# Rating and Ratemaking

- ***Ratemaking*** refers to the pricing of insurance and the calculation of insurance premiums

- ***A rate*** is the price per unit of insurance

- ***An exposure unit*** is the unit of measurement used in insurance pricing

***Premium = rate * exposure units***

# Rating and Ratemaking

- ***Total premiums charged must be <u>adequate</u> for paying all claims and expenses during the policy period***
- ***Rates and premiums are determined by an actuary, using the company's past loss experience and industry statistics***

# Underwriting

- ***Underwriting*** refers to the process of selecting, classifying, and pricing applicants for insurance

- A statement of underwriting policy establishes policies that are consistent with the company's objectives, such as:

- Acceptable classes of business
- Amounts of insurance that can be written
- A line underwriter makes daily decisions concerning the acceptance or rejection of business

# Underwriting

- **Important principles of underwriting**:

- The primary objective of underwriting is to attain an underwriting profit
- The second principle is to select prospective insureds according to the company's underwriting standards

- The ***purpose*** of underwriting standards is to reduce adverse selection against the insurer

# Underwriting

- ***Adverse selection*** is the tendency of people with a higher-than-average chance of loss to seek insurance at standard rates. If not controlled by underwriting, this will result in higher-than-expected loss levels.
- Underwriting should also maintain equity among the policyholders
- One group of policyholders should not excessively subsidize another group

# Underwriting

- Underwriting starts with the agent in the field

- Information for underwriting comes from:

1. The application
2. The agent's report
3. An inspection report
4. Physical inspection
5. A physical examination and attending physician's report

# Underwriting

- After reviewing the information, the underwriter can:

1. Accept the application
2. Accept the application subject to restrictions or modifications
3. Reject the application

# Production

- Production refers to the sales and marketing activities of insurers
- Agents are often referred to as producers
- Life insurers have an agency or sales department
- Property and liability insurers have marketing departments
- An agent should be a competent professional with a high degree of technical knowledge in a particular area of insurance and who also places the needs of his or her clients first

# Claim Settlement

- **<u>The objectives of claims settlement include</u>**:

1. Verification of a covered loss
2. Fair and prompt payment of claims
3. Personal assistance to the insured
4. Some laws prohibit unfair claims practices, such as:

- Refusing to pay claims without conducting a reasonable investigation
- Not attempting to provide prompt, fair, and equitable settlements
- Offering lower settlements to compel insureds to institute lawsuits to recover amounts due

# Claim Settlement

- The **claim process** begins with a notice of loss
- Next, the claim is investigated
- A claims adjustor determines if a covered loss has occurred and the amount of the loss
- The adjustor may require a proof of loss before the claim is paid
- The adjustor decides if the claim should be paid or denied
- Policy provisions address how disputes may be resolved

# Reinsurance

- **Reinsurance** is an arrangement by which the primary insurer that initially writes the insurance transfers to another insurer part or all of the potential losses associated with such insurance
- The primary insurer is the ***ceding company***
- The insurer that accepts the insurance from the ceding company is the ***reinsurer***
- The ***retention limit*** is the amount of insurance retained by the ceding company
- The amount of insurance ceded to the reinsurer is known as a ***cession***

# Reinsurance

***Reinsurance is used to***:

1. Increase underwriting capacity
2. Stabilize profits
3. Reduce the unearned premium reserve
4. The ***unearned premium reserve*** represents the unearned portion of gross premiums on all outstanding policies at the time of valuation
5. Provide protection against a catastrophic loss
6. Retire from business or from a line of insurance or territory
7. Obtain underwriting advice on a line for which the insurer has little experience

# Types of Reinsurance Agreements

*There are two principal forms of reinsurance:*

1. ***Facultative reinsurance*** is an optional, case-by-case method that is used when the ceding company receives an application for insurance that exceeds its retention limit

Facultative reinsurance is often used when the primary insurer has an application for a large amount of insurance

# Types of Reinsurance Agreements

2. ***Treaty reinsurance*** means the primary insurer has agreed to cede insurance to the reinsurer, and the reinsurer has agreed to accept the business

- All business that falls within the scope of the agreement is automatically reinsured according to the terms of the treaty

# Methods for Sharing Losses

- **There are two basic methods for sharing losses**:

1. Under the ***Pro rata method***, where the ceding company and reinsurer agree to share losses and premiums based on some proportion
2. Under the ***Excess method***, where the reinsurer pays only when covered losses exceed a certain level

# Methods for Sharing Losses

- Under a ***quota-share treaty***, the ceding insurer and the reinsurer agree to share premiums and losses based on some proportion
- Under a ***surplus-share treaty***, the reinsurer agrees to accept insurance in excess of the ceding insurer's retention limit, up to some maximum amount
- An ***excess-of-loss treaty*** is designed for catastrophic protection
- A reinsurance pool is an organization of insurers that underwrites insurance on a joint basis

# Reinsurance Alternatives

- Some insurers use the capital markets as an alternative to traditional reinsurance
- ***Securitization of risk*** means that an insurable risk is transferred to the capital markets through the creation of a financial instrument, such as a futures contract
- ***Catastrophe bonds*** are corporate bonds that permit the issuer of the bond to skip or reduce the interest payments if a catastrophic loss occurs
- Catastrophe bonds are growing in importance and are now considered by many to be a standard supplement to traditional reinsurance.

# Investments

- Because premiums are paid in advance, they can be invested until needed to pay claims and expenses
- Investment income is extremely important in reducing the cost of insurance to policyowners and offsetting unfavorable underwriting experience
- Life insurance contracts are long-term; thus, safety of principal is a primary consideration
- In contrast to life insurance, property insurance contracts are short-term in nature, and claim payments can vary widely depending on catastrophic losses, inflation, medical costs, etc

# Other Insurance Company Functions

- The **electronic data processing area** maintains information on premiums, claims, loss ratios, investments, and underwriting results
- The **accounting department** prepares financial statements and develops budgets
- In the **legal department**, attorneys are used in advanced underwriting and estate planning
- Property and liability insurers provide numerous **loss control services**