UNDERWRITING FUNDAMENTALS (65-1)

*[**Insurance** transfers business and individual loss exposures to an insurer, which then reimburses individual insureds for their covered losses and shares loss costs among all insureds.*
Insurer functions vary by department:

1. ***The claim department***--*investigates claims and satisfies insurer obligations to its clients.*
2. ***The actuarial department***--*sets rates, verifies loss reserves, evaluates profitability, analyzes industry competitiveness, and prepares statistical reports for the insurer and its regulators.*
3. ***The marketing department***--*identifies marketing opportunities, develops new products,* ***and*** *measures market success.*
4. ***The loss control department***--*employs* ***loss control representatives****, who inspect the premises and operations of insurance applicants and recommend loss control activities that improve account profitability.*
5. ***The premium auditing department***--*examines insureds' financial records to determine financially-based premiums.* ***Premium auditors*** *perform* ***field audits (physical audits),*** *visiting the insureds to examine and consult on their financial records.*
   Some insureds provide ***voluntary reports*** *of financial information to avoid physical audits.*
6. ***The reinsurance department***--*negotiates with the insurer's reinsurers.]*

EO 1. **UNDERWRITING** selects policyholders, determines policy terms and premiums, and monitors the effects of those decisions. Favorable underwriting results allow insurers to survive and grow profitably.

THE PURPOSE OF UNDERWRITING is to maintain a profitable **book of business** (group of in-force policies). To achieve that purpose, underwriters avoid **adverse selection** (an above average proportion of policyholders with above average risk exposures at average premiums). The underwriter who practices the least selective screening relative to competing insurers is subject to the most adverse selection.

EO 2. **LINE UNDERWRITERS work in regional offices and perform day-to-day underwriting tasks. Seven typical activities of line underwriters: Line underwriters**

1. **select insureds--The selection process** uses the available insurance capacity to create the best spread of loss exposures by location, class, size of risk, and line of business.
   The law of large numbers states that the accuracy of an insurer's loss predictions increases as the number of pooled risks increases. When losses are predictable, the insurer can charge enough premium to cover losses and generate a profit.
   Selection also involves monitoring the current book of business for continued acceptability.
2. **classify risks**--Group insureds into categories of similar expected loss frequency and severity in order to properly rate policies. Misclassified accounts result in premiums that are either too high (which causes insureds to seek cheaper coverage elsewhere) or too low (which causes the insurer to subsidize some losses out of its own profits).
3. **determine proper coverage--**Work with the risk manager and producer to select the most acceptable coverage for each insured. **A manuscript policy** is written to address the specific needs of an insured, but in most cases standard policies suffice.
4. **price policies**--Often, proper classification automatically sets the proper rate. Other times, an **underwriting technician** adjusts the rate based on the insured's individual risk characteristics.
5. **service policies**--Issue policies, process endorsements, and help insureds and **producers** (agents and brokers, those who sell insurance).
6. **manage books of business--**Make sure the book of business continues to reflect the insurer's goals.
7. **provide marketing support--**Encourage producers to submit applicants that meet the insurer's underwriting policies. Do not reject applicants that meet those policies.

Special agents (field representatives) market the insurer and its products to producers.
Production underwriters act as both underwriters and special agents, helping producers to develop accounts that meet their insurers' guidelines. Combining marketing and underwriting activities reduces the amount of time the insurer spends evaluating unacceptable applicants.

STAFF UNDERWRITERS work in the home office and set underwriting policy.
Ten typical activities of staff underwriters: Staff underwriters

1. **formulate underwriting policy--Underwriting policy (the underwriting philosophy)** guides underwriting decisions and is based on the insurer's mission statement.
   The mission statement lists the insurer's major goals.
   The underwriting policy translates those goals into specific strategies.
   Underwriting policy is usually expressed in the form of **underwriting guidelines (the underwriting guide),** which is a written manual of underwriting rules and procedures.
   Staff underwriters evaluate the insurance market to determine what products to sell, what accounts/classifications to pursue, which states to enter, which states to avoid or leave, what mix of insurance products is ideal, and what premium/volume goals to target.
   The 'standard insurance market' consists of insurers that seek better-than-average accounts and charge average premiums.
   The 'nonstandard insurance market' consists of insurers that seek worse-than-average accounts and charge higher-than-average premiums.
   The 'specialty market' consists of insurers that seek insureds with unique needs.
2. **advise on complex accounts**--Act as consultants to line underwriters
3. **evaluate experience**--Analyze loss and premium data for both the insurer and the industry to determine trends by line, class, size of risk, and territory.
   Change underwriting and sales strategies as needed.
4. **develop coverages and policy forms**--Develop new products and modify existing products to reflect the changing market and legal environment.
   Recent court decisions and changes to 'standard' forms developed by insurance advisory organizations might trigger an insurer to change its own products.
   Recent **commercial lines deregulation** in some states has removed the requirement for large commercial insurers to file their rates and forms, allowing for easier product modification.
5. **review and revise rating plans**--Update rating plans to respond to changing loss experience, competition, and inflation.
   Insurance advisory organizations gather data from member insurers to calculate **prospective loss costs** (loss data modified to reflect loss development, trending, and credibility) from which insurers calculate their own rates.
   The Insurance Services Office (ISO) is the leading supplier of statistical, actuarial, and underwriting information for the property-casualty insurance industry.
   The National Council on Compensation Insurance (NCCI) is the leading supplier of statistical, actuarial, and underwriting information for workers' compensation insurance.
   The American Association of Insurance Services (AAIS) is an incorporated association of insurers that functions as a rating organization and a statistical agent, *[like a mini-ISO]*.
6. **prepare underwriting guides and bulletins--Underwriting guides and bulletins** describe the selection standards, evaluative factors, and procedures used to implement underwriting policy.
7. **arrange treaty reinsurance--Reinsurance** is insurance for insurers.
   Treaty reinsurance transfers risks on an ongoing basis for specific insurance products.
   Facultative reinsurance, on the other hand, transfers a single risk at a time.
   Staff underwriters determine reinsurance needs, select and negotiate with reinsurers, and maintain relations with reinsurers. Sometimes, the underwriting guidelines contain a **line authorization guide,** which sets the maximum coverage limits the insurer can offer.

8. **conduct underwriting audits--An __underwriting audit__** is an on-site review of underwriting files to check for adherence to underwriting guidelines.
9. **participate and represent their employers in industry associations and bureaus.**
10. **conduct education and training--**of line underwriters.

EO 3. **__HOW INSURERS DISTRIBUTE AUTHORITY FOR UNDERWRITING DECISIONS__:**

__Underwriting authority__ is the extent to which underwriters are allowed to make, and take responsibility for, underwriting decisions. Authority varies by position, grade level, and experience.

__Centralized authority__ concentrates decision-making at the home office.

__Decentralized authority__ concentrates decision-making at regional offices and on producers.

A __front-line underwriter__ is a producer who is authorized to reject applicants that will not meet the insurer's underwriting requirements.

__Factors affecting the distribution of authority__: the insurer's philosophy, lines of business written, degree of specialization, and (when delegating to producers) producer experience and expertise.

[__Underwriting policy__ *determines the composition of the insurer's book of business by striking a balance among underwriting objectives.*

A __line of business__ *refers to a particular insurance product (Workers' compensation is a different line of business than commercial auto liability.).]*

[__The three dimensions of underwriting policy__ are

1. ***the lines and classes of business--****to be written;*
2. ***the territories--****to be developed;* ***and***
3. ***the forms, rates, and rating plans--****to be used.]*

EO 4. **__THE FOUR CONSTRAINING FACTORS AFFECTING UNDERWRITING POLICY__ are**

1. **capacity--__The capacity to write business__** decreases as the insurer's ratio of written premiums to policyholders' surplus increases. Higher levels of written premiums and lower levels of policy-holders' surplus reduce the capacity to write business.
   Limited capacity increases the importance of underwriting only the most acceptable risks.
   __Statutory accounting principles (SAP)__ are conservative accounting rules used by insurance regulators.
   __Generally accepted accounting principles (GAAP)__ are the more common accounting rules used by noninsurance businesses.
   Insurers use both SAP and GAAP.
   __Return on equity__ measures capacity and insurer profitability.
   __The SAP calculation for return on equity__ = net income / average policyholders' surplus.
   __The GAAP calculation for return on equity__ = net income / average owners' equity.
2. **regulation--State and federal regulation affects underwriting by**
   1. requiring licenses to write specific lines of insurance;
   2. approving (or not approving) insurers' rates, rules, and forms; ***and***
   3. setting various other restrictions on the sale and service of policies.

   State insurance regulators are primarily concerned with insurer solvency.
3. **personnel--**The insurer needs enough people with enough skills at enough (and the right) locations to sell and service its policies.
   A decision to write ocean marine cargo insurance, for instance, would require an insurer to hire experienced underwriting specialists in that field.
4. **__reinsurance__--**Reinsurance increases the insurer's surplus and capacity; therefore, the price and availability of reinsurance influences an insurer's underwriting policy.
   The reinsurer may set its own underwriting requirements for the reinsured business.

Once underwriting policy is set, any proposed change should be evaluated for its effects on the three dimensions and four constraining factors of underwriting policy. **Underwriting policy will change with changes to the insurer's** territory, coverage options, coverage limits, policyholder acceptance guidelines, classes of business, pricing standards, rating schedules, payment plan options, and competition.

EO 5. **THE FIVE MAIN PURPOSES OF UNDERWRITING GUIDELINES:**

1. **Provide for structured decisions**--by identifying the principal hazards associated with each class of business.
2. **Ensure uniformity and consistency**--by providing the basis for all underwriting decisions.
3. **Synthesize insights and experience**--by distributing useful information from experienced and knowledgeable underwriters to less experienced and less knowledgeable underwriters.
4. **Distinguish between routine and nonroutine decisions**--and require the submission of nonroutine decisions to higher underwriting authority.
5. **Avoid duplication of effort**--by providing, in one place, the information needed for many routine decisions.

[Monitor underwriting policy by performing underwriting audits that

1. *determine if line underwriters are following underwriting policy,*
2. *measure underwriting results,* ***and***
3. *identify unused or conflicting guidelines.]*

EO 6. **CALCULATION OF FINANCIAL PERFORMANCE MEASURES:**

The combined ratio is the sum of the insurer's loss and expense ratios.
The most commonly used combined ratio is the **trade basis combined ratio,** which equals the **loss ratio** (incurred losses / ***earned*** premium) plus the **expense ratio** (underwriting expenses / ***written*** premium).

Using **Application Question 2, the**

1. **Loss ratio** = incurred losses / earned premium = 36 million / 45 million = 80%.
2. **Expense ratio** = underwriting expenses / written premium = 18 million / 50 million = 36%.
3. **Trade basis combined ratio** = loss ratio + expense ratio = 80% + 36 % = 116%.

The loss ratio, which pairs losses with earned (not written) premium recognizes the fact that the insurer must maintain an **unearned premium reserve** for coverage that has been paid for but not yet delivered (as when an insured pays for six months of auto coverage during the first month of coverage). Changes in premium volume alter the combined ratio. ***Example:*** A decrease in premium volume reduces the loss ratio and increases the expense ratio, overstating the combined ratio and making the insurer appear less profitable.
Delays in loss reporting reduce the loss ratio and understate the combined ratio.
Reporting delays are partially offset by the insurer's **IBNR (incurred but not recorded)** reserve, which sets aside money to pay for losses that have occurred but have not yet been reported.
The insurer bases its IBNR reserve on **gross IBNR,** which is the insurer's best estimate of IBNR losses.

Because our industry is cyclical *[or, at least used to be cyclical],* an insurer's unusually poor or good results may reflect the **underwriting cycle** (the fluctuations between hard and soft markets that characterize the insurance industry) rather than its own efforts.
A soft market exists when increased competition causes low insurance prices and broader coverages.
A hard market exists when restrictive underwriting causes high prices and restricted coverages.
Compare results with other insurers to get a more accurate measure of performance.
Measure results using the **operating profit (or loss) ratio,** which is the sum of underwriting profit or loss (the combined ratio) and investment profit or loss (net investment ratio).
[Exhibit 1-4 shows that investment earnings tend to offset underwriting losses during a soft market.]

EO 7. **<u>QUALITATIVE PERFORMANCE MEASURES</u>:**

1. **<u>Selection standards</u>**--set and monitor goals specifying the mix of highly desirable, average, and below-average risks in the book of business.
2. **<u>Production mix standards</u>**--set and monitor goals for the precise mix of new and renewal business.
3. **<u>Pricing standards</u>**--set an allowable range of deviation from manual premium for both individual accounts and entire books of business. Deviations beyond those ranges are closely monitored.
4. **<u>Accommodated risks standards</u>**--log all **<u>accommodations</u>** (substandard exposures accepted in consideration of other, more profitable, business) for evaluation during all audits.
   The auditors make sure the number of accommodations isn't too large and that the promised, profitable business has been delivered.
5. **<u>Retention ratio standards</u>**--set and monitor goals for the percentage of business renewed known as the **<u>retention ratio</u>.**
   A low retention ratio may indicate poor service to producers, noncompetitive pricing, or poor claims service.
6. **<u>Success ratio standards</u>**--set and monitor goals for the ratio of business written to business quoted known as the **<u>success ratio</u>.**
   A high success ratio may indicate limited competition, low or inadequate rates, broader coverage than other insurers, or poor selection.
   A low success ratio may indicate high competition, high rates, restrictive coverages, restrictive selection criteria, or poor service.
7. **<u>Service to producer standards</u>**--set and monitor minimum acceptable service standards to producers (number of days for quotes, new policies, replies to correspondence).
8. **<u>Premium to underwriter standards</u>**--determine if individual underwriters are doing their share of the work.

EOs 8 + 9. **<u>THE FIVE-STEP UNDERWRITING PROCESS</u>** helps underwriters make decisions and identify acceptable accounts by specifying the steps to follow when evaluating an insurance applicant. *[This sounds important.]*

1. **GATHER INFORMATION--**to identify and evaluate hazards.
   Underwriters try to achieve **<u>information efficiency</u>,** a balance between the hazards presented by the application and the information needed to underwrite the applicant reliably.
   A <u>hazard</u> is any condition that increases the expected frequency or severity of loss.
   a. **<u>Physical hazards</u> involve tangible characteristics of the exposure** that increase the expected frequency or severity of loss (drunk or untrained drivers, lack of fire extinguishers, old age).
   b. **<u>Moral hazards</u> involve active inducement of loss** (or exaggeration of loss).
      <u>The three main indicators of moral hazard</u>: the policyholder's
      1) **weak financial condition**--He may cause a loss to raise cash.,
      2) **undesirable associates--**He who associates with criminals may be a criminal., ***and***
      3) **poor moral character--**indicated by previous questionable losses, a criminal record, and unethical behavior.
   c. **<u>Morale hazards</u> involve passive indifference to loss.**
      <u>The three main indicators of morale hazard</u>:
      1) **poor personality traits**--indicated by carelessness, thoughtlessness, and lack of pride of ownership;
      2) **weak financial condition**--which might make the insured indifferent to a loss that would actually improve his financial condition; and
      3). **poor management--**indicated by sloppy housekeeping and bookkeeping, neglect of fire and safety equipment, poor internal controls, and failure to cooperate with loss control personnel.

2. **IDENTIFY AND DEVELOP ALTERNATIVES--**Accept, accept subject to modifications, or reject the submission.
   The four major modifications are
   a. adopt loss control programs or devices;
   b. change rates, rating plans, or policy limits;
   c. amend policy terms and conditions; ***and/or***
   d. use facultative reinsurance.
3. **SELECT YOUR BEST ALTERNATIVE--Consider the submission's** exposures, degree of risk, controls and protection features, and management's commitment to loss control.
   There are five more factors to consider:
   a. **Stay within your underwriting authority--**Check the underwriting guidelines before offering coverage or referring an applicant to a higher authority.
   b. **Observe regulatory constraints--**Avoid mandatory acceptance or renewal of otherwise unacceptable accounts by not accepting them in the first place.
   c. **Consider the presence of supporting business--<u>Account underwriting</u>** evaluates all applications from a single applicant as a whole.
      An insurer may accept an otherwise unacceptable risk if the applicant's other risks are above average.
   d. **Consider the mix of business--<u>The mix of business</u>** is the distribution of the insurer's business by producer, territory, line, and/or classification.
   e. **Consider producer/insurer relationships--**An insurer may accept an otherwise unacceptable risk to maintain a good relationship with a valued producer.
4. **IMPLEMENT YOUR DECISION--**Communicate your decision to the producer and all concerned personnel; develop the documentation (policy, binder, certificates); and record policy and applicant information for accounting, statistical, and monitoring activities.
   ***[A <u>binder</u>** provides written evidence of temporary coverage.]*
5. **MONITOR THE EXPOSURES--**Be sure the decision creates acceptable results.
   Review individual accounts at renewal, during routine safety inspections, and after loss.
   Review entire books of business by class of business, territory, or producer to identify specific underwriting problems.
   Develop and evaluate loss ratios for your book of business.
   Make sure the premium volume is large enough to cover fixed costs and overhead expenses.