

Risk Management

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MGM510

Lec.6 : company Insurance operations



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“People who work for insurance companies do a lot more than sell insurance.”
Insurance Information Institute



Lecture objectives

After studying this chapter, you should be able to:

- ❖ Explain the rate-making function of insurers.
- ❖ Explain the steps in the underwriting process.
- ❖ Describe the sales and marketing activities of insurers.
- ❖ Describe the steps in the process of settling a claim.
- ❖ Explain the reasons for reinsurance and the various types of reinsurance treaties.
- ❖ Explain the importance of insurance company investments and identify the various types of investments of insurers.

Insurance Company Operations

- ❖ The most important operations of an insurance company include the following:
- ❖ Rate making
- ❖ Underwriting
- ❖ Production
- ❖ Claims settlement
- ❖ Reinsurance
- ❖ Investments



Rating and Rate making

- ❖ Rate making refers to the pricing of insurance and the calculation of insurance premiums. The premium paid by the insured is the result of multiplying a rate determined by actuaries by the number of exposure units, and then adjusting the premium by various rating factors (a process called rating). A rate is the price per unit of insurance. An exposure unit is the unit of measurement used in insurance pricing, which varies by line of insurance.
- ❖ Insurance pricing differs considerably from the pricing of other products.
- ❖ The person who determines rates and premiums is known as an actuary. He or she is a highly skilled mathematician who is involved in all phases of insurance company operations, including planning, pricing, and research

Underwriting

- ❖ Underwriting refers to the process of selecting, classifying, and pricing applicants for insurance. The underwriter is the person who decides to accept or reject an application.

Statement of Underwriting Policy

- ❖ Underwriting starts with a clear statement of underwriting policy. An insurer must establish an underwriting policy that is consistent with company objectives.
- ❖ The insurer's underwriting policy is determined by top-level management in charge of underwriting. The underwriting policy is stated in detail in an underwriting guide that specifies the lines of insurance to be written; territories to be developed; forms and rating plans to be used; acceptable, borderline, and prohibited business; amounts of insurance to be written; business that requires approval by a senior underwriter; and other underwriting details.

Basic Underwriting Principles

Underwriting is based on a number of principles.

Three principles are especially important:

- 1- Attain an underwriting profit.
- 2- Select prospective insureds according to the company's underwriting standards.
- 3- Provide equity among the policyholders.



Basic Underwriting Principles

- ❖ The primary objective of underwriting is to attain an underwriting profit. The objective is to produce a profitable book of business. The underwriter constantly strives to select certain types of applicants and to reject others so as to obtain a profitable portfolio of business.
- ❖ The second principle is to select prospective insureds according to the company's underwriting standards. This means that the underwriters should select only those insureds whose actual loss experience is not likely to exceed the loss experience assumed in the rating structure.
- ❖ A final underwriting principle is equity among the policyholders. This means that equitable rates should be charged, and that each group of policyholders should pay its own way in terms of losses and expenses. Stated differently, one group of policyholders should not unduly subsidize another group.

Steps in Underwriting

- ❖ **Agent as First Underwriter** This step is often called **field underwriting**. The agent is told what types of applicants are acceptable, borderline, or prohibited..

Sources of Underwriting Information

The underwriter requires certain information in deciding whether to accept or reject an applicant for insurance.

Important sources of information include the following:

Application: The type of information required depends on the type of insurance requested.

Agent's report: Many insurers require the agent or broker to give an evaluation of the prospective insured.

Inspection report: In property insurance, the company may require an inspection report by some outside agency, especially if the underwriter suspects moral hazard. An outside firm investigates the applicant for insurance and makes a detailed report to the company.

Sources of Underwriting Information

Physical inspection: In property insurance and casualty insurance, the underwriter may require a physical inspection before the application is approved.

Physical examination : In life insurance, a physical exam may be required to determine if the applicant is overweight; has high blood pressure; or has any abnormalities in the heart, respiratory system, urinary system, or other parts of the body.

Making an Underwriting Decision

After the underwriter evaluates the information, an underwriting decision must be made. There are three basic underwriting decisions with respect to an initial application for insurance:

- ❖ Accept the application
- ❖ Accept the application subject to certain restrictions or modifications
- ❖ Reject the application.

Other Underwriting Considerations

- ❖ **Rate adequacy and underwriting:** Property and casualty insurers are more willing to underwrite new business for a specific line if rates are considered adequate.
- ❖ **Reinsurance and underwriting:** Availability of reinsurance may result in more liberal underwriting. However, if reinsurance cannot be obtained on favorable terms, underwriting may be more restrictive.
- ❖ **Renewal underwriting:** In life insurance, policies are not cancellable. In property and casualty insurance, most policies can be canceled or not renewed. If the loss experience is unfavorable, the insurer may either cancel or not renew the policy.

Production

❖ The term production refers to the sales and marketing activities of insurers. Agents who sell insurance are frequently referred to as producers. This word is used because an insurance company can be legally chartered, personnel can be hired, and policy forms printed, but no business is produced until a policy is sold. The key to the insurer's financial success is an effective sales force.

❖ **Agency Department**

This department is responsible for recruiting and training new agents and for the supervision of general agents, branch office managers, and local agents.

Claims Settlement

- ❖ Every insurance company has a claims division or department for adjusting claims. This section of the chapter examines the basic objectives in adjusting claims, the different types of claim adjusters, and the various steps in the claim-settlement process.
- ❖ Basic Objectives in Claims Settlement From the insurer's viewpoint, there are several basic objectives in settling claims.
- ❖ Verification of a covered loss
- ❖ Fair and prompt payment of claims
- ❖ Provide personal assistance to the insured

Claims Settlement

- ❖ The first objective in settling claims is to verify that a covered loss has occurred. This step involves determining whether a specific person or property is covered under the policy, and the extent of the coverage .
- ❖ The second objective is the fair and prompt payment of claims. If a valid claim is denied, the fundamental social and contractual purpose of protecting the insured is defeated.
- ❖ A third objective is to provide personal assistance to the insured after a covered loss occurs. Aside from any contractual obligations, the insurer should also provide personal assistance after a loss occurs.

Types of Claims Adjustors

- ❖ Personnel who adjust claims are known as a claims adjustors. The major types of adjustors include the following:
 - ❖ Agents
 - ❖ Staff claims representatives
 - ❖ Independent adjustors
 - ❖ Public adjustors.



Insurance agents

- ❖ Insurance agents often have authority to settle small first-party claims up to some maximum limit. A first-party claim is a claim submitted by the insured to the insurer, such as a small theft loss by the insured. The insured submits the claim directly to the agent, who has the authority to pay up to some specified amount. This approach to claims settlement has several advantages: It is speedy, it reduces adjustment expenses, and it preserves the policyholder's goodwill..

Staff claims representatives

- ❖ Staff claims representatives are employees of an insurer who adjust most claims. Staff claim representatives are typically salaried employees and represent only one insurer. After notice of the loss is received, a claims representative will investigate the claim, determine the amount of loss, and arrange for payment.

Independent adjustors

- ❖ Independent adjustors can also be used to adjust claims. An independent adjustor is an organization or individual that adjusts claims for a fee. Claims personnel are highly trained individuals who adjust claims on a full-time basis.

Public adjustors

❖ Public adjustors are also used to settle claims. A public adjustor represents the insured rather than the insurance company and is paid a fee based on the amount of the claim settlement. A public adjustor may be employed by the insured if a complex loss situation occurs and technical assistance is needed, and also in those cases where the insured and insurer cannot resolve a dispute over a claim..

Steps in Settlement of a Claim

There are several important steps in settling a claim:

- ❖ Notice of loss must be given.
- ❖ The claim is investigated.
- ❖ A proof of loss may be required.
- ❖ A decision is made concerning payment.

Reinsurance

Reinsurance is another important insurance operation.

- ❖ Reinsurance is an arrangement by which the primary insurer that initially writes the insurance transfers to another insurer (called the reinsurer) part or all of the potential losses associated with such insurance.
- ❖ The primary insurer that initially writes the insurance is called the ceding company. The insurer that accepts part or all of the insurance from the ceding company is called the reinsurer. The amount of insurance retained by the ceding company for its own account is called the retention limit, or net retention.

Reinsurance

- ❖ The amount of insurance ceded to the reinsurer is known as the cession. Finally, the reinsurer in turn may reinsure part or all of the risk with another insurer.

Reasons for Reinsurance

Reinsurance is used for several reasons. The most important reasons include the following:

- ❖ Increase underwriting capacity
- ❖ Stabilize profits
- ❖ Reduce the unearned premium reserve
- ❖ Provide protection against a catastrophic loss

Reinsurance also enables an insurer to retire from a territory or class of business and to obtain underwriting advice from the reinsurer.

Increase Underwriting Capacity

Reinsurance can be used to increase the insurance company's underwriting capacity to write new business. The company may be asked to assume liability for losses in excess of its retention limit. Without reinsurance, the agent would have to place large amounts of insurance with several companies or not accept the risk.

Stabilize Profits

Reinsurance is used to stabilize profits. An insurer may wish to avoid large fluctuations in annual financial results. Loss experience can fluctuate widely because of social and economic conditions, natural disasters, and chance. Reinsurance can be used to stabilize the effects of poor loss experience

Reduce the Unearned Premium Reserve

Reinsurance can be used to reduce the unearned premium reserve. For some insurers, especially newer and smaller companies, the ability to write large amounts of new insurance may be restricted by the unearned premium reserve requirement. The unearned premium reserve is a liability item on the insurer's balance sheet that represents the unearned portion of gross premiums on all outstanding policies at the time of valuation.

Provide Protection against a Catastrophic Loss

- ❖ Reinsurance also provides financial protection against a catastrophic loss. Insurers often experience catastrophic losses because of hurricanes and earthquakes and other natural disasters, industrial explosions, commercial airline disasters, and similar events. Reinsurance can provide considerable protection to the ceding company that experiences a catastrophic loss.
- ❖ The reinsurer pays part or all of the losses that exceed the ceding company's retention up to some specified maximum limit.

Other Reasons for Reinsurance

- ❖ An insurer can also use reinsurance to retire from the business or from a given line of insurance or territory. Reinsurance permits the insurer's liabilities for existing insurance to be transferred to another carrier; thus, policyholders' coverage remains undisturbed.
- ❖ Finally, reinsurance allows an insurer to obtain the underwriting advice and assistance of the reinsurer.
- ❖ The reinsurer can often provide valuable assistance with respect to rating, retention limits, policy coverages, and other underwriting details.

Types of Reinsurance

There are two principal types of reinsurance: facultative reinsurance and treaty reinsurance.

- ❖ **Facultative reinsurance** is an optional, case-by-case method that is used when the ceding company receives an application for insurance that exceeds its retention limit. Reinsurance is not automatic..
- ❖ **Treaty reinsurance** means the primary insurer has agreed to cede insurance to the reinsurer, and the reinsurer has agreed to accept the business. All business that falls within the scope of the agreement is automatically reinsured according to the terms of the treaty.

Methods for Sharing Losses

There are two basic methods for sharing losses: pro rata and excess-of-loss. Under the pro rata method, the ceding company and reinsurer agree to share losses and premiums based on some proportion. Under the excess-of-loss method, the reinsurer pays only when covered losses exceed a certain level.

The following reinsurance methods for the sharing of losses are examples of both methods:

- ❖ Quota-share treaty
- ❖ Surplus-share treaty
- ❖ Excess-of-loss reinsurance
- ❖ Reinsurance pool

Methods for Sharing Losses

❖ Quota-Share Treaty

Under a quota-share treaty, the ceding company and reinsurer agree to share premiums and losses based on some proportion. The ceding company's retention is stated as a percentage rather than as a dollar amount.

❖ Surplus-Share Treaty

Under a surplus-share treaty, the reinsurer agrees to accept insurance in excess of the ceding insurer's retention limit, up to some maximum amount. The retention limit is referred to as a line and is stated as a dollar amount.

Methods for Sharing Losses

❖ Excess-of-Loss Reinsurance

Excess-of-loss reinsurance is designed largely for protection against a catastrophic loss. The reinsurer pays part or all of the loss that exceeds the ceding company's retention limit up to some maximum level.

❖ Reinsurance Pool

Reinsurance can also be provided by a reinsurance pool. A reinsurance pool is an organization of insurers that underwrites insurance on a joint basis. Reinsurance pools have been formed because a single insurer alone may not have the financial capacity to write large amounts of insurance, but the insurers as a group can combine their financial resources to obtain the necessary capacity

Investments

The investment function is extremely important in the overall operations of insurance companies. Because premiums are paid in advance, they can be invested until needed to pay claims and expenses.

- ❖ Life insurance investments have an important economic and social impact on the nation for several reasons. First, life insurance contracts are long-term, and the liabilities of life insurers extend over long periods of time, such as 50 or 60 years. Thus, safety of principal is a primary consideration. Consequently, as stated earlier, the majority of investments in the general account are in bonds.

Investments

- ❖ Second, investment income is extremely important in reducing the cost of insurance to policyholders because the premiums can be invested and earn interest. The interest earned on investments is reflected in the payment of dividends to policyholders, which reduces the cost of life insurance.
- ❖ Finally, life insurance premiums also are an important source of capital funds to the economy. These funds are invested in shopping centers, housing developments, office buildings, hospitals, new plants, and other economic and social programs.

Investments

Two important points must be stressed when the investments of property and casualty insurers are analyzed.

- ❖ First, in contrast to life insurance, property insurance contracts generally are short-term in nature. The policy period in most contracts is one year or less, and property claims are usually settled quickly. Also, in contrast to life insurance claims, which are generally fixed in amount, property insurance claim payments can vary widely depending on catastrophic losses, inflation, medical costs, construction costs, auto repair costs, economic conditions, and changing value judgments by society. For these reasons, the investment objective of liquidity is extremely important.
- ❖ Second, investment income is extremely important in offsetting unfavorable property and casualty underwriting experience. The investment of capital and surplus funds, along with the funds set aside for loss reserves and the unearned premium reserve, generate investment earnings that usually permit an insurer to continue its insurance operations despite an underwriting deficit.

Other operations

Other important insurance company operations include investments, information systems, legal services, and loss-control services.

Information systems

information systems are extremely important in the daily operations of insurers. These systems depend heavily on computers and new technology.

Accounting

The accounting department is responsible for the financial accounting operations of an insurer. Accountants prepare financial statements, develop budgets, analyze the company's financial operations, and keep track of the millions of dollars that flow into and out of a typical company each year

Other operations

Legal Function

Another important function of insurance companies is the legal function. In life insurance, attorneys are widely used in advanced underwriting and estate planning.

Loss-Control Services

Loss control is an important part of risk management, and a typical property and casualty insurer provides numerous loss-control services. These services include advice on alarm systems, automatic sprinkler systems, fire prevention, occupational safety and health, prevention of boiler explosions, and other loss-prevention activities.



Thank You