

OVERVIEW OF OUR INSURANCE INDUSTRY: Benefits, Roles, Legal Forms, Levels, and Forces For Change (132-1)

[The six benefits of insurance:

1. **reduced financial insecurity**--Insurance substitutes a small, known premium payment for a possible, large, unknown loss.
2. **reduced losses**--through loss control activities.
3. **financial assistance**--at time of loss.
4. **economic expansion**--Insurers invest premiums for unpaid losses and supply credit.
5. **employment**--The P + C insurance industry employs over a million people in the US.
6. **tax revenue**--Taxes on our industry are a major source of state and federal government revenue.]

EO 1. **INSURANCE AS A RISK-SHARING PROCESS:** Insurance spreads the financial consequences of a single insured's loss among many insureds.

The insured transfers his risk of loss to the insurer in exchange for a known cost (the **premium**).

EO 2. **THE ROLE OF INFORMATION IN INSURANCE:** Efficient and effective risk pooling requires accurate records of exposures, coverages, premiums, and losses.

Insurers rely on the **law of large numbers**, which states that as the number of observations increases, the easier it is to predict results accurately.

Accurate data help insureds and insurers make decisions, such as what coverages are needed, in what amounts, and at what premiums. **Insurers use outside data to** predict loss frequency and severity, establish underwriting standards, estimate future claims payments, and select target markets.

EO 3. **THE STRUCTURE OF THE INSURANCE INDUSTRY:** Our industry is divided into insurance product distributors, insurance companies, government programs, service organizations, and regulators.

THE ROLES OF THE MAJOR ORGANIZATIONS IN THE P + L INSURANCE INDUSTRY:

A. **INSURANCE PRODUCT DISTRIBUTORS** arrange insurance protection for insureds.

P + L (aka **P + C**--property and casualty) insurance is primarily distributed through an agency system: Licensed agents sell the insurer's policies on a commission basis.

Agencies earn **commissions** calculated at a percentage of the premiums they sell. Agencies earn bonuses (**contingent commissions**) based on the amount and profitability of the policies they sell.

1. **Independent agency system**--An independent agency represents many insureds and pays its own operating expenses. Independent agencies have **binding authority** (They can commit an insurer to insure a loss exposure for a limited time.). The independent agency 'owns' the right to solicit policy renewals and may transfer its customers' policies from one insurer to another at will. Independent agencies that act as **managing general agents (MGAs)** underwrite, issue, and administer policies and pay claims for the insurer, usually in specialized lines. Most agencies use an **agency management system (AMS)**, an automated system that performs necessary information processes. Agencies and insurers try to achieve an **agency/company interface** (or simply **interface**) by using similar information systems that allow information exchanges.
2. **Direct writing agents**--are employed by, and work out of facilities owned by, the insurer. They are paid base salaries plus commissions or bonuses. They only represent their one insurer and those others their employing insurers authorize them to represent. The insurer 'owns' the customer relationship (the right to solicit renewals) and deals directly with the customer for billing, administration, and service.
3. **Exclusive agents**--are independent contractors who sell exclusively for one insurer. Exclusive agents work for **exclusive agencies**. Exclusive agencies do ***not*** 'own' the customer relationship.

4. **Insurance brokers**--represent insurance customers, *not* insurers.
Brokers determine their customers' needs, buy insurance at the best available terms (often from several insurers), and receive a commission for each policy written.
Brokers may also provide other customer services for fees.
Brokers are state-licensed and lack binding authority.
 5. **Direct distributors**--are insurers that market their products directly to their customers rather than through an agency or brokerage.
Direct distribution approaches include direct mail, telemarketing, and newspaper and television advertisements.
- B. **INSURANCE COMPANIES** provide life/health and/or property/liability insurance.
1. **Primary companies** insure consumers, both personal and business. They evaluate the risks, structure the coverages, set the premiums, appraise the losses, and determine if payment is owed.
Primary insurers specialize by product line:
 - a. **Personal lines insurers** market to individuals (PAP, HO).
 - b. **Commercial lines insurers** market to businesses (BPP, WC).
 - c. **Multiple-lines insurers** sell many P + L lines.
 - d. **All-lines insurers** sell life and health (**L + H**) insurance as well as P + L insurance.
 - e. **Excess and surplus lines insurers** specialize in risks unacceptable to most other insurers.
 2. **Reinsurance companies** insure primary insurers. Primary insurers can underwrite large risks by sharing the financial consequences of loss with a reinsurer.
Reinsurance intermediaries work as brokers for groups of companies interested in providing reinsurance by finding reinsurance customers and underwriting and administering the reinsurance.
There are two main types of reinsurance:
 - a. **Treaty reinsurance** automatically reinsures a portion of each primary company's risk. Insurer and reinsurer renegotiate each reinsurance treaty annually.
 - b. **Facultative reinsurance** is negotiated risk-by-risk and is generally reserved for the primary insurer's unusual risks.
- C. **GOVERNMENT PROGRAMS** provide insurance not provided by private insurers, such as Social Security, Medicare, and flood insurance.
- D. **SERVICE ORGANIZATIONS** provide insurance-specific services to insurers.
1. **Statistical and rate advisory organizations**, such as the **ISO** (Insurance Services Office) and the **NAII** (National Association of Independent Insurers), perform two main functions: **They**
 - a. gather statistical data from insurers and report them, as required, to the state **and**
 - b. use those data to develop statistically sound rates.
 2. **ACORD** (Agency Company Operations Research and Development) develops standard forms and procedures for recording information. It supplies property and liability insurers with forms and automation services.
 3. **IVANS** (Insurance Value Added Network Services) provides us a common communications network, including agency interface and electronic mail.
- E. **REGULATORS** set rules and procedures for our industry. Most regulation is at the state level, although the McCarran-Ferguson Act of 1945 allows federal regulation of insurance not regulated at the state level.
1. **State insurance departments** regulate insurance operations in their states. State regulation protects insureds by guarding against insurer insolvencies and by keeping premiums fair and equitable. Insurers must report vast numbers of data to the state insurance departments.
 2. **The National Association of Insurance Commissioners (NAIC)** is the organization of state insurance commissioners formed to draft model legislation and discuss and develop standard procedures for state insurance departments.
 3. **Insurance guarantee associations** are formed by state laws and require all solvent insurers in the state to cover the financial obligations of the state's insolvent insurers.
The associations are divided: one for P + L and one for L + H insurers.

THE MAJOR FUNCTIONS PERFORMED AT THE THREE INSURANCE INDUSTRY LEVELS:

A. Agencies and brokerages perform eight functions:

1. **market and sell policies**--make potential prospects and customers aware of the products and services the agency/brokerage offers.
2. **select risks**--choose insureds that meet their insurers' underwriting requirements and sales emphasis.
3. **package the products**--combine coverages from one or more insurers into a program that meets the insured's needs.
4. **secure price quotations**--rate standard policies according to their insurers' guidelines and submit unusual risks to the insurer for rating.
5. **deliver policies**--Some insurers authorize agencies to issue policies on the insurers' behalves.
6. **provide customer services**--act as a liaison between insurer and insured for policy changes.
7. **respond to claims**--act as a liaison between insurer and insured for loss notification and processing.
8. **bill and collect premiums**--The insurer may bill the agency monthly for premiums due or receive an **account current** from the agency, which itemizes premiums collected for the insurer. Most insurers bill and collect premiums themselves.

B. Insurance company branch and regional offices perform seven functions:

1. **market and sell policies**--appoint the most productive agencies in the area and offer the policies and services those agencies need.
2. **select risks**--set underwriting requirements and prices for standardized programs and evaluate and price unusual risks.
3. **code and rate policies**--**Coding** divides policy coverages into major perils and describes the attributes of the insured risk.
Rating develops policy rates according to the company rate manual.
Rating is usually automated in personal lines.
4. **prepare policies**--assemble policies for delivery to the insured.
5. **process claims**--determine if coverage exists for the loss, the extent of loss, and the loss payment. In complex cases, a claims examiner reviews information to determine the payment. The claims examiner estimates the company's total liability for loss (the **claim reserve**) and monitors the reserve adequacy as the insurer makes payments toward the loss.
6. **provide loss control services**--help insureds reduce the number and size (**frequency and severity**) of their future losses.
7. **perform premium audits**--When the policy premium depends on a variable not known until the end of the policy period, the insured pays an estimated advance premium and settles up at the end of the policy period.
Premium audits performed after the policy period gather those data needed to calculate the final premium.

C. Insurance company home offices perform eleven functions:

1. **general management**--set the corporate mission and general direction of the company; oversee the conduct of regional and branch offices; and ensure the accomplishment of company objectives.
2. **investment**--invest loss reserves to secure the best possible yield while keeping adequate funds available to meet loss payout patterns.
3. **legal**--perform claim work, manage litigation, develop contracts, and monitor regulatory issues. Outside attorneys often manage litigation.
4. **claims management**--develop guidelines and documentation standards for claims examiners and adjusters; train examiners and adjusters; review closed claim files for consistency; handle complex losses referred by branch offices; and manage loss adjustment expenses.
5. **underwriting management**--develop, apply, and monitor the results of standards for risk selection and pricing; work with the marketing department to develop new programs and packages; buy reinsurance coverage; and underwrite complex risks referred by branch offices.

6. **finance and accounting**--maintain the company's financial records; manage the company budget, investment portfolio, and cash balances, compile financial reports for regulators, executives, and stockholders; collect and disburse company funds; and prepare tax statements.
7. **statistical**--set standards for recording premiums and losses; maintain the accuracy and quality of statistical data; and prepare and submit statistical reports as required by regulators.
8. **actuarial**--use company and industry data to monitor rate adequacy, predict loss development, and develop rates and file rates and forms.
9. **internal audit**--make sure each department's financial and operating controls are adequate.
10. **human resource management**--administer payroll and benefits; develop personnel policies; and develop and train staff.
11. **systems development and management**--develop, operate, and maintain automated systems.

EO 4. A **STAKEHOLDER** is a person or entity that significantly influences or is influenced by the organization.

INSURANCE FIRM STAKEHOLDERS include owners, product distributors and retailers, employees, customers, suppliers, communities in which facilities are located, government bodies, and trade and professional groups.

Insurance managers balance the interests of their **strategic stakeholders** (their major stakeholder groups).

[Unasked EO. **THE LEGAL FORMS OF ORGANIZATION USED BY INSURANCE COMPANIES:**

1. **Stock companies**--owned by stockholders. A stockholder-elected board of directors sets policy. Dividends are paid to stockholders.
2. **Mutual companies**--owned by policyholders. A policyholder-elected board of directors sets policy and runs the company. Dividends, if any, are paid to the policyholders. Mutuels exist mainly to provide coverage for low premiums, **not** to give good investment returns.
3. **Reciprocals**--owned by **subscribers** (participating insureds/insurers who reciprocally self-insure their group's losses). A subscriber-appointed **attorney-in-fact** runs the company.
4. **Lloyds associations**--unincorporated groups of individual underwriters. Each underwriter assumes a share of the liabilities of the policies he underwrites. Lloyd's of London is the largest Lloyd's.
5. **Residual and special market organizations**--offer minimum levels of insurance for risks that are uninsurable in the voluntary private market. Most residuals and special market organizations are state-run, yet are funded by private insurers or the already-insured general public.]

[Unasked EO. **THREE MAJOR TYPES OF INSURANCE CORPORATE STRUCTURES:**

1. **Functional structures** organize personnel and activities by function: underwriting, claims, and accounting. ***In small companies***, functional structures create management balance because the objectives of the different functions offset each other to prevent functional extremes--eg, the marketing department and the claims department would prevent the underwriting department from respectively overpricing or underpricing its policies. ***In larger companies***, functional balance is harder to achieve because there are fewer interactions among employees in different functions and more attention on departmental rather than organizational results.
2. **Product or territorial structures** organize personnel and activities by **line of business** or by territory. Large companies choose these structures to allow line specialization and to better manage their branch offices. Each line or territory has its own manager, who is responsible for the operation and profitability of that line or territory.
3. **Strategic business units (SBUs)** are organized around customer groups, such as chemical firms. Unlike product or territorial structures, SBUs are customer-driven and operate autonomously.]