

OVERVIEW OF INSURER TYPES, OBJECTIVES, FUNCTIONS, AND OPERATIONS (520-1)

*[Insurance transfers risks of loss from insured participants to insurers for premium payments. Insurers apply **the law of large numbers** (as the number of independent insured exposures increases, the percentage accuracy of the estimate of total insured losses increases) to predict the loss settlements they'll have to make and hence the premiums they will have to charge.]*

EO 1. THE RISK TRANSFER (risk management--RM) process [possible exam question]:

1. Identify the entity's loss exposures.
2. Analyze the entity's loss exposures.
3. Examine the feasibility of alternative risk management techniques.
4. **Choose the technique or techniques to treat the loss exposures.**
 - a. **Risk avoidance**--Give the property away, subcontract the work, etc.
 - b. **Risk control**--Reduce the potential loss frequency, severity, [*and/or dispersion*].
 - c. **Risk retention**--Pay for the losses that do occur from your own funds.
 - d. **Risk transfer**--Contractually obligate another entity to pay for losses that might occur.
5. Implement the chosen technique(s). *Only* avoidance is used alone.
6. Monitor the results and reapply this process as needed.

EO 2. HOW INSURERS ARE ORGANIZED AND CATEGORIZED:

I. FORMS OF LEGAL OWNERSHIP--

A. Proprietary insurers--are profit seeking insurers, including

1. **Stock insurers**--are corporations owned by stockholders who elect their respective boards of directors that appoint officers and set policy.
2. **Lloyds**--are marketplaces where coverage is accepted or rejected by **syndicate managers** on behalf of independent **members/underwriters/investors/corporations**. Each Lloyd's member's liability is limited to the amount that member agrees to write. **American Lloyds** operate as single syndicates managed by **attorneys-in-fact, not** necessarily lawyers, who do all the service work. American Lloyds account for a *small* portion of US premiums. Most American Lloyds are domiciled in Texas.
3. **Insurance exchanges**--are marketplaces where members belong to syndicates and delegate daily operations to syndicate managers. *Only* the Illinois Insurance Exchange still operates.

B. Cooperative insurers--involve nonprofit risk sharing, including

1. **Mutual insurers**--are corporations owned directly by their insureds who bear the ultimate risk of operation. Most mutuals are **advance premium mutuals**, which require insureds to pay annual deposit premiums. Some mutuals assess insureds for additional premiums *if* more funds are needed.
2. **Reciprocal exchanges or reciprocals**--are unincorporated, nonprofit associations of insureds operated by corporate, profit-seeking attorneys-in-fact who handle all business matters. Reciprocals transfer one member's losses to the members of the entire group.
3. **Others--Captive insurers or captives** insure the exposures of their owners. **Risk retention groups and purchasing groups** are limited to specific groups or types of insureds under their enabling special legislation.
4. **Fraternals**--provide life and health coverage for their members.

C. Pools and Associations--provide insurance for exposures where the loss potential is too high (nuclear power) or the loss frequency is too high (assigned risk auto, medical malpractice, WC, liquor liability). Participation is often required by law. **FAIR (Fair Access to Insurance Requirements) plans** operate in 28 states. FAIR plans provide high-risk property insurance.

D. Government insurers--insure everything from Social Security to surface collapse, export credit, flood, and crime insurance.

- II. **PLACES OF INCORPORATION**--A **domestic** insurer is domiciled/chartered in the state of status determination.
 A **foreign** insurer is domiciled in another state.
 An **alien** insurer is domiciled in another country.
- III. **STATUS OF LICENSURE**--Insurers are
 A. **admitted** (licensed to transact business in a state through any agent or broker) *or*
 B. **nonadmitted** (*not* licensed to transact business *except* through surplus lines brokers).
- IV. **MARKETING DISTRIBUTION SYSTEM**--The insurer may use an independent agency system, exclusive agency system, direct writer system, direct response system, or a combination of systems.

EO 3. **THE FOUR MAJOR OBJECTIVES OF INSURERS:**

1. **Earn a profit**--adequate enough to attract funds in the capital market and to compensate those who invested in the insurer. Cooperative insurers must earn a large enough profit to enable them to maintain a healthy premium to surplus ratio and to grow in their premium writings.
2. **Meet customer needs**--including offering insurance at a price insureds can afford, providing prompt service, *and* providing loss adjustment and loss control assistance.
3. **Meet legal requirements**--*not just* to be good citizens, *but also* because noncompliance with laws is expensive in terms of fines and penalties.
4. **Meet humanitarian objectives**--such as reducing human suffering and promoting the well-being of employees, insureds, and others.

Note how those objectives conflict. The more fully #s 2, 3, and 4 are met, the lower the profit earned. Meeting customer needs or humanitarian objectives may be illegal. (Offering a good insured an actuarially fair price, that does *not* include a surcharge for careless accident-prone insureds, is generally illegal.)

INTERNAL ENVIRONMENTAL CONSTRAINTS THAT IMPEDE AN INSURER FROM MEETING THOSE FOUR OBJECTIVES:

1. **Efficiency**--Poor management may prevent an insurer from meeting its profit objectives, and hence its humanitarian, customer needs, and legal objectives in that order if insolvency results.
2. **Expertise**--Lack of underwriting and other expertise causes problems.
3. **Size**--The bigger an insurer is, the more it can do.
Although smaller insurers often have enough greater flexibility to compensate.
4. **Financial resources**--Insurers decide how to allocate scarce financial resources by choosing one objective over another. Underwriting and investment losses reduce financial resources.
5. **Other constraints**--Lack of market recognition and a poor reputation can hurt an insurer.

EXTERNAL ENVIRONMENTAL CONSTRAINTS THAT IMPEDE AN INSURER FROM MEETING THOSE FOUR OBJECTIVES:

1. **Regulation**--Insurers have to do what they're told, from incorporation to liquidation, from policy forms to rates, or face dire consequences. Just complying with the laws of 50 states is a problem.
2. **Public opinion**--When the public cries loud enough, government responds, insurers comply, *and* profit and societal objectives go unmet.
3. **Competition**--3,900 insurers, 900 operating nationally, cause intense price competition, low profits, *and* unmet objectives.
4. **Economic conditions**--Demand for insurance is inelastic, but inflation increases losses faster than premiums rise to increase income.
5. **Marketing systems**--No insurer has proven very successful in using more than one distribution system. Independent agents do best with commercial lines. Exclusive agents and direct writers do best with personal lines. Mail order works for insureds who don't want in-person service.
6. **Other constraints**--Natural or man-made catastrophes, the breakdown of societal values, *and* changes in the legal system can all hurt insurers.

MEASURES USED TO EVALUATE AN INSURER'S PERFORMANCE:

1. **Earning a profit**--Problems in measuring profit: Reserves are under-estimated or over-estimated resulting in errors **both** in the year they are reserved **and** in the year they are corrected.
 - a. **Premium volume**--Aim for real growth (not just premium increases) to avoid stagnation and to provide funds for investment.
Faster than average growth may mean relaxed underwriting standards **and** decreased profitability. Compare growth to the industry's average.
 - b. **Expense ratio**--equals expenses **divided by written** premiums.
A lower than average expense ratio may mean higher efficiency **or** premiums rising more rapidly than expenses **or** concentration of business in lines of coverage with low expenses.
 - c. **Loss ratio**--equals incurred losses **divided by earned** premiums.
A lower than average loss ratio allows for a higher expense ratio.
Incurred losses includes, **always**, loss adjustment expenses (**LAEs**).
 - d. **Combined ratio**--(**Financial basis combined ratio** aka **statutory combined ratio** equals the sum of incurred losses, LAEs, **plus** incurred expenses **divided by earned** premium.
Trade basis combined ratio equals incurred expenses **divided by written** premium [since most underwriting expenses fall near policy inception] **plus** incurred losses **divided by earned** premiums.) [Possible exam question.] A combined ratio under 100% means an underwriting profit, which hasn't occurred industry-wide since 1978.
 - e. **Investment income**--**Investable funds** (from surplus, loss reserves, loss adjustment expense reserves, and unearned premium reserves) yield investment income, which increases as the industry's proportion of long-tail liability coverage increases **and** as interest rates increase. Investment income comes from current payments and net realized capital gains.
 - f. **Operating profit (or loss)**--equals the sum of underwriting profit (almost **always** a loss) **plus** investment profit (almost **never** a loss).
2. **Meeting customers' needs**--Success here is indicated **indirectly by** growth in premium volume (which could also result from inadequate rates), policyholder or agent surveys, **and** complaint rates with insurance departments.
3. **Meeting legal requirements**--Success here is indicated by the number of criminal, civil, **and** regulatory actions against the insurer.
4. **Meeting humanitarian objectives**--Success here is indicated by the levels of employee benefits (or overall pay levels); loss control activities (based on expenditures); **and** charitable giving.]

EO 4. **THE PRINCIPAL DEPARTMENTS (functions) OF AN INSURER:**

1. **Marketing**--communicates the insurer's products, rates, premiums, and loss control assistance to potential customers after doing market research, advertising, training, setting sales goals, and motivating and managing producers.
2. **Underwriting**--decides which applicants to accept at what price under what terms and conditions in order to earn a profit.
3. **Claims**--performs the insurer's obligations to insureds after losses. Overpayments result in non-competitive rates. Underpayments result in fewer sales and more troublesome regulatory actions.
4. **Loss control**--prevents and minimizes losses to hold down loss settlement, hence premium, costs.
5. **Reinsurance**--allows direct insurers to accept more, larger risks.
6. **Actuarial**--calculates rates, develops rating plans, and sets loss reserves.
7. **Investment**--earns income to help lower rates. Investment risk should balance the underwriting risk. Invest for time periods that balance policy payment periods (long for life, short for fire insurance).
8. **Information technology**--supports internal and external communications and automates rating, statistical, and claim payment functions.
9. **Other functions**--accounting, premium audit, personnel, legal, and training departments all, ultimately, serve **any insurers' principal purpose: risk transfer.**

INTERRELATIONSHIPS OF AND INTERDEPENDENCIES AMONG THE FUNCTIONAL DEPARTMENTS OF INSURERS:

1. **Marketing and underwriting--Underwriting counterbalances marketing efforts to sell more**
 - a. by rejecting some applicants,
 - b. by limiting coverages, *and*
 - c. by charging higher rates.Underwriting helps marketing by finding ways to make marginal applicants acceptable and by developing products that will sell.
Marketing helps underwriting by providing applicant information.
2. **Underwriting and loss control--Loss control engineers ('the eyes and ears of the underwriter')** inspect risks and gather information for underwriters.
3. **Loss control and marketing--Insureds don't want losses, so a good loss control department is a strong sales point.**
Also, by suggesting ways to make an applicant acceptable, engineers can help increase sales.
4. **Claims and other departments--Claims helps underwriting with information about insureds.**
Underwriting interprets coverage intent for claims.
The claims department helps marketing by being fair in loss settlements and notifying the marketing department before it refuses to pay a good insured's uncovered claims.
5. **Actuarial and other departments--Actuaries**
 - a. set rates and rating plans for underwriting,
 - b. consider the views of the marketing department when setting rates and rating plans, *and*
 - c. develop loss reserves for claims.

[Roles played in the risk transfer process:

1. **Risk managers** are responsible for identifying and treating the entity's risks.
Mom or Dad and the owner or president or risk manager are the family's or firm's risk managers.
2. **Consultants** are risk experts who are paid fees for their RM advice.
3. **Insurance agents and brokers** help risk managers identify risks and decide which to avoid, control, retain, *and/or* transfer.
Agents and brokers place coverage for risks that are transferred and negotiate the terms of transfer.
Agents and brokers receive commissions on the insurance they place.
4. **Insurers perform eight functions to facilitate the risk transfer process:**
 - a. **Develop policy contracts**--either directly or through advisory organizations such as the Insurance Services Office (**ISO**)--to reduce the transfers to writing.
 - b. **Price coverages**--set **rates** per unit of coverage and **premiums** for entire policies that are appropriate for the risk transferred.
 - c. **Market policies**--so risk managers know what's available at what cost so they can then select the cost/coverage combination they want.
 - d. **Underwrite exposures--to determine**
 - 1) what risks to assume,
 - 2) what premiums to charge, *and*
 - 3) what terms and conditions to apply.
 - e. **Adjust claims**--An insurance policy is a conditional promise to perform.
Loss adjusters star in the delivery of that performance.
 - f. **Control losses**--to reduce loss frequency and severity to reduce the total cost of risk transfer, thus benefiting both insured and insurer.
 - g. **Reinsure**--those exposures too large for the insurer to retain.
 - h. **Invest unearned premiums**--to lower the cost of risk transfer.]