



# SOCIETY OF FINANCIAL EXAMINERS<sup>®</sup>

## *Supplemental Background Material*

NAIC Examiner Project

### **Course AFE 2**

### **Property and Liability Insurance Fundamentals**

*(Passing grade for this exam is 70)*

Please note that this study guide is a tool for learning the materials you need to effectively study for this examination. As new editions of the textbooks are published, the SOFE Testing committee makes every effort to update the page references in this guide, but it is not always possible to keep it current. Therefore, it is the student's responsibility to see the topic listed in the study guide and find it in the required textbooks. But if it is not on the page indicated, then you need to go the textbook's table of contents or index and locate the topic. If you are unable to locate the topic anywhere in the textbook you are using, please e-mail SOFE headquarters at [info@sofe.org](mailto:info@sofe.org) and tell us the topic you cannot locate, where that topic is in the study guide and what version of the textbook you are using.

The following textbooks are required for this course:

- *Fundamentals of Risk and Insurance*  
*Emmett J. Vaughan & Therese M. Vaughan, (11th Edition)*
- *Insurance Operations, Regulation, and Statutory Accounting*,  
*American Institute for Property and Casualty Underwriters, (2<sup>nd</sup> Edition)*  
*Myhr and Markham. (Book is dark blue and not available at the Actuarial Bookstore but can be purchased from internet third-party sellers such as Amazon)*

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**Property and Liability Insurance Fundamentals**

Unit: 1

Topic: Insurance Risk Mechanisms and Risk Management

Learning Objectives: Become familiar with the principles of the insurance mechanism

Assigned Readings: *Fundamentals of Risk and Insurance, Vaughan and Vaughan*,  
Chapter 1 - The Problem of Risk  
Chapter 2 – Introduction to Risk Management  
Chapter 3 – The Insurance Device

**The Problem of Risk – Learning Objectives to Master:**

- Define and explain the meaning of the term *risk*
- Distinguish among the terms *risk, peril, and hazard*
- Identify and explain the classes of hazards
- Differentiate between pure risk and speculative risk
- Differentiate between fundamental and particular risk
- Describe the categories into which pure risk may be subdivided
- Identify and explain the principal methods of handling risk

**Introduction to Risk Management – Learning Objectives to Master:**

- Describe the evolution of modern risk management and identify the developments that led to the transition from insurance management to risk management
- Define and explain what is meant by the term *risk management*
- Identify the various reporting relationships that the risk management function may assume in an organization
- Identify the two broad approaches to dealing with risk that are recognized by modern risk management theory
- Identify the four techniques that are used in risk management
- Describe risk management's contribution to the organization
- Distinguish risk management from insurance management and general management

**The Insurance Device – Learning Objectives to Master:**

- Define insurance from the viewpoint of the individual and of society
- Identify and explain the two essential features in the operation of insurance
- Explain how the law of large numbers supports the operation of the insurance mechanism
- Explain what is meant by *adverse selection* and why it is a problem for insurers
- Explain the economic contributions of insurance

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**Property and Liability Insurance Fundamentals**

Unit: 2

Topic: Insurance Regulation

Learning Objectives: An introduction to the history and nature of insurance regulation in the United States

Assigned Readings: *Fundamentals of Insurance and Risk, Vaughan and Vaughan*,  
Chapter 6 - Regulation of the Insurance Industry

*Insurance Operations, Regulation, & Statutory Accounting*,  
Chapter 2 – Insurance Regulation

**Regulation of the Insurance Industry – Learning Objectives to Master:**

- Identify and explain the reasons why insurance is subject to regulation
- Identify the major areas of insurer operations that are regulated
- Trace the history of insurance regulation and identify the landmark cases and laws that led to the current regulatory environment
- Identify the major aspects of insurance company operations that are subject to regulation
- Identify and explain the statutory requirements that exist with respect to insurance rates
- Describe the different approaches the states have taken toward the regulation of insurance rates
- Identify the arguments favoring state or federal regulation of insurance

**Insurance Regulation – Learning Objectives to Master:**

- Identify three recurring issues in insurance regulation
- Describe the effect each of the following had on insurance regulation:
  - *Paul v Virginia*
  - Sherman Antitrust Act
  - South-Eastern Underwriters Association Decision
  - McCarren-Ferguson Act
  - Insurance Services Office (ISO) & the Attorneys General Lawsuit
  - Gramm-Leach-Bliley Act
- Explain how insurance regulation protects consumers, contributes to maintaining solvency, and assists in preventing destructive competition
- Identify the regulatory activities of state insurance departments and the duties typically performed by state insurance commissioners

- Describe the arguments for and against federal regulation of insurance
- Describe how many insurers are formed and the licensing requirements for insurers and insurer personnel
- Describe the methods that regulators use to ensure the solvency of insurers and identify the challenges of insure solvency regulation
- Describe the process used to regulate rates
  - Identify the goals of insurance rate regulation
  - Describe the major types of state rating laws and discuss the advantages and disadvantages of these laws
- Explain how insurance policies are regulated
- Describe the market conduct areas in insurance that are regulated, and explain how these regulations operate
- Identify organizations that act as unofficial regulators in insurance, and explain how these organizations affect insurance activities

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**Property and Liability Insurance Fundamentals**

Unit: 3

Topic: The Private Insurance Industry

Learning Objectives: Become aware of the various types of insurance enterprises, how they developed, and the reasons they exist

Assigned Readings: *Fundamentals of Insurance and Risk, Vaughan and Vaughan,*  
Chapter 5 - The Private Insurance Industry

**The Private Insurance Industry – Learning Objectives to Master:**

- Identify the categories of insurers classified by type of product
- Identify the major categories of insurers classified according to form of ownership
- Identify and describe the distinguishing characteristics of the different categories of insurers by form of ownership
- Identify the different distribution systems that are used in property and liability insurance
- Describe the major areas in which members of the insurance industry cooperate
- Identify and describe the major areas in which insurers cooperate
- Describe the evidences that indicate the extent of competition in the insurance industry

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Unit: 4

Topic: The Functions of Insurance, Ratemaking

Learning Objectives: Develop an understanding of the principles of insurance ratemaking

Assigned Readings: *Insurance Operations, Regulation, & Statutory Accounting*,  
Chapter 1 – Overview of Insurance Operations

*Fundamentals of Insurance and Risk, Vaughan and Vaughan*,  
Chapter 7 – Functions of Insurers

**Overview of Insurance Operations – Learning Objectives to Master:**

- Describe the risk management process
- Explain how insurers have organized to provide property-casualty insurance
- Describe insurers' major goals and the constraints that impede insurers from achieving them
- Describe and calculate the measurements used to evaluate insurer performance
- Explain how the principal functions within an insurer operate and how they interrelate

**Functions of Insurers – Learning Objectives to Master:**

- Identify and differentiate between the two broad approaches to ratemaking
- Explain the purpose of underwriting and describe the steps in the underwriting process
- Identify the principal sources of information on which an underwriter may rely
- Identify and differentiate among the various types of adjusters
- Identify and explain the steps in the loss adjustment process

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Unit: 5

Topic: The Functions of Insurance, Ratemaking

Learning Objectives: Develop an understanding of the principles of insurance ratemaking

Assigned Readings: *Fundamentals of Insurance and Risk, Vaughan and Vaughan,*  
 Chapter 7 – Functions of Insurers

*Insurance Operations, Regulation, & Statutory Accounting,*  
 Chapter 7 - Ratemaking Principles

**Functions of Insurers – Learning Objectives to Master:**

- Identify and differentiate between the two broad approaches to ratemaking
- Explain the purpose of underwriting and describe the steps in the underwriting process
- Identify the principal sources of information on which an underwriter may rely
- Identify and differentiate among the various types of adjusters
- Identify and explain the steps in the loss adjustment process

**Ratemaking Principles – Learning Objectives to Master:**

- Describe the goals and ideal characteristics of ratemaking
- Explain how actuaries are involved in the ratemaking process
- Describe rate components and ratemaking terms
- Describe factors that affect ratemaking
- Given a case, calculate a rate
- Describe the following ratemaking methods:
  - Pure premium
  - Loss ratio
  - Judgement
- Describe the steps in the ratemaking data development process
- Describe the policy-year, calendar-year, and accident-year data collection methods
- Explain why and how ratemaking data are adjusted
- Explain how to prepare rate filings
- Explain how ratemaking varies by type of insurance
- Explain why and how increased limit factors are used

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Unit: 6

Topic: The Marketing Function

Learning Objectives: Develop an understanding of the marketing process in property and liability insurance companies

Assigned Readings: *Insurance Operations, Regulation, & Statutory Accounting*, Chapter 3 – Insurance Marketing

**Insurance Marketing – Learning Objectives to Master:**

- Describe the unique characteristics of insurance marketing, including the legal status of agents and the powers and duties of agents
- Describe the basic elements of an insurance product marketing plan
- Describe the three types of traditional insurance marketing systems including the principal characteristics that distinguish one marketing system from another
- Describe the functions performed by insurance producers
- Describe the collaborations for marketing insurance products that resulted from the Gramm-Leach-Bliley Act and market convergence
- Describe the five types of alternative insurance distribution channels
- Describe the challenges associated with using the Internet as an alternative distribution channel for insurance products and services
- Describe the key factors an insurer should evaluate during the distribution channel selection process
- Describe the considerations in combining traditional marketing systems and alternative distribution channels for insurance products

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Unit: 7

Topic: The Underwriting Function

Learning Objectives: Become familiarized with the process of underwriting and the factors which are considered in insurance company underwriting

Assigned Readings: *Insurance Operations, Regulation, & Statutory Accounting*,  
Chapter 4 - Underwriting

**Underwriting – Learning Objectives to Master:**

- Describe the purpose of underwriting
- Describe the six steps in the underwriting process
- Contrast the responsibilities of staff underwriters with those of line underwriters
- Explain how underwriting results are measured

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Unit:	8
Topic:	The Claim Function, Loss Reserving & Claims Adjusting
Learning Objectives:	Develop an understanding of the claims process and principles of insurance company claims practices
Assigned Readings:	<i>Insurance Operations, Regulation, &amp; Statutory Accounting</i> , Chapter 8 - The Claim Function & Loss Reserving Chapter 10 - Liability Claims Adjusting

**The Claim Function – Learning Objectives to Master:**

- Describe the goals of the claim function
- Describe the users of claim information
- Explain how and with whom claim personnel interact
- Explain how the claim function can be organized
- Describe claim function management and settlement authority
- Describe the claim adjusting process
- Describe the types of claim reports
- Explain why loss reserving is an important claim activity and how it operates
- Explain how performance of the claim function is measured
- Explain how claim activities are regulated

**Liability Claims Adjusting – Learning Objectives to Master:**

- Describe the steps in the liability claim adjusting process
- Explain how and why adjusters use negotiation and other settlement techniques in adjusting liability claims
- Describe the litigation process
- Describe the challenges of adjusting each of the following types of claims:
  - Auto bodily injury liability claims
  - Auto property damage claims
  - Premises liability claims
  - Operations liability claims
  - Products liability claims
  - Workers' compensation claims
  - Professional liability claims

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**Property and Liability Insurance Fundamentals**

Unit: 9

Topic: The Reinsurance Function

Learning Objectives: Develop an understanding of the functions of reinsurance, the types of reinsurance, and the nature of the reinsurance transaction

Assigned Readings: *Insurance Operations, Regulation, & Statutory Accounting*, Chapter 11 - Reinsurance**Reinsurance – Learning Objectives to Master:**

- Explain how reinsurance operates and how it benefits policyholders
- Describe reinsurance marketing systems and the functions of reinsurance
- Describe the categories and types of reinsurance
- Given a case, determine how the primary insurer and the reinsurer would share the amount of insurance, the premium, and covered losses under quota share and surplus share treaties
- Given a case, determine how the primary insurer and the reinsurer would share losses under per risk excess of loss, per policy excess of loss, per occurrence excess of loss, and aggregate excess of loss treaties
- Evaluate the effectiveness of per risk excess of loss, per policy excess of loss, per occurrence excess of loss, and aggregate excess of loss treaties in providing stabilization of loss experience, large-line capacity, catastrophe protection, and surplus relief
- Explain why a primary insurer would use facultative reinsurance instead of treaty reinsurance
- Explain how finite risk reinsurance operates
- Describe the factors that should be considered in developing a reinsurance program
- Given a case, evaluate the reinsurance needs of an insurer and recommend a reinsurance program to meet those needs
- Explain how reinsurance retentions and limits are set
- Describe the information that the reinsurer and the primary insurer usually request from one another when negotiating reinsurance agreements
- Explain how reinsurance intermediaries operate and how they are compensated
- Describe the role of the primary insurer and the reinsurer in reinsurance program administration
- Explain how reinsurance is regulated

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**Property and Liability Insurance Fundamentals**

Unit: 10

Topic: Insurance Financial Management

Learning Objectives: Become familiar with insurance operations and financial management

Assigned Readings: *Insurance Operations, Regulation, & Statutory Accounting*,  
Chapter 12 – Insurer Financial Statements  
Chapter 14 – Insurer Financial Management

**Insurer Financial Statements – Learning Objectives to Master:**

- Identify who uses the insurer financial statements
- Describe the elements of an insurer's balance sheet and income statement
- Describe the elements of an insurer's completed NAIC Annual Statement and the information those elements contain
- Explain how statutory accounting principles (SAP) and generally accepted accounting principles (GAAP) differ

**Insurer Financial Management – Learning Objectives to Master:**

- Describe the investment strategy issues faced by insurers
- Describe the constraints imposed on insurer assets and investments
- Describe the issues involved in managing an insurer's bond and underwriting portfolio
- Explain how case reserves, as well as IBNR reserves, are established
- Describe the techniques used to analyze loss reserves
- Explain how the NAIC's Risk Based Capital system operates

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**Property and Liability Insurance Fundamentals**

Unit: 11

Topic: The Legal Basis of Insurance Contracts

Learning Objectives: Understand legal concepts relevant to specific insurance contracts and their interpretation

Assigned Readings: *Fundamentals of Insurance and Risk, Vaughan and Vaughan*,  
Chapter 9 - The Legal Framework

**The Legal Framework – Learning Objectives to Master:**

- Identify and explain the essential elements of a contract
- Explain how the general law of contracts applies to insurance contracts
- Explain why the principle of indemnity is important to the operation of the insurance mechanism
- Explain the ways in which the principle of indemnity is enforced in insurance contracts
- Explain what is meant by the statements that insurance contracts are contracts of adhesion, aleatory contracts, conditional contracts, unilateral contracts, and contracts of utmost good faith
- Define and explain the nature of waiver and estoppel
- Explain the application of the doctrines of concealment and misrepresentation in the insurance transaction

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**Property and Liability Insurance Fundamentals**

Unit: 12

Topic: Homeowners Insurance

Learning Objectives: Understand the essential features of homeowners insurance policies

Assigned Readings: *Fundamentals of Insurance and Risk, Vaughan and Vaughan*, Chapters 24 and 25 - The Homeowners Policy

**The Homeowners Policy – General Provisions – Learning Objectives to Master:**

- Explain the general nature of the homeowners program
- Identify and distinguish among the homeowners forms and describe the individual for whom each form is designed
- Explain the difference between named-peril and open-peril coverage
- Identify the coverage parts of the homeowners policy
- Identify coverage features of each Section I coverage part

**The Homeowners Policy Forms – Learning Objectives to Master:**

- Interpret loss-settlement provisions
- Recognize significant exclusions and limitations in the homeowners Section I coverage
- List and describe the optional coverages available to broaden the homeowners forms

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**Property and Liability Insurance Fundamentals**

Unit: 13

Topic: General Liability Insurance for Individuals

Learning Objectives: Understand the essential features of general liability insurance for individuals

Assigned Readings: *Fundamentals of Insurance and Risk, Vaughan and Vaughan*, Chapter 28 – General Liability Insurance for the Individual

**General Liability Insurance for the Individual – Learning Objectives:**

- Explain the distinction between a denial of payment by an insurer because there is no liability and denial because there is no coverage
- Identify the coverage features under Section II of the homeowners forms
- Describe the insuring agreements of liability insurance contracts generally and explain the insurer's obligation to defend the insured
- Explain the insuring agreement of the Section II Personal Liability coverage
- Explain the insuring agreement of the Section II Medical Payments coverage
- Recognize significant exclusions under the homeowners Section II
- Describe the personal umbrella liability contracts, including qualification requirements and typical exclusions
- List the available endorsements for broadening Personal Liability coverage

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**Property and Liability Insurance Fundamentals**

Unit: 14

Topic: Automobile Insurance Coverage

Learning Objectives: An introduction to automobile insurance contracts

Assigned Readings: *Fundamentals of Insurance and Risk, Vaughan and Vaughan*,  
Chapter 29 - The Automobile and Its Legal Environment  
Chapter 30 - The Personal Auto Policy

**The Automobile and Its Legal Environment – Learning Objectives to Master:**

- Explain the special provisions of tort law applicable to automobiles
- Explain the principles of vicarious liability and the special provisions applicable to guests
- Explain the legal requirements imposed by the states regarding automobile liability insurance
- Explain the no-fault concept and the basic philosophy on which this concept is based, and evaluate the arguments for and against no-fault laws
- Explain the differences among the approaches to reform of the automobile reparations system that have been adopted by the states
- Discuss the various systems for providing insurance to high-risk drivers
- Discuss the automobile insurance classification system and how rates are affected by various underwriting factors

**The Personal Auto Policy – Learning Objectives to Master:**

- Determine if an automobile is eligible for coverage under the Personal Auto Policy (PAP)
- Identify and explain the four coverage sections of the PAP
- Describe the coverage features of the PAP liability coverage, including the persons and automobiles for which coverage is provided
- Describe the scope of coverage under the medical payments coverage of the PAP, including the persons to whom the coverage is applicable
- Describe the scope of coverage under the uninsured motorists coverage of the PAP, including the persons to whom the coverage is applicable
- Describe the scope of coverage under the Damage to Your Auto coverage of the PAP
- Identify and explain the Duties after Loss and general provisions of the PAP

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**Property and Liability Insurance Fundamentals**

Unit: 15

Topic: Commercial Property Insurance

Learning Objectives: An introduction to commercial property insurance contracts

Assigned Readings: *Fundamentals of Insurance and Risk, Vaughan and Vaughan*,  
Chapter 31 - Commercial Property Insurance

**Commercial Property Insurance – Learning Objectives to Master:**

- Identify the seven broad classes of property and liability insurance for business firms
- Identify and distinguish among the four broad classes of commercial property insurance, and explain the distinguishing characteristics of each class
- Describe the general nature of coverage available to business firms with respect to fixed location property
- Distinguish between direct damage property insurance coverages and indirect loss coverages
- Identify and explain the general nature and uses of indirect loss (time element coverages) and explain the circumstances in which each type of coverage is needed
- Describe the general nature of the coverage available to business firms with respect to property that is not at a fixed location
- Explain the principal features of boiler and machinery insurance and the feature that distinguishes it from other types of insurance
- Identify the two broad classes of commercial crime insurance

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**Property and Liability Insurance Fundamentals**

Unit: 16

Topic: Commercial Liability Insurance Coverage

Learning Objectives: An introduction to commercial liability insurance contracts

Assigned Readings: *Fundamentals of Insurance and Risk, Vaughan and Vaughan*,  
Chapter 32 - Commercial Liability Insurance

**Commercial Liability Insurance – Learning Objectives to Master:**

- Identify and differentiate among the three broad categories into which liability insurance for business firms may be divided
- Identify the coverage elements in a Workers Compensation and Employers Liability Policy and explain the exposure that each is designed to cover
- Identify and explain the general liability exposures facing a business
- Identify the major coverages of a Commercial General Liability Policy
- Explain the purpose and intent of each of the exclusions in a Commercial General Liability Policy
- Explain the difference between an occurrence general liability policy and a claims-made liability form
- Describe the coverages offered in ISO's Information Security Protection Policy
- Identify and differentiate among the four types of commercial automobile insurance policies
- Identify and differentiate among the three broad classes of automobiles that may be insured under a Business Auto Policy
- Explain the liability of a common carrier and explain how this exposure is generally insured
- Identify and differentiate among the types of bailment and explain the liability associated with each class
- Explain how bailee liability coverages differ from other forms of liability insurance
- Describe the characteristics of commercial excess liability policies and commercial umbrella liability policies