including policies for owners, landlords, and tenants (covering liability incurred on the premises); for manufacturers and contractors (for liability incurred on all premises); for a company's products and completed operations (for liability that results from warranties on products or injuries caused by products); for owners and contractors (protective liability for damages caused by independent contractors engaged by the insured); and for contractual liability (for failure to abide by performances required by specific contracts).

Some years ago, different types of individual and business coverage had to be purchased separately and often from different companies. Today, most insurance is available on a package basis, through single policies that cover the most important risks. These are often called multiperil policies.

### Key Takeaway

Although insurance is a need for every US business, and many businesses operate in all fifty states, regulation of insurance has remained at the state level. There are several forms of public insurance (Social Security, disability, Medicare) and many forms of

private insurance. Both individuals and businesses have significant needs for various types of insurance, to provide protection for health care, for their property, and for legal claims made against them by others.

### Exercises

1. Theresa Conley is joining the accounting firm of Hunter and Patton in Des Moines, Iowa. She is a certified public accountant. What kind of insurance will she (or the firm, on her behalf) need to buy because of her professional activities?
2. Nate Johnson has just signed a franchise agreement with Papa Luigi's Pizza and will be operating his own Papa Luigi's store in Lubbock, Texas. The franchise agreement requires that he personally contract for "all necessary insurance" for the successful operation of the franchise. He expects to have twelve employees, five full-time and seven part-time (the delivery people), at his location, which will be on a busy boulevard in Lubbock and will offer take-out only. Pizza delivery employees will be using their own automobiles to deliver orders. What kinds of insurance will be "necessary"?

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