Property and Liability Insurance Principles

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Chapter Two

Who provides Insurance ***and***
How is it regulated?

OBJECTIVES

- After studying this chapter, you should be able to know the following:
- **Describe the various types of private insurers that provide property-casualty insurance.**
- **Explain how insurance rates are developed.**
- **Describe the objectives of rate regulation.**
- **Explain how insurance regulators monitor insurers' financial condition and protect consumers.**
- **Explain how the excess and surplus lines market meets the needs of various classes of business that are often unable to find insurance in the standard market.**

WHO PROVIDES INSURANCE *AND* HOW IS IT REGULATED?

- Insurance is a risk management technique, a transfer system, a business and a contract, and it is provided by several types of insurers.

- Regulatory mechanisms are designed by the government to maintain the integrity of insurers, govern rates and address the needs of the customers.

WHO PROVIDES INSURANCE *AND* HOW IS IT REGULATED?

- The insurance industry is not well understood or held in high regard by much of the purchasing public. The mechanism of insurance is relatively complex in comparison to purchases of other goods and services. Besides, when some insurers fail to fulfill the promises made in their contracts , this may heighten the public’s suspicions regarding all insurers.

TYPES OF INSURANCE ORGANIZATIONS

A) Private Insurers

They differ from one another in several ways, in terms of:

- **The purpose for which they where formed.**
- **Their legal form of organization.**
- **Their ownership.**
- **Their method of operation.**

All insurers provide a means to indemnify insureds if a covered loss occurs, and to spread the cost of losses among insureds.

All of them perform the basic functions, but the motives of the parties forming different types of insurers are not the same.

1- STOCK INSURERS

"An insurer that is owned by its stockholders and formed as a corporation for the purpose of earning a profit for the stockholders."

- **Purpose for which formed**: to earn a profit for its stockholders.
- **Legal form**: corporation
- **Ownership**: stockholders
- **Method of operation**: the board of directors, elected by stockholders, appoints officers to manage the company.

1- Stock Insurers

- It creates the corporate goals and objectives and appoints a (CEO)
- The stock form of ownership also provides financial flexibility for the insurer.
- The ability to raise additional funds by selling common stock is an important aspect of the stock form of organization.

2- Mutual Insurers

"An insurer that is owned by its policyholders and formed as a corporation for the purpose of providing insurance to them."

- **<u>Purpose for which formed</u>**: to provide insurance for its owners (policyholders).
- **<u>Legal form</u>**: corporation
- **<u>Ownership</u>**: policyholders
- **<u>Method of operation</u>**: the board of directors, elected by policyholders, appoints officers to manage the company.

2- MUTUAL INSURERS

- They pay dividends to policyholders as a return of a portion of premiums paid.
- Some of them have the right to charge insureds an assessment, or additional premium, after the policy has gone into effect.
- In recent years , some mutual companies have made structural changes to be converted to stock companies through a process called ***demutualization***.

3-RECIPROCAL INSURANCE EXCHANGE (INTER INSURANCE EXCHANGE)

"An insurer that is owned by its policyholders, formed as an unincorporated association for the purpose of providing insurance coverage to its members (subscribers), and managed by an attorney-in-fact."

- **Purpose for which formed**: to provide reciprocity for subscribers (to cover each other's losses)
- **Legal form**: unincorporated association
- **Ownership**: subscribers (members)
- **Method of operation**: subscribers choose an attorney-in-fact to operate the reciprocal

3-RECIPROCAL INSURANCE EXCHANGE (INTER INSURANCE EXCHANGE)

- **Subscribers** " they are the policyholders of a reciprocal insurance exchange who agree to insure each other".
- **Attorney-in-fact** "is the contractually authorized manager of the reciprocal who administers its affairs and carries out its insurance transactions". His existence distinguishes as a reciprocal from other types of insurers.
- A subscription agreement authorizes the attorney-in-fact to act on behalf of the subscribers to market and underwrite the insurance coverage, collect premiums, invest funds and handle claims.

4- Lloyd's

- **<u>Purpose for which formed</u>**: to earn a profit for its individual investors("Names") and its corporate investors.
- **<u>Legal form</u>**: unincorporated association
- **<u>Ownership</u>**: investors
- **<u>Method of operation</u>**: it is regulated by the U.K. Financial Services Authority (FSA), which delegates much authority to the Council of Lloyd's

4- Lloyd's

- It is an association that provides the physical and procedural facilities for its members to write insurance.
- Members of Lloyd's are investors (companies and individuals) that hope to earn profit from the insurance operations that occur at Lloyd's.
- Each investor called a "Name", of Lloyd's belongs to one or more groups called syndicates.
- Lloyd's has earned a reputation for accepting applications for very unusual types of insurance.

5- American Lloyd's

- American Lloyd's associations are much smaller than Lloyd's.

- Their members are called " underwriters" and have limited liability [limited to their investment in the Lloyd's association].

6- Captive Insurers

" An insurer formed as a subsidiary of its parent company, organization, or group, for the purpose of providing all or part of the insurance on the parent company or companies."

- Three factors have contributed to the growth of captives in recent years:

1) Low insurance cost
2) Insurance availability
3) Improved cash flow

7- Reinsurance Companies

Reinsurance " is a contractual agreement that transfers some or all of the potential costs of insured loss exposures from policies written by one insurer to another insurer.

Primary insurer "is the insurer that transfers some or all of the potential costs its insured loss exposures to another insurer in a reinsurance contractual agreement.

Reinsurer " is the insurer that assumes some or all of the potential costs of insured loss exposures of the primary insurer in a reinsurance contractual agreement."

B) <u>**GOVERNMENT INSURANCE PROGRAMS**</u>

- Some loss exposures do not possess the characteristics that make them commercially insurable, but a significant need for protection against costs of losses still exists.

1- Federal Government Insurance Programs

- Only the government has the ability to tax in order to provide the financial resources needed to insure some loss exposures and the power to make the system viable by requiring mandatory participation.
- Mandatory participation in the social security program for those eligible for coverage eliminates the need for individual underwriting and helps to generate premium revenues to operate the system.
- Private insurers provide similar benefits (retirement benefits, life insurance, disability insurance, and health insurance) to some insureds, but they cannot approach the scope of the Social Security program.

1- Federal Government Insurance Programs

- The Social Security Administration operates the program and provides the following benefits to the eligible citizens:

1. Retirement benefits to elderly.
2. Survivorship benefits for the dependents of deceased workers.
3. Disability payments for disabled workers
4. Medical benefits for the elderly.

2- State Government Insurance program

- Among the most common types of insurance programs provided or operated by state governments are as follows:

1. Worker’s compensation insurance funds.
2. Unemployment insurance programs.
3. Automobile insurance programs.
4. Fair access to Insurance Requirements plans.
5. Beachfront and windstorm pools.

INSURANCE REGULATION

- The possibility that an insurer might not be able to pay legitimate claims to or for policyholders is the primary concern of insurance regulators. They want to protect the public from irresponsible, unwise, or dishonest activities that could leave consumers with worthless insurance policies.
- **The primary <u>objectives</u> of insurance regulation are as follows**:

1. Rate regulation
2. Solvency surveillance
3. Consumer protection

1. Rate Regulation

- ***<u>Ratemaking</u>*** “ the process insurers use to calculate the rates that determine the premium to charge for insurance coverage.
- An insurer must collect sufficient premiums to pay for the insured losses that occur, to cover the costs of operating the company, and to allow a reasonable profit.
- Typically, the profit comes from the investment of those premiums until losses are paid.

1. Rate Regulation

- ***Rate*** " the amount per exposure unit for insurance coverage, used to arrive at a premium when multiplied by the number of exposure units.
- ***Premium*** " the price of the insurance coverage provided for a specified period.

Premium = Rate × Number of exposure units

Ex.: if an insurer charges a rate of $1.2 per $100 of coverage on jewelry, the premium for a ring insured for $1000 would be $12.

Objectives of Rate Regulation

1- To ensure that rates are adequate

- This means that the price charged for a given type of insurance coverage should be high enough to meet all anticipated losses and expenses associated with that coverage while generating a reasonable profit for the insurer.

Objectives of Rate Regulation

2- To ensure that rates are not excessive

- Determining whether rates are excessive or inadequate are is difficult because insurers must price insurance policies long before the results of the pricing decision are known.

Objectives of Rate Regulation

3- To ensure that rates are not unfairly discriminatory

- Because insurance is a system of sharing the costs of losses, each insured should pay a fair share of all policyholder's losses.

- There are <u>two concepts</u> under which a fair share could be determined:

OBJECTIVES OF RATE REGULATION

- One concept involves **"Actuarial equity"**

It is a ratemaking concept through which actuaries base rates on calculated loss experience to place insureds with similar characteristics in the same rating class.

- On the other hand **"Social equity"**

It is a rating concept that holds that rate structures discriminate unfairly if they impose a higher rate on an insured for factors beyond the insured's control, such as age or gender.

Rate regulation attempts to balance both concepts.

2- Solvency Surveillance

- ***Solvency*** : “is the ability of an insurer to meet its financial obligations as they become due, even those resulting from insured losses that may be claimed several years in the future.”
- ***Solvency Surveillance***: “is the process, conducted by state insurance regulator, of verifying the solvency of insurers and determining whether their financial condition enables them to meet their financial obligations and to remain in business.”

2- Solvency Surveillance

- There are two major aspects:

a) Insurer Examinations: Regulatory authority periodically examine insurers. An examination consists of a thorough analysis of an insurer's operations and financial condition. In addition, the insurer's financial records are carefully analyzed to ensure that the company is meeting all state financial reporting requirements and to determine whether the insurer has the ability to meet its obligations. If the examination uncovers problems, the insurance department usually has broad powers to take control of the situation to correct whatever problems are identified.

2- SOLVENCY SURVEILLANCE

b) Insurance Regulatory Information System(IRIS):

An information and early-warning system established and operated by National Association of Insurance Commissioners (NAIC) to monitor the financial soundness of insurers.

3- Consumer Protection

In addition to rate regulation and solvency surveillance, the activities that regulators undertake to protect insurance consumers include:

a) Licensing insurers.

b) Licensing insurer representatives.

c) Approving policy forms.

d) Examining market conduct.

e) Investigating consumer complaints.

A) LICENSING INSURERS

- ***Licensed insurer or admitted insurer***: "an insurer authorized by the state insurance department to sell insurance within that state."
- ***Domestic insurer***: "an insurer incorporated in the same state in which it is writing insurance."
- ***Foreign insurer***: "an insurer licensed to operate in a state but incorporated in another state."
- ***Alien insurer***: "an insurer licensed in a U.S. state but incorporated in another country."

b) Licensing insurer representatives

- A license is usually granted only after the applicant passes an examination on insurance laws and practices.
- In most states, the agent, broker, or claim representative must complete a prescribed amount of continuing education during a specified period before renewing a license.

C) APPROVING POLICY FORMS

- Many states require insurers to file their policy forms with the state insurance department .
- Whenever an insurer wants to change the language of a particular policy, it must submit the new form for approval.
- Regulatory approval of policy forms reduces the possibility of misleading wording. Having clear and readable, fair and reasonable provisions in insurance policies is a goal of most regulators.

D) EXAMINING MARKET CONDUCT

- ***Market conduct regulation***:

"Regulation of the practices of insurers in regard to four areas of operation: sales practices, underwriting practices, claim practices and bad – faith actions."

E) INVESTIGATING CONSUMER COMPLAINTS

- Every state insurance department has a consumer complaints division to investigate consumer complaints help insureds deal with problems they have encountered with insurers and their representatives.

Excess and Surplus Lines Insurance

- ***Standard market:*** " Collectively, insures who voluntarily offer insurance coverages at rates designed for customers with average or better than average loss exposures."
- Changes in business practices or technology might create new loss exposures not contemplated in traditional insurance policies. These exposures require a creative, nontraditional insurance market.
- Insurance coverages unavailable in the standard market that are written by nonadmitted insurers.

Classes of E&S Business

1- Unusual or Unique Loss Exposures:

One of the usual requirements of a commercially insurable loss exposures is that a large number of similar exposure units should exist. If an exposure does not meet this requirement, the coverage is difficult to price and therefore standard insurers are often unwilling to provide coverage.

Classes of E&S Business

2- Nonstandard business:

Sometimes loss exposures do not meet the underwriting requirements of the standard insurance market. There may be evidence of poor loss experience that cannot be adequately controlled. Perhaps the premiums that standard insures normally charge are not adequate to cover these exposures.

Classes of E&S Business

3- Insureds Needing High Limits of Coverage:

Some businesses demand very high limits of coverage, especially for liability insurance. The E&S market often provides the needed limits in excess of the limits written by a standard insurer.

Classes of E&S Business

4- Insureds Needing Unusually Broad Coverage

5- Loss Exposures That Require New Forms:

Producers and consumers often turn to the E&S market when they have an immediate need for a new type of coverage, such as coverage for media liability.

EXCESS AND SURPLUS LINES REGULATION

- E&S lines insurance is usually written by nonadmitted insurers.
- Nonadmitted insurers or unlicensed insurer “ is an insurer that is not licensed in many of the states in which it operates and that writes E&S insurance coverages.
- They are not required to file their rates and policy forms with state insurance department , providing them with more flexibility than that of standard insurers. But the E&S market is subject to regulation.

Excess and Surplus Lines Regulation

- E&S insurers and brokers provide a valuable service to the insurance industry and to the public. They provide insurance to many insureds who might otherwise be unable to obtain coverage. They find solutions to problems created by unusual or unique loss exposures.