

## INTRODUCTION TO UNDERWRITING (60-1)

EO 1. The Burnham System defines each assignment's **KEY WORDS AND PHRASES** in context. So you can find them easily, they are both **bolded and underlined**, and **CAPITALIZED** too if they're used in an educational objective.

EO 2. **UNDERWRITERS** select, price, and design coverages they will accept on their insurers' behalfs and they monitor the results of their prior decisions. Some insurers delegate underwriting tasks to other employees. Hence, some employees without the title 'underwriter' perform underwriting tasks.

*[In the 17th century, a ship owner would present a proposed insurance contract to potential backers. Risk-taking entrepreneurs would then **write** their names and the amount of risk they would accept and the price they would charge **under** the proposal. Hence, our word 'underwrite'.]*

EO 3. **RISK** means the chance of financial loss **or** the subject of insurance **or** the peril or cause of loss. In its first sense, there are **two types of risk**:

**Pure risk** presents the possibility of loss or of no loss--**no** chance of gain.

**Example:** the risk of losing one's home in a fire.

**Speculative risk** presents three possible outcomes: loss, no loss, and gain.

**Example:** gambling and investing in the stock market.

EO 4. **HOW UNDERWRITING DIFFERS FROM GAMBLING:**

1. **Creation of the risk**--The gambler **creates** the chance of loss when he decides to gamble. If the gambler chooses not to place a bet, there is no risk. The underwriter chooses whether to accept or reject an **existing** risk, such as the risk of fire burning one's home.
2. **The assets at risk**--A gambler risks his own personal assets. Underwriters risk their employers' assets and are held to a higher standard of accountability.
3. **The nature of the risks**--Gambling involves speculative risk, with the possibility of gain. Insurance involves pure risk, with no possibility of gain.

EO 5. **THE PURPOSE OF UNDERWRITING** is to develop a growing, profitable **book of business** (collection of insurance policies with at least one common characteristic). **Underwriting** involves selecting insureds, pricing coverages, designing policy terms and conditions, and monitoring previous underwriting decisions. **To underwrite** is to carry on the business of insurance because all other activities are related to or develop from underwriting decisions. **Insurance** is the system in which entities (**insureds**) transfer risk to an insurance company (the **insurer**) which reimburses its insureds for their covered losses.

*[Types of insurers: **Stock insurers** are owned by stockholders who invested in their insurers.*

***Mutual insurers** are owned by directly by their insureds.]*

EO 6. **THE JOBS OF UNDERWRITERS**--A **home office underwriter** handles questions and applications beyond the abilities of **branch underwriters** (who work in regional or field offices).

A **line underwriter** handles individual applications and accounts.

A **staff underwriter** develops underwriting guidelines and procedures. *[A **producer** sells insurance.]*

### THE NINE-STEP UNDERWRITING PROCESS:

1. Gather and evaluate information about the **loss exposure** (condition creating loss potential).
2. Determine eligibility.
3. Evaluate the insurer's preference for the type of risk.
4. Determine the premium.

5. Weigh the risk against the premium.
6. Decide whether to accept or to reject the submission.
7. Propose the price, conditions, and **warranties** (insured's promises to fulfill specified conditions) to the potential insured.
8. Negotiate and prepare the final policy.
9. Monitor the decision and service the policy.

EOs 7 + 9. **THE OBJECTIVES OF UNDERWRITING--The goal of underwriting** (a growing, profitable book of business) requires balance among the following **six objectives of underwriting**. Overemphasis on one objective creates deficiencies in the other objectives.

1. **Provide proper coverage--Proper coverage** is protection that meets a need. Proper coverage can be provided by a **standardized policy** for needs that exist among many insureds or by a **manuscript policy** tailored to the specific needs of an individual insured.
2. **Maintain selection standards**--Overly strict standards keep the book of business from growing. Overly lax standards keep the insurer from making a profit. **Adverse selection** occurs because the people who most want to buy insurance are the ones who are most likely to have losses. If unchecked, adverse selection results in unaffordable premiums or insurer insolvency. **Insurers respond to adverse selection** by bundling coverages and by forming pools or by seeking government help in insuring exposures susceptible to adverse selection, such as flood and earthquake.
3. **Maintain pricing standards**--Insurance rates should be high enough to pay insurer expenses and earn profits yet low enough to be competitive. **Underwriters maintain pricing standards by** allocating risks to proper classes and using judgment to set premiums. Many smaller insurers do not have enough business to develop credible loss statistics.
 

**Rating bureaus were formed to**

  - a. compile data from member insurers,
  - b. publish rating plans, *and*
  - c. file final rates (or loss costs) on behalf of their members.
4. **Maintain a stable market**--A stable market has consistent pricing and selection standards. Competition may prompt insurers to change their pricing or selection standards, but wide fluctuations in prices or coverages make long-term planning difficult.
5. **Provide good service**--Insurers measure service to their producers in terms of turn-around times for requests and in terms of underwriters' attitudes and professionalism.
6. **Maintain professional competence**--Underwriters maintain professionalism through training and continuing education such as the AU and CPCU.

EO 8. **HOW INSURANCE PREMIUMS ARE DETERMINED--The rate** is the price for insurance coverage per exposure unit. **The exposure unit** is the measure of loss potential.

**The exposure base** is the denomination in which the exposure unit is expressed, for example gross sales, payroll, area, units, or dollars of value.

**The premium** equals the rate times the number of exposure units.

**Example:** If the fire insurance rate is \$0.25 per \$100 of insurance, the fire insurance on a \$250,000 building would cost \$625.

**Two types of insurance rates:**

1. **Class rating**--applies to groups of separate, yet **homogeneous** (similar), exposures with clearly identifiable exposure characteristics. Insureds in a class pay a premium based on the **class rate** (aka the **manual rate**). The underwriter has no discretion to raise or lower the price except as allowed by its **rating plan** (set of rules, definitions, surcharges, etc. used in applying class rates).
2. **Individual rating**--applies individually-developed rates to unique exposures when the number of homogeneous or similar insureds is too small to group into a class for class rating.