

# PRINCIPLES OF RISK MANAGEMENT AND INSURANCE

## CLASS NOTES

### Chapter 25 Insurance Company Operations

#### Topics

- Rate making
- Underwriting
- Production
- Claim settlement
- Reinsurance
- Investments
  
- Rate making refers to the pricing of insurance
  - Total premiums charged must be adequate for paying all claims and expenses during the policy period
  - Rates and premiums are determined by an actuary, using the company's past loss experience and industry statistics
- Underwriting refers to the process of selecting, classifying, and pricing applicants for insurance
  - The objective is to produce a profitable book of business
- A statement of underwriting policy establishes policies that are consistent with the company's objectives, such as
  - Acceptable classes of business
  - Amounts of insurance that can be written
- A line underwriter makes daily decisions concerning the acceptance or rejection of business
- There are three important principles of underwriting:
  - The underwriter must select prospective insureds according to the company's underwriting standards
  - Underwriting should achieve a proper balance within each rate classification
    - In class underwriting, exposure units with similar loss-producing characteristics are grouped together and charged the same rate
  - Underwriting should maintain equity among the policyholders
- Underwriting starts with the agent in the field
- Information for underwriting comes from:
  - The application
  - The agent's report
  - An inspection report
  - Physical inspection
  - A physical examination and attending physician's report
  - MIB report
- After reviewing the information, the underwriter can:
  - Accept the application
  - Accept the application subject to restrictions or modifications
  - Reject the application

- Production refers to the sales and marketing activities of insurers
  - Agents are often referred to as producers
  - Life insurers have an agency or sales department
  - Property and liability insurers have marketing departments
- An agent should be a competent professional with a high degree of technical knowledge in a particular area of insurance and who also places the needs of his or her clients first

### Claim Settlement

- The objectives of claims settlement include:
  - Verification of a covered loss
  - Fair and prompt payment of claims
  - Personal assistance to the insured
- Some laws prohibit unfair claims practices, such as:
  - Refusing to pay claims without conducting a reasonable investigation
  - Not attempting to provide prompt, fair, and equitable settlements
  - Offering lower settlements to compel insureds to institute lawsuits to recover amounts due
- The claim process begins with a notice of loss
- Next, the claim is investigated
  - A claims adjustor determines if a covered loss has occurred and the amount of the loss
- The adjustor may require a proof of loss before the claim is paid
- The adjustor decides if the claim should be paid or denied
  - Policy provisions address how disputes may be resolved

### Reinsurance

- Reinsurance is an arrangement by which the primary insurer that initially writes the insurance transfers to another insurer part or all of the potential losses associated with such insurance
  - The primary insurer is the ceding company
  - The insurer that accepts the insurance from the ceding company is the reinsurer
  - The retention limit is the amount of insurance retained by the ceding company
  - The amount of insurance ceded to the reinsurer is known as a cession
- Reinsurance is used to:
  - Increase underwriting capacity
  - Stabilize profits
  - Reduce the unearned premium reserve
    - The unearned premium reserve represents the unearned portion of gross premiums on all outstanding policies at the time of valuation
  - Provide protection against a catastrophic loss
  - Retire from business or from a line of insurance or territory
  - Obtain underwriting advice on a line for which the insurer has little experience
- There are two principal forms of 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
- Treaty reinsurance means the primary insurer has agreed to cede insurance to the reinsurer, and the reinsurer has agreed to accept the business
  - Under a quota-share treaty, the ceding insurer and the reinsurer agree to share premiums and losses based on some proportion
  - 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
  - An excess-of-loss treaty is designed for catastrophic protection
  - A reinsurance pool is an organization of insurers that underwrites insurance on a joint basis

### Reinsurance Alternatives

- Some insurers use the capital markets as an alternative to traditional reinsurance
- Securitization of risk means that an insurable risk is transferred to the capital markets through the creation of a financial instrument, such as a futures contract
- Catastrophe bonds are corporate bonds that permit the issuer of the bond to skip or reduce the interest payments if a catastrophic loss occurs

### Investments

- Because premiums are paid in advance, they can be invested until needed to pay claims and expenses
- Investment income is extremely important in reducing the cost of insurance to policyowners and offsetting unfavorable underwriting experience
- Life insurance contracts are long-term; thus, safety of principal is a primary consideration
- In contrast to life insurance, property insurance contracts are short-term in nature, and claim payments can vary widely depending on catastrophic losses, inflation, medical costs, etc

### Other Insurance Company Functions

- The electronic data processing area maintains information on premiums, claims, loss ratios, investments, and underwriting results
- The accounting department prepares financial statements and develops budgets
- In the legal department, attorneys are used in advanced underwriting and estate planning
- Property and liability insurers provide numerous loss control services

End./.