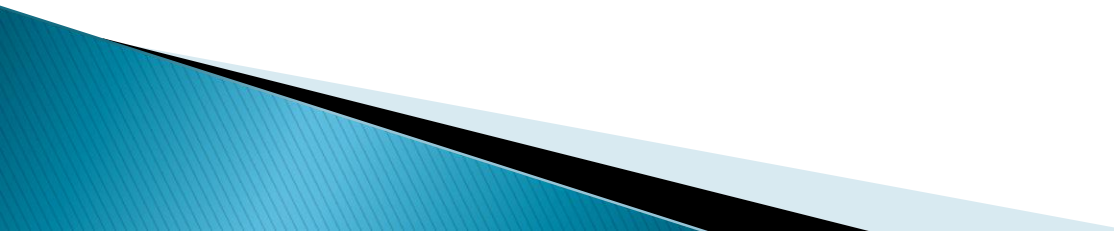


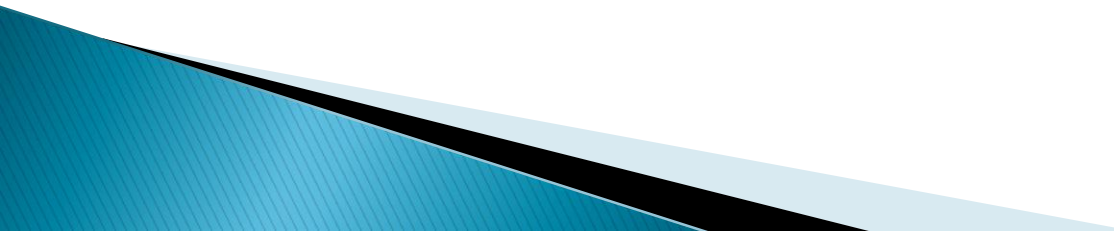
Chapter Five

Underwriting

Objectives

- ▶ Describe the purpose of underwriting and an insurer's major underwriting activities to achieve that purpose.
 - ▶ Describe the responsibilities of underwriting management.
 - ▶ Describe the steps in the underwriting process.
 - ▶ Describe information sources that underwriters use in the underwriting process.
 - ▶ Explain how states regulate underwriting activities.
- 

Underwriting

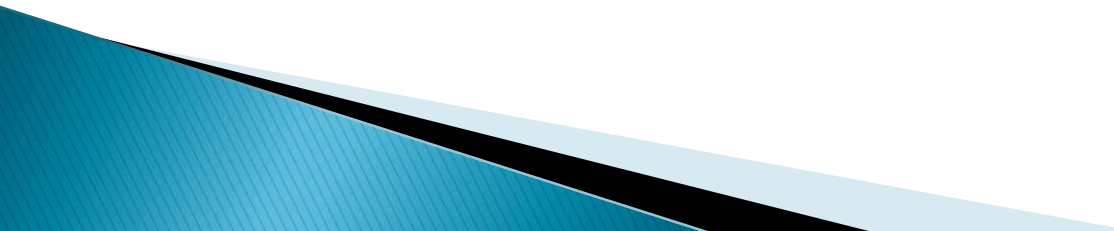
- ▶ “ It is the process of selecting insureds, pricing coverage, determining insurance policy terms and conditions, and then monitoring the underwriting decisions made.”
 - ▶ **Underwriter:** “ An insurer employee who evaluates applicants for insurance, selects those that are acceptable to the insurer, prices coverage, and determines policy terms and conditions.”
- 

Underwriting Activities


▶ Underwriting consists of the following activities:

- 1) Selecting insureds
- 2) Pricing coverage
- 3) Determining policy terms and conditions
- 4) Monitoring underwriting decisions

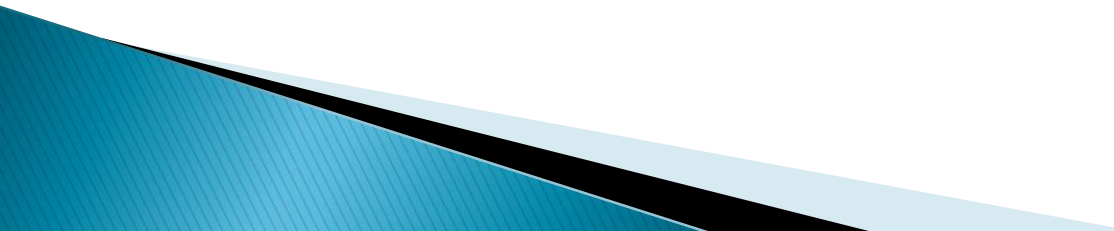
The first three activities occur simultaneously while the last one is ongoing.



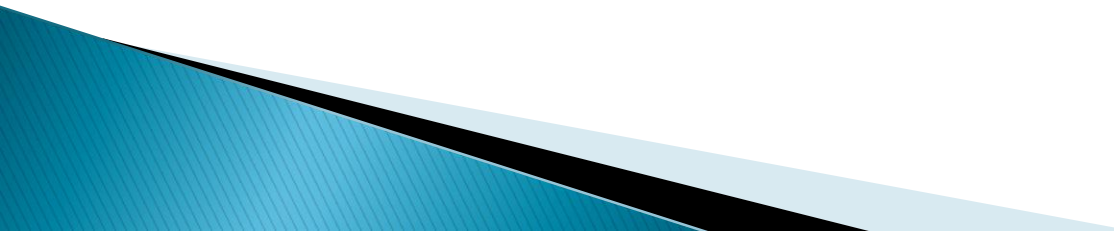
1) Selecting Insureds

- ▶ Insurers must carefully screen applicants to determine which ones to insure otherwise some insureds might be able to purchase insurance at prices that do not adequately reflect their loss exposures.
 - ▶ **An insurer can not accept all applicants for the following reasons:**
 - 1.To avoid adverse selection
 - 2.An insurer's ability to provide insurance is limited by its capacity to write new policies
- 

1) Selecting Insureds

1. **Adverse selection:** “ A situation that occurs because people with the greatest probability of loss are the ones most likely to purchase insurance.”
 2. **Capacity considerations:** “ The amount of business an insurer is able to write, usually based on a comparison of the insurer’s written premiums to its policyholders’ surplus.”
- 

1) Selecting Insureds

- ▶ An insurer must have adequate policyholders' surplus to increase the volume of insurance it writes.
 - ▶ An insurer can increase its capacity through steady, orderly growth in sales of policies that contribute to the insurer's profits.
 - ▶ Planned growth is generally one of the goals of an insurer.
- 

1) Selecting Insureds

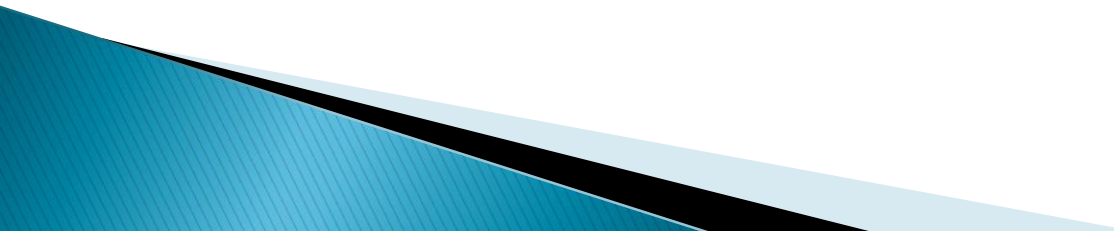
- ▶ *Insurers attempt to protect their available capacity in the following three primary ways:*

1) *By maintaining a spread of risk:* insurers must allocate their available capacity. They prefer to spread their risk among various types of insurance and different geographic areas.

1) Selecting Insureds

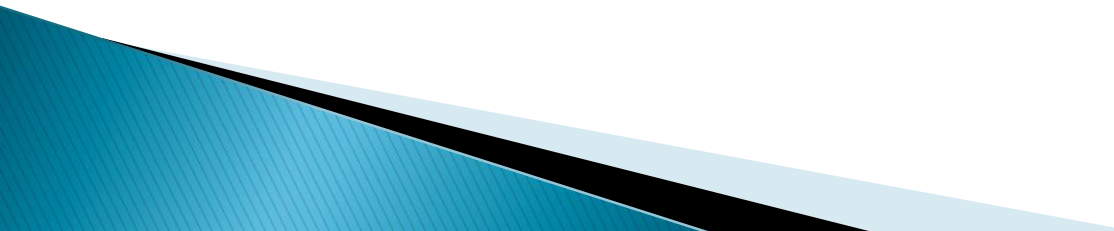
2) By optimizing use of available resources:

In addition to its financial resources, every insurer depends on other resources. Among these are physical resources, which include offices and equipment, and human resources which include underwriters, claim representatives, producers and service personnel.

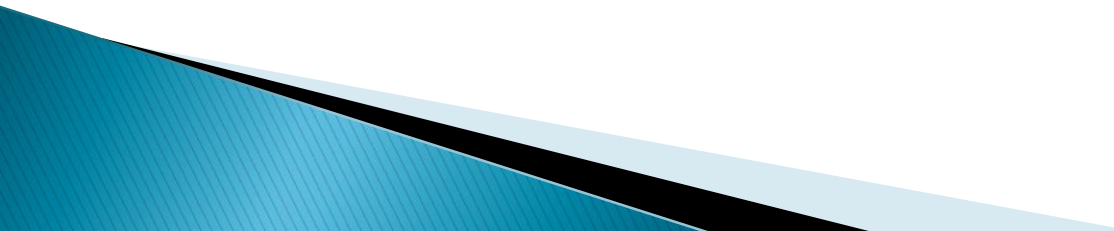


1) Selecting Insureds

3) *By securing reinsurance:* if reinsurance is readily available, insurers can increase the number of new policies they write by transferring some of the premium and financial consequences of loss exposures to reinsurers.



2) Pricing coverage

- ▶ Each insured's premium should be set at a level that is adequate to enable the total premiums paid by a large group of similar insureds to pay the losses and expenses of that group and to allow the insurer to achieve a reasonable profit.
 - ▶ The premium is determined by multiplying the rate by the number of exposure units.
- 

2) Pricing coverage

- ▶ Example: the premium for property insurance with a limit of \$250000 at a rate of \$0.4 per \$100 of insurance is:
- ▶ Premium = $250000 / 100 =$
 $2500 \text{ units} \times 0.4 = \1000
- ▶ In determining the appropriate premium to charge for coverage, insurers use either class rates or individual rates.

2) Pricing coverage

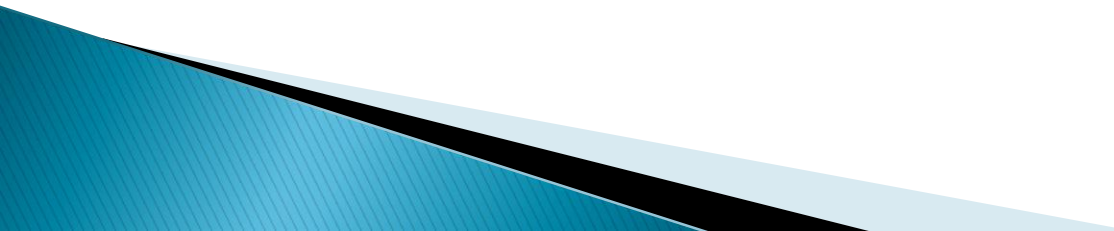
a) **Class rate:** “ it is a type of insurance rate that applies to all insureds in the same rating category or rating class.”

Merit rating plan: “ a rating plan that modifies class rates to reflect loss characteristics of a particular insured.”

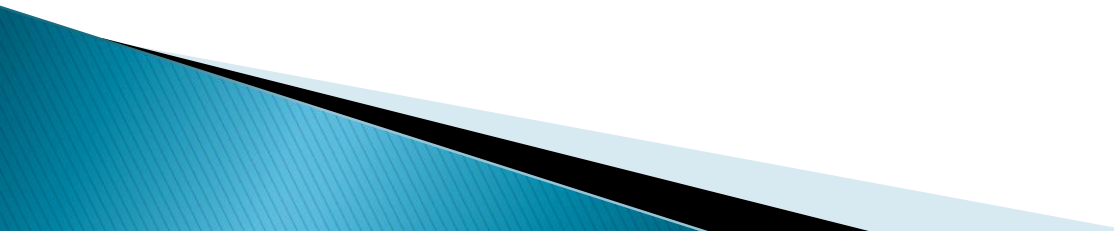
2) Pricing coverage

b) *Individual Rate:* “ it is a type of insurance rate that reflects the unique characteristics of an insured or the insured’s property.”

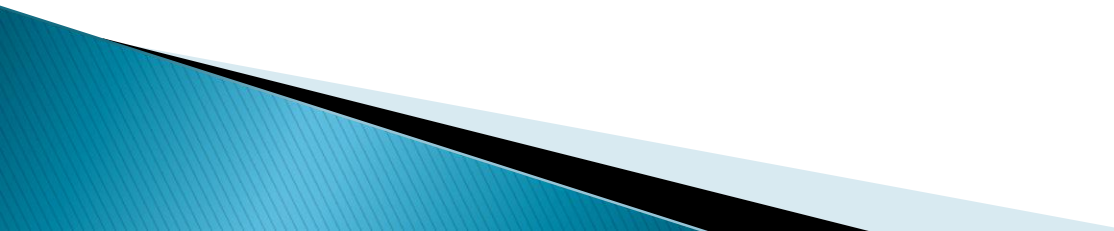
Judgment rate: “ it is a type of individual rate that is used to develop a premium for a unique exposure for which there is no established rate.”




3) Determining Policy Terms and Conditions

- ▶ The insurer must decide exactly what types of coverage it will provide to each applicant and then charge a premium appropriate to that coverage.
 - ▶ In addition to developing loss costs, insurance advisory organizations develop policy forms using standard insurance wording. They are called standard forms.
- 

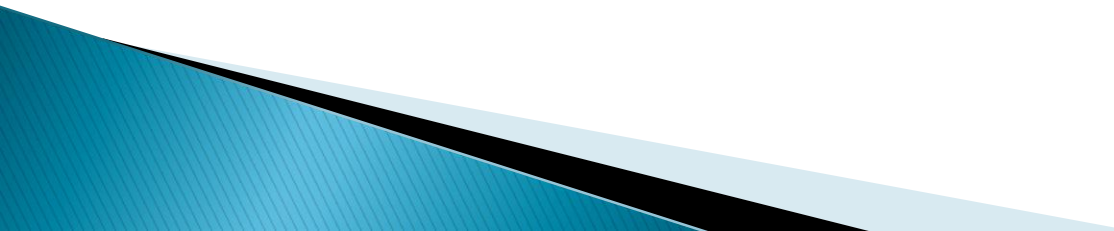
3) Determining Policy Terms and Conditions

- ▶ **Standard Form:** “ A policy form that contains standard insurance wording; it is used by insurers that subscribe to the services of insurance advisory organizations.”
 - ▶ When advisory organizations develop insurance policies, they also develop rules specifying what kinds of insureds will be eligible for certain policies.
- 

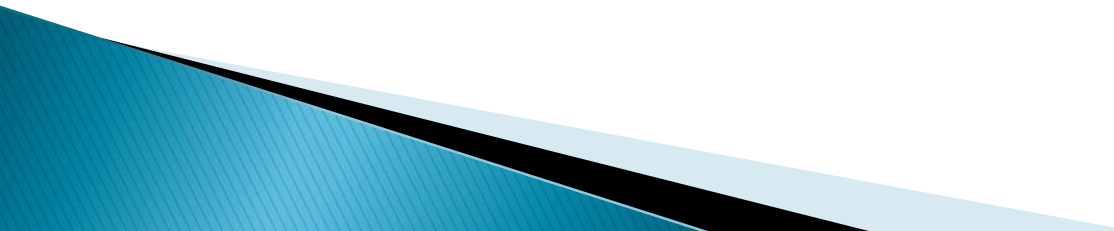
4) Monitoring Underwriting Decisions

- ▶ Underwriters periodically monitor the hazards, loss experience and other conditions of specific insureds for significant changes.
 - ▶ If an underwriter made loss control recommendations to a particular insured, follow up is necessary to ensure that the insured has implemented the recommendations. An increase in hazards might change an acceptable insured into an unacceptable one for the coverage and premium charged.
- 

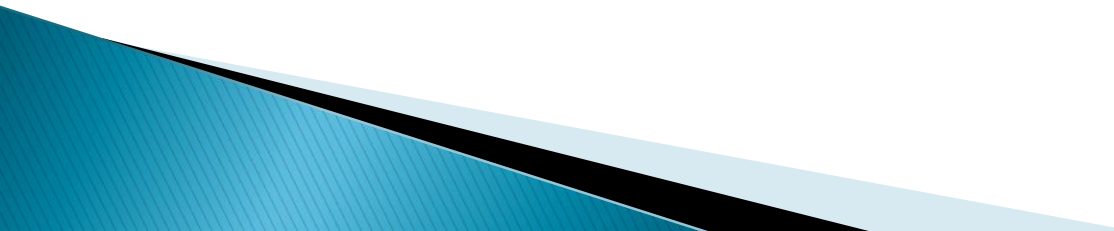
4) Monitoring Underwriting Decisions

- ▶ Monitoring also applies to underwriting decisions on an entire book of business.
 - ▶ **Book of business:** “ it is a group of policies with a common characteristic, such as territory or type of coverage. A book of business can also refer to all policies written by a particular insurer or agency.”
 - ▶ Underwriters might also be responsible for maintaining the profitability of it by achieving written premium and loss ratio goals for that book.
- 

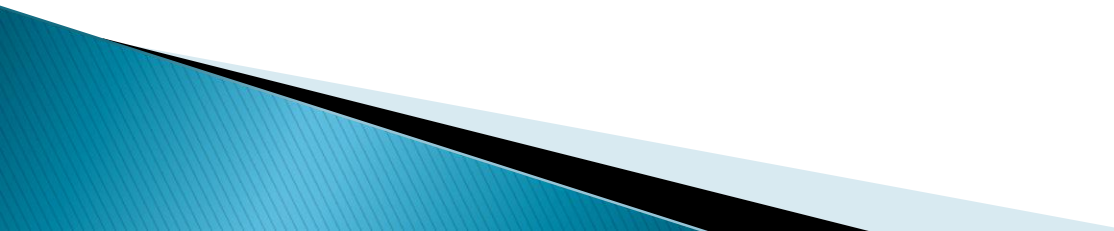
Underwriting Management

- ▶ **An insurer's underwriting management has many responsibilities, including:**
 - 1 – Participating in the insurer's overall management
 - 2 – Arranging reinsurance
 - 3 – Delegating underwriting authority
 - 4 – Developing and enforcing underwriting guidelines
 - 5 – Monitoring underwriting results
- 

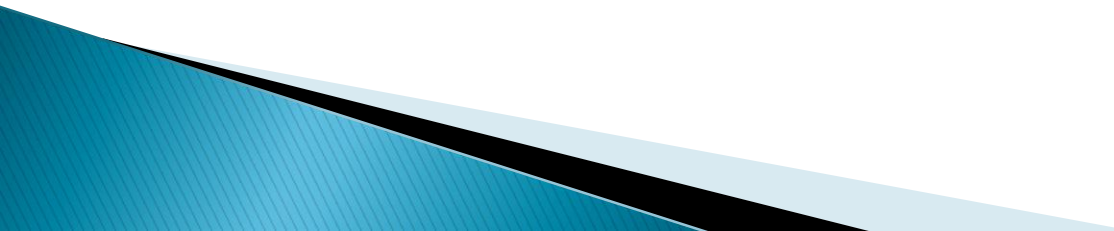
1 – Participating in the insurer's overall management

- ▶ The head of an insurer's underwriting department participates with other members of the insurer's management team in making broad business decisions about the insurer's goals, including annual written premium and loss ratio goals and plans to meet those goals. Decisions at this level might determine what type of marketing system will be used, where offices will be located, what emphasis will be placed on personal and commercial insurance and so forth.
- 

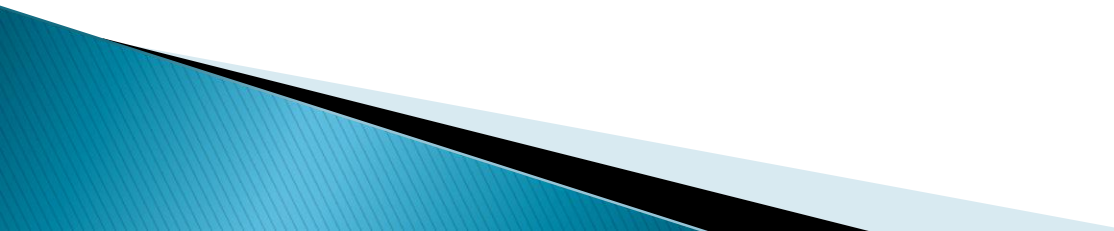
2– Arranging Reinsurance

- ▶ *Choosing between the two broad categories of reinsurance:*
 - ▶ **Treaty reinsurance:** “ An arrangement whereby a reinsurer agrees to automatically reinsure a portion of all eligible insurance of the primary insurer.”
 - ▶ **Facultative reinsurance:** “ An arrangement where by the primary insurer chooses which policies to submit to the reinsurer and the reinsurer can accept or reject any policies submitted.”
- 

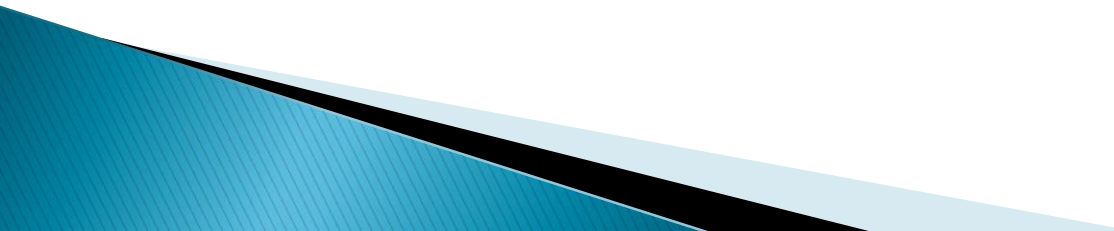
3– Delegating Underwriting Authority

- ▶ *Underwriting Authority:* “ the scope of decisions that an underwriter can make without receiving approval from someone at a higher level.”
 - ▶ With some insurers, underwriting authority is highly decentralized; that is, underwriting management delegates extensive underwriting authority to personnel in the field offices.
- 

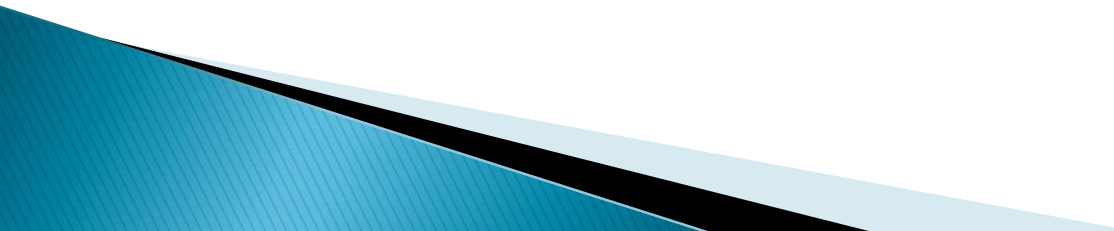
3– Delegating Underwriting Authority

- ▶ Other insurers are highly centralized, with many or all final underwriting decisions being made in the home office.
 - ▶ Many insurers also grant some underwriting authority to the agents who represent the company and are called front-line underwriters.
- 

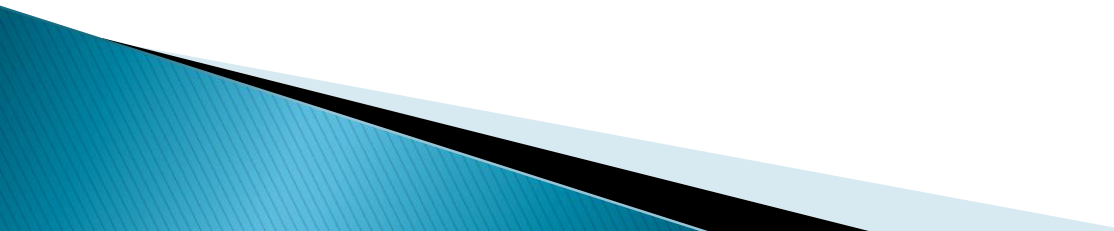
4– Developing and enforcing underwriting guidelines

- ▶ Underwriting management develops the guidelines that underwriters use in the underwriting process.
 - ▶ Underwriting guidelines and bulletins explain how underwriters should approach each application. The guidelines list the factors that should be considered by the underwriter for each type of insurance, the desirable and undesirable characteristics of applicants relative to those factors and the insurer's overall attitude toward applicants that exhibit those characteristics.
- 

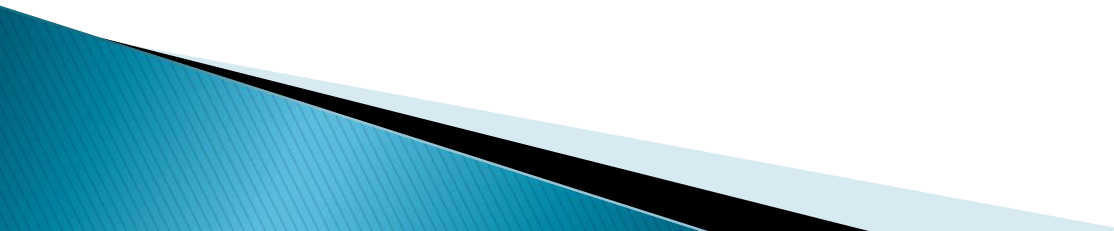
5– Monitoring underwriting results

- ▶ Monitoring includes steps to ensure that underwriters are following underwriting guidelines and that underwriting goals are being met.
 - ▶ *Underwriting Audit*. “ A process in which members of the home office underwriting department examine files to see whether underwriters are following underwriting guidelines.”
- 


The Underwriting Process

- ▶ The underwriting process consists of the following four steps:
 1. Gathering underwriting information.
 2. Making the underwriting decision.
 3. Implementing the underwriting decision.
 4. Monitoring the underwriting decision.
- 

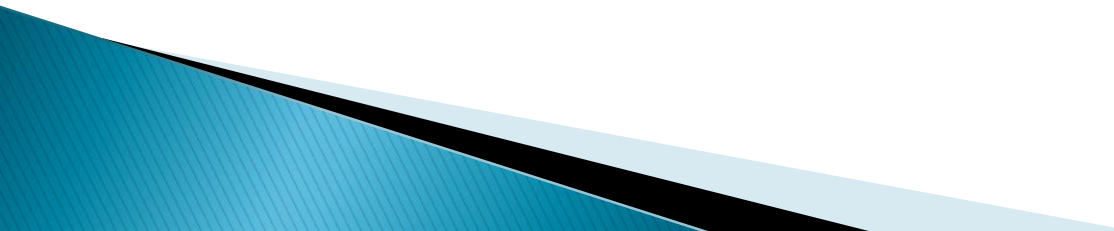
The Underwriting Process

- ▶ Traditionally, underwriting was a nonautomated process that depended on human judgment. Increasingly, however, portions of the underwriting process, particularly in personal insurance, are computerized.
 - ▶ *Expert systems, or Knowledge-based systems:*
“computer software programs that supplement the underwriting decision-making process. These systems ask for the information necessary to make an underwriting decision, ensuring that no information is overlooked.”
- 

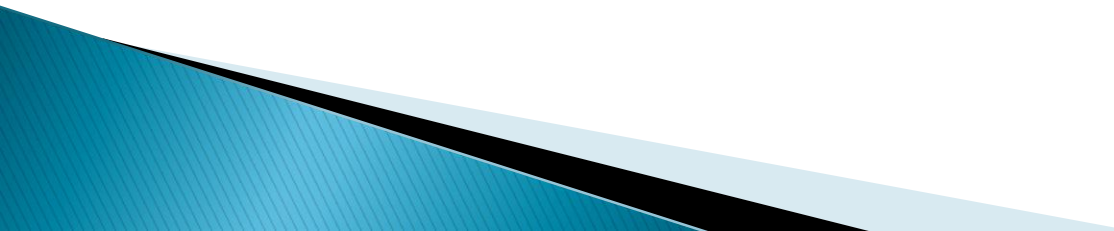
1. Gathering underwriting information

- ▶ Underwriters base their decisions about individual applications on a combination of information and judgment. Underwriters derive information from several sources, including the following:
 - ▶ Producers
 - ▶ Consumer investigation reports
 - ▶ Government records
 - ▶ Financial rating services
 - ▶ Inspection reports
- 

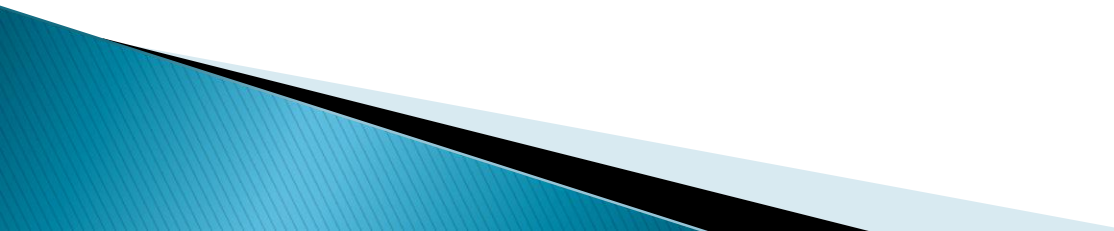
1. Gathering underwriting information.

- ▶ Field marketing personnel
 - ▶ Claim files
 - ▶ Production records
 - ▶ Premium audit reports
 - ▶ Applicant's or insured's records
- 

2. Making the underwriting decision

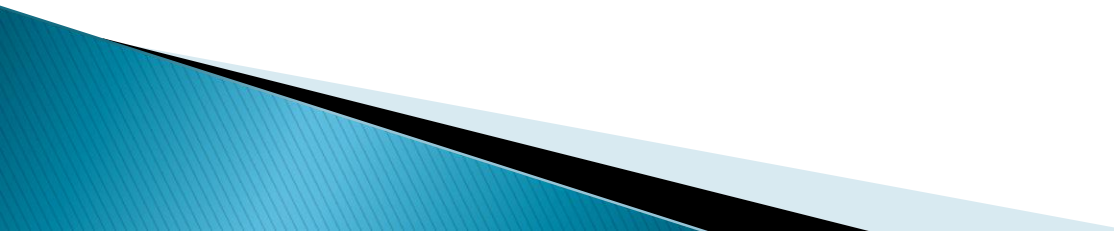
- ▶ Once the underwriter has gathered the necessary information, he must analyze the information to determine what hazards the applicant presents. To make an underwriting decision, the underwriter must then evaluate underwriting options and choose the best one.
 - ▶ An underwriter must evaluate the following four categories of hazards:
- 

2. Making the underwriting decision.

- a) **Moral Hazard:** “ a condition that may lead a person to intentionally cause or exaggerate a loss.”
 - b) **Attitudinal or morale Hazard:** “ a hazard that involves carelessness about or indifference to potential loss on the part of an insured or applicant.”
 - c) **Physical Hazard:** “ A tangible characteristic of property, persons or operations that tends to increase the frequency or severity of loss.”
- 

2. Making the underwriting decision

d) Legal Hazard: “ a characteristic of the legal or regulatory environment that hampers an insurer’s ability to collect a premium commensurate with the exposure to loss.”



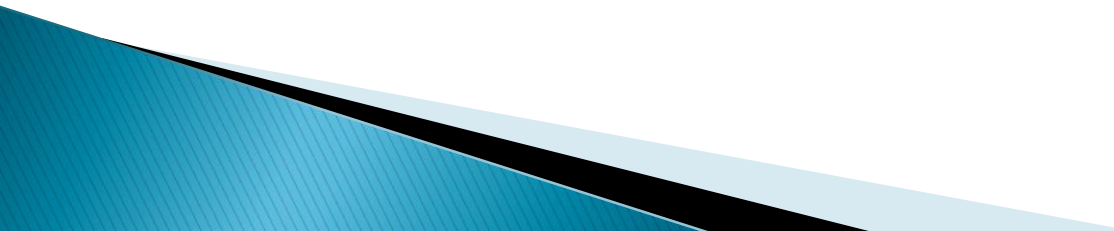
2. Making the underwriting decision

▶ *Evaluating underwriting options*


In evaluating each application, an underwriter has the following three options:

1. Accept the application without modification
2. Reject the application
3. Accept the application with modification

3. Implementing the Underwriting Decision

- ▶ If the underwriter decision is within the underwriter's authority and consistent with underwriting guidelines, the underwriter can approve the policy and submit the file for processing and policy issuance.
 - ▶ To accept an application for coverage exceeding the underwriter's authority, an underwriter must seek a supervisor's approval. The supervisor may simply approve or reject the underwriter's recommendation, or the entire application may be referred to a more specialized or experienced senior underwriter.
- 

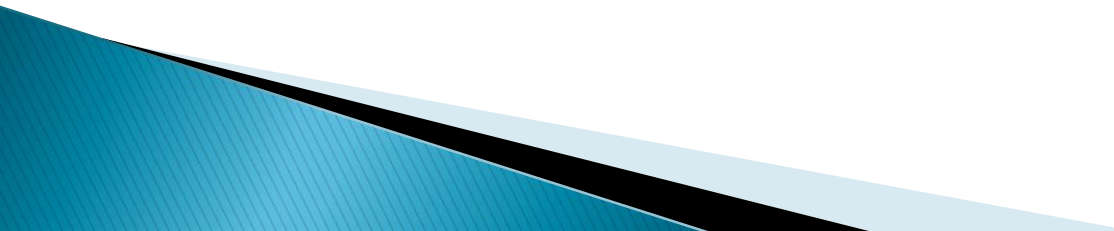
4. Monitoring the Underwriting Decision

- ▶ The underwriter must monitor the results of the initial underwriting decision. Among other things, the underwriting needs to reevaluate his underwriting decisions by considering claims that develop from accounts that were accepted.
 - ▶ If serious problems develop with an account, the underwriter may need to take corrective action.
 - ▶ Finally, as the expiration date of the policy approaches, the underwriter may need to repeat the underwriting process before agreeing to renew the policy for another term.
- 

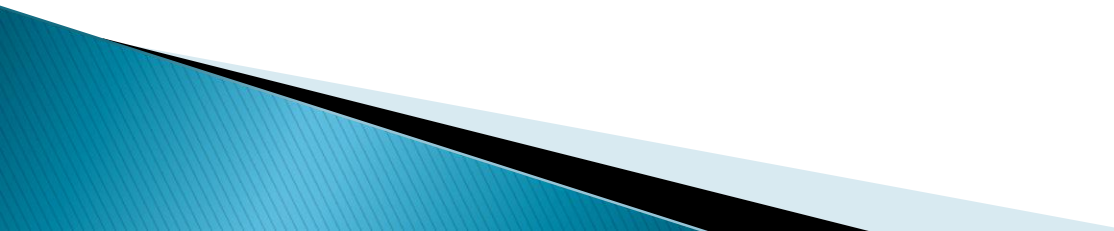
Regulation of underwriting activities

- ▶ **Two important examples of underwriting activity regulation are as follows:**
 - a) Prohibition of unfair discrimination
 - b) Restrictions on cancellation and nonrenewal

a) Prohibition of unfair discrimination

- ▶ The challenge lies in distinguishing between fair discrimination and unfair discrimination.
 - ▶ Underwriting involves distinguishing among properties, businesses and people and grouping them into categories. An insurer's ability to discriminate fairly is essential if insureds are to be charged a premium commensurate with their loss exposures.
- 

a) Prohibition of unfair discrimination

- ▶ Examples of unfair discrimination include the following:
 - ▶ Geographic location
 - ▶ Gender or marital status
 - ▶ Race
- 

b) Restrictions on cancellation and nonrenewal

- ▶ Most states require that insurers provide notification to the insured within a specified period, such as thirty days, before a policy is to be canceled or nonrenewed. This notice is intended to give the insured an opportunity to replace the coverage.
 - ▶ Generally, restrictions of this kind help insurance to serve its purpose of providing protection for policyholders. However, such restrictions also limit the speed with which an underwriter can stop providing coverage for an insured who has become undesirable.
- 