Direct Your Learning

2

Insurers and How They Are Regulated

Educational Objectives

After learning the content of this assignment, you should be able to:

- Describe the various types of private insurers that provide property-casualty insurance:
  - Stock insurers
  - Mutual insurers
  - Reciprocal insurance exchanges
  - Lloyd's
  - Captive insurers
  - Reinsurance companies
- Distinguish among the following insurance functions:
  - Marketing
  - Underwriting
  - Claims
  - Risk control
  - Premium audit
- Describe United States federal and state government insurance programs in terms of the following:
  - The reasons for these programs
  - The different levels of government involvement in these programs
  - Common examples of federal and state government insurance programs
- Explain why insurance operations are regulated.
- Explain how individual states in the United States regulate the licensing of insurers.

Outline

2

Educational Objectives, continued

- Explain how individual states in the United States regulate insurance rates and policy forms.
- Explain how the individual states in the United States regulate market conduct and insurer solvency.
- Explain how the surplus lines insurance market meets the needs of various classes of business that are often unable to find insurance in the standard insurance market.

Insurers and How They Are Regulated

2

TYPES OF PRIVATE INSURERS

Numerous kinds of private insurers provide property and liability coverage for individuals, families, and organizations.

Private insurers may be classified based on a variety of factors, one of which is their form of ownership. Proprietary insurers are formed for the purpose of earning a profit for their owners. Stock insurers and Lloyd's fall into this classification. Cooperative insurers are formed to provide insurance at a minimum cost to policyholders, who own the insurer. Cooperative insurers include mutual insurers and reciprocal insurance exchanges. The exhibit outlines the major differences among private insurers when they are classified in this fashion. Insurers may also be classified according to their licensing status, the marketing systems they use, and the types of insurance coverage they provide. See the exhibit "Differences Among Types of Insurer Ownership."

Private insurer
A nongovernment insurance provider.

Differences Among Types of Insurer Ownership

Type	Purpose for Which Formed	Legal Form	Ownership	Method of Operation
Stock insurer	To earn a profit for its stockholders	Corporation	Stockholders	The board of directors, elected by stockholders, appoints officers to manage the company.
Mutual insurer	To provide insurance for its owners (policyholders)	Corporation	Policyholders	The board of directors, elected by policyholders, appoints officers to manage the company.
Reciprocal insurance exchange (interinsurance exchange)	To provide reciprocity for subscribers (to cover each other's losses)	Unincorporated association	Subscribers (members)	Subscribers choose an attorney-in-fact to operate the reciprocal.
Lloyd's	To earn a profit for its individual investors ("Names") and its corporate investors	Unincorporated association	Investors	Lloyd's is regulated by the U.K. Financial Services Authority (FSA), which delegates much authority to the Council of Lloyd's.

[DA02097]

These are types of private insurers:

- Stock insurers
- Mutual insurers
- Reciprocal insurance exchanges
- Lloyd's
- Captive insurers
- Reinsurance companies

Stock Insurers

Stock insurer

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

Many of the largest property-casualty insurers in the United States are **stock insurers**. One of the primary objectives of a stock insurer is returning a profit to its stockholders. These companies have been able to attract and retain stockholders by the expectation of investment returns. Insurers formed for the purpose of making a profit for their owners are typically organized as stock corporations. The stock form of ownership provides financial flexibility for the insurer. For example, a stock insurer can finance expansion by selling additional shares of common stock. The ability to raise additional funds by selling common stock is an important aspect of the stock form of organization.

Stockholders have the right to elect the board of directors, which has the authority to control the insurer's activities. The board of directors creates and oversees corporate goals and objectives and appoints a chief executive officer (CEO) to carry out the insurer's operations. The CEO and a team of senior management personnel are given authority by the board of directors to implement the programs necessary to operate the company.

Mutual Insurers

Mutual insurer

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

Mutual insurers include some very large national insurers and many more regional ones. From the perspective of the insured, differences between stock and mutual insurers are becoming less significant. Some mutual insurers have converted to stock insurers through a process called "demutualization." The similarities of mutual insurers and stock insurers include these:

- Mutual insurers generally seek to earn profits in their ongoing operations, as do stock insurers.
- A stock insurer may choose to share profits with its stockholders by the payment of dividends, which are a return on the stockholders' investment. Mutual insurers also may opt to share profits, but pay dividends instead to policyholders as a return of a portion of premiums paid.
- The policyholders of a mutual insurer have voting rights similar to those of the stockholders of a stock company. They elect a board of directors that performs the same functions as the board of directors of a stock company.

Some mutual insurers have the right to charge insureds an assessment, or additional premium, after the policy has gone into effect. Such an assessment might be made after the insurer has endured a series of losses from a catastrophic event, such as a hurricane. These insurers are known as assessment mutual insurance companies, and they are less common than in the past.

Reciprocal Insurance Exchanges

Each member of a **reciprocal insurance exchange, or interinsurance exchange**, is both an insured and an insurer. Because a reciprocal's members, called subscribers, are not experts in running an insurance operation, they contract with an individual or organization to operate the reciprocal; this manager is called an attorney-in-fact. An agreement (known as a subscription agreement) authorizes the attorney-in-fact to act on behalf of the subscribers to market and underwrite insurance coverage, collect premiums, invest funds, and handle claims. The existence of an attorney-in-fact, empowered by the subscribers, is one of the main features that distinguish a reciprocal from other types of insurers. Reciprocals make up a small percentage of the total number of insurance companies in the U.S., but they do include some major national and international insurers. Small regional reciprocals also operate on a state-by-state basis.

Reciprocal insurance exchange (interinsurance exchange)
An insurer owned by its policyholders, formed as an unincorporated association for the purpose of providing insurance coverage to its members (called subscribers), and managed by an attorney-in-fact. Members agree to mutually insure each other, and they share profits and losses in the same proportion as the amount of insurance purchased from the exchange by that member.

Lloyd's

Lloyd's (formerly Lloyd's of London) is an insurance and reinsurance marketplace whose operation resembles that of a stock exchange. Members of Lloyd's are investors that hope to earn a profit from the insurance operations that occur at Lloyd's. Lloyd's is an unincorporated association. Each individual 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 unusual types of insurance, such as insuring the legs of a famous football player against injury. However, the bulk of Lloyd's business does not involve such exotic coverages. Lloyd's functions as an alien insurer in the U.S. and is usually one of the two largest writers of premiums in the surplus lines market. In fact, Lloyd's derives over one-third of its premium income from business in the U.S.[1]

In addition to the original Lloyd's organization that is domiciled in the United Kingdom, insurers called "American Lloyds" are domiciled in the U.S., mainly in Texas. These companies, like the original Lloyd's, operate as unincorporated associations, but are much smaller and have a much narrower scope of operations than the original Lloyd's. Most of the American Lloyds associations were formed by or have been acquired by major insurers domiciled in the U.S.

Captive Insurers

Captive insurer, or captive
A subsidiary formed to insure the loss exposures of its parent company and the parent's affiliates.

Captive insurers have been in existence since the early part of the twentieth century but became more prevalent in the late 1970s and early 1980s for these reasons:

- Low insurance cost—Captives might be able to provide insurance coverage at a lower cost than other private insurers because acquisition costs are eliminated. For example, captives might not have to pay producers' commissions or advertising expenses because they provide insurance primarily to the parent company.
- Insurance availability—A captive helps to eliminate the problems some corporations might face because necessary or desired insurance coverage is unavailable or costs more than the corporation is willing or able to pay. Forming a captive insurer eases the problems of availability and affordability for a parent company with loss exposures that may be difficult to insure.
- Improved cash flow—A premium paid to a captive remains within the corporate structure until it is used to pay claims. Instead of paying premiums to an unrelated insurer, the corporation is able to invest its funds until the time they are needed for claims. The corporation can receive a significant cash flow advantage by creating a captive. This advantage becomes even greater when interest rates are high.

Captive insurers have become an important alternative in the insurance-buying decisions of corporations. The relative importance of the factors affecting the growth of captives changes over time, but it appears that captives will remain an important source of insurance.

Reinsurance Companies

Reinsurance
The transfer of insurance risk from one insurer to another through a contractual agreement under which one insurer (the reinsurer) agrees, in return for a reinsurance premium, to indemnify another insurer (the primary insurer) for some or all of the financial consequences of certain loss exposures covered by the primary's insurance policies.

Some private insurers provide **reinsurance**. A primary insurer might buy reinsurance for a variety of reasons. One of the most important reasons is that reinsurance permits the primary insurer to transfer some of its loss exposures to the reinsurer. For example, an insurer that writes a large amount of property insurance in an area where tornadoes commonly occur can use reinsurance to reduce its exposure to windstorm losses.

Reinsurance also enables a small insurer to provide insurance for large accounts (such as large national or multinational corporations) whose insurance needs would otherwise exceed the insurer's capacity. For example, consider a primary insurer that writes a commercial liability policy for a large company that manufactures sports helmets. Because the potential for large liability losses resulting from injuries caused by defective helmets is great, the primary insurer might contract with a reinsurer to cover all of its liability losses for this insured over a certain amount, such as $1 million. In this way, the primary insurer and the reinsurer share the liability loss exposures for this insured.

OVERVIEW OF INSURANCE FUNCTIONS

Insurers perform many functions to provide products and services to their customers.

Insurers sell insurance policies and pay claims as required by those policies, but they do much more. They perform multiple key functions in order to accomplish their goal of protecting their customers while earning a profit:

- Marketing
- Underwriting
- Claims
- Risk control
- Premium audit

Many insurers have a department for each of these functions. Some insurers may outsource some functions, and others combine several functions within a department. Insurers may use different terms for these functions than those used here.

Each of these functions contributes to or detracts from the overall effectiveness of the insurer, depending on how well it is performed. The functions must also interact with each other; their efficient interaction is vital to the survival and continued success of an insurer.

Marketing

Marketing involves determining the products or services customers want and need and delivering them to those customers. The marketing function contributes significantly to an insurer's profit goals and its goals of meeting customers' needs. The insurer cannot make a profit if it does not provide products and services the customer needs.

An insurer will likely include these elements in a successful marketing program:

- Using market research to determine the needs of potential customers
- Advertising to inform customers about the insurer's products and services
- Selecting appropriate marketing systems
- Training to prepare the sales force to meet the customer's needs
- Setting sales goals and implementing strategies for achieving them
- Motivating and managing the sales force

Underwriting

The role of the **underwriting** function is to determine what loss exposures will be insured, for what amount of coverage, at what price, and under what conditions. **Underwriters** typically follow the underwriting process, which involves

Underwriting
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.

gathering the necessary information, making the underwriting decision, and implementing that decision.

Underwriters must carry out a variety of activities to apply the underwriting process. These examples of underwriting activities are central to the underwriting process:

- Selecting insureds
- Pricing coverage
- Determining policy terms and conditions

Underwriters carefully screen potential insureds to determine which ones to insure. They make their selections by applying the underwriting criteria set by the insurer to the loss exposures of customers who have applied for insurance policies. A successful underwriting function ensures that those applicants who are selected receive the level of coverage that adequately reflects their loss exposures at the appropriate price.

After selecting insureds, underwriting determines the price for the insurance. The goal is to charge a premium that is commensurate with the loss exposure. In other words, 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.

Selection of insureds and pricing of coverage are intertwined with a third underwriting activity—determining policy terms and conditions, which requires certain circumstances to occur or not occur before coverage will apply to a loss. An insurer must decide exactly what policy terms and conditions of coverage it will offer each applicant. For example, an insurer may be willing to add flood coverage to a commercial property policy if the insured building is not located in a high-hazard flood zone.

Claims

Claim

A demand by a person or business seeking to recover from an insurer for a loss that may be covered by an insurance policy.

Insurers expect to pay **claims**. Without claims, insurance would be unnecessary. When policyholders purchase insurance, they are buying protection for the potential financial consequences of covered losses. The insurer promises to make payments to or on behalf of the insured for covered losses. The claim function is responsible for keeping this promise to the insured by providing prompt and professional loss adjustment services.

Because more than half of what insurers spend goes to the claim function, its proper and efficient performance is important to an insurer's profitability.

When evaluating a claim, the adjuster typically applies a claim handling process that includes these six activities:

1. Acknowledging a claim and assigning it to a claim representative
2. Identifying the policy
3. Contacting the insured or the insured's representative
4. Investigating and documenting the claim
5. Determining cause of loss and loss amount
6. Concluding the claim

The purpose of the claim handling process is to achieve a fair and equitable settlement based on the circumstances of the loss. Loss settlements that are too high increase the cost of insurance for everybody. Loss settlements that are too low deprive the insured of the full benefits of the insurance policy. Paying inadequate loss settlements also diminishes the insurer's business reputation and can negatively affect the marketing function.

Risk Control

The primary purpose of an insurer's **risk control** function is to prevent or reduce losses, if possible. From an economic viewpoint, controlling losses is preferable to insuring losses because it reduces the waste of valuable resources. As a practical matter, both insuring and controlling losses are likely to be used jointly for most large loss exposures, because preventing all losses is seldom possible.

Risk control

A conscious act or decision not to act that reduces the frequency and/or severity of losses or makes losses more predictable.

The risk control function supports underwriters in selecting which loss exposures to insure. Risk control representatives can provide information to underwriters beyond what the application provides. For example, field inspection reports on an applicant's premises and operations can provide important details about the applicant's loss exposures that are not apparent on the application.

An insurer's risk control representatives also provide a valuable service for insureds by helping them prevent losses or reduce their effect. For example, a risk control representative can provide expert advice concerning sprinkler systems for fire suppression.

Premium Audit

Another insurer function is the **premium audit** function. Many commercial insurance policies are written subject to audit because the premium amount is calculated using a loss exposure measurement that can change during the policy period, which is often one year. The purpose of the audit, which occurs at the end of a policy period, is to determine any adjustments to the premium that may be required based on the insured's actual loss exposures during that period.

Premium audit

Methodical examination of a policyholder's operations, records, and books of account to determine the actual exposure units and premium for insurance coverages already provided.

For example, the premium of a workers compensation policy that pays when an employee is injured on the job is based on the amount of the employer's payroll. However, due to new hires, raises, terminations, and retirements during the policy period, the employer won't know the actual size of its payroll until the end of the policy period. It is only after the policy period is over that the insurer and the insured are able to determine how much the premium should be.

The insured pays an estimated premium at the beginning of the policy period. At the end of the policy period, typically one year, a premium auditor examines, or audits, the insured's records to determine the final premium. If the final premium exceeds the estimated premium, an additional premium is charged. If the final premium is less than the estimated premium, the insured receives a partial refund.

Because of their direct contact with policyholders, premium auditors also have an opportunity to share their observations with other insurer departments. Auditors can notify underwriters of larger loss exposures than originally contemplated, unacceptable operations, new products, new operations, or financial problems. Premium audit information can also identify marketing opportunities and assist the claim department in adjusting certain types of losses.

Apply Your Knowledge

For each of these actions, identify the insurance function that is most closely associated with it:

Determining the premium for a new customer's personal auto policy

a. Underwriting
b. Risk control
c. Marketing
d. Premium audit

Feedback: a. This action is an underwriting function.

Visiting a prospective insured's factory to inspect the fire suppression system

a. Marketing
b. Risk control
c. Premium audit
d. Claims

Feedback: b. This action is a risk control function.

provided by the government is compulsory, spending money on marketing or paying sales commissions (two large expenses for insurers) is unnecessary. Governments sometimes try to avoid sales costs by setting up their own distribution channels. Alternatively, as is the case with the National Flood Insurance Program (NFIP), they market through established insurance producers who also market other insurance.

Achieve Collateral Social Purposes

The government may participate in insurance to accomplish social goals because insurance is often seen as a social good. By making use of the pooling mechanism, insurance can reduce risk to society. This is beneficial both to society and to the overall economy.

An issue arises when individuals do not have an incentive to purchase insurance, even though it would benefit society. If, for example, an organization conducted a cost-benefit analysis and determined that workers compensation insurance was too expensive, it would not want to purchase the insurance. However, workers compensation laws encourage injury prevention and injured workers' rehabilitation. Therefore, the government provides incentives for the purchase of insurance through a combination of regulation and provision of insurance at a reasonable price. Organizations respond to these measures by purchasing insurance, which, as well as benefiting the organization, benefits society.

Level of Government Involvement

There are three levels at which the government can participate in an insurance program:

- The government can be an exclusive insurer either because of law or because no private insurer offers a competing plan. For example, in a few states, all employers must obtain their workers compensation insurance from the state-owned insurer (called an exclusive, or monopolistic, fund). A federal or state government can function as a primary insurer by collecting premiums, providing coverage, and paying all claims and expenses (with the backing of government funds if necessary). Alternatively, the government can function as a reinsurer, either by providing 100 percent reinsurance to private insurers writing a particular coverage (an exclusive reinsurer), or by reinsuring part of the risk in excess of the private insurer's retention.
- Government partnerships with private insurers can develop when private insurers are no longer able to adequately provide coverages they had typically offered previously. Two examples of such partnerships are TRIP and NFIP. TRIP is an example of a partnership under which the government operates a reinsurance plan, providing reinsurance on specific loss exposures for which private insurers retain only part of the loss. The NFIP is an example of a partnership under which the federal government underwrites

the insurance policy but private insurers and insurance producers deliver the policies to consumers. The private insurers take a percentage of the premium as a sales commission and pass the remainder of the premium on to the NFIP.

- Government involvement may also take the form of operating an insurance plan in direct competition with private insurers. This type of involvement often evolves when the private insurance market has not failed, but is not operating as efficiently as regulators prefer. In these instances, the government performs essentially the same marketing, underwriting, actuarial, and claim functions as a private insurer. Examples include the competitive workers compensation funds offered in some states.

Common Examples of Federal and State Programs

The final distinction among government property-casualty insurance programs is whether a state government or the federal government is involved with the program. Common examples of federal government insurance plans include NFIP, TRIP, and federal crop insurance. See the exhibit "Examples of Property-Casualty Insurance Offered by the Federal Government."

Examples of Property-Casualty Insurance Offered by the Federal Government

Plan	Characteristics of Government Plan	Relationship to Private Insurance
National Flood Insurance Program	• Meets previously unmet needs for flood insurance. • Serves the social purposes of amending and enforcing building codes and reducing new construction in flood zones.	• Federal government can act as primary insurer. • Federal government can partner with private insurers. Private insurers sell the insurance and pay claims; government reimburses insurers for losses not covered by premiums and investment income.
Terrorism Risk Insurance Program	• Designed to temporarily meet the unmet needs for a backstop to insured terrorism losses. • Serves the social purpose of preventing economic disruptions that market failures in terrorism coverage could have caused.	• Private insurers act as the primary insurer for terrorism coverages. • Federal government temporarily acts as reinsurer for terrorism coverage.
Federal Crop Insurance	• Provides crop insurance at affordable rates to reduce losses that result from unavoidable crop failures. • Covers most crops for perils such as drought, disease, insects, excess rain, and hail.	• Federal government subsidizes and reinsures private insurers; private insurers sell and service the federal crop insurance. • Private insurers also independently offer crop insurance for certain perils.

[DA07627]

Examples of state government insurance programs include workers compensation plans, residual auto plans, and beach and windstorm plans. See the exhibit "Examples of Property-Casualty Insurance Offered by State Governments."

Examples of Property-Casualty Insurance Offered by State Governments

Plan	Characteristics of Government Plan	Relationship to Private Insurance
Fair Access to Insurance Requirements (FAIR) Plans	• Make basic property insurance available to property owners who are otherwise unable to obtain insurance because of their property's location or any other reason.	• Organization varies by state. Typically it is an insurance pool through which private insurers collectively address an unmet need for property insurance on urban properties. • Does not replace normal channels of insurance; is only for consumers who could not obtain coverage in the private market.
Workers Compensation Insurance	• Helps employers meet their obligations under state statutes to injured workers.	• Private insurers provide workers compensation insurance. • State government can operate as an exclusive insurer, as a competitor to private insurers, or as a residual market.
Beach and Windstorm Plans	• Make property insurance against the windstorm cause of loss available to property owners who are otherwise unable to obtain insurance because of their property's location.	• Organization varies by state: some states are insurance pools of private insurers; other states are ultimately guaranteed with taxpayer funds. • Does not replace normal channels of insurance; is only for consumers who could not obtain coverage in the private market.
Residual Auto Plans	• Make compulsory automobile liability coverage available to high-risk drivers who have difficulty purchasing coverage at a reasonable rate in the private market.	• Organization varies by state. Typically it is an insurance pool through which private insurers collectively address an unmet need for compulsory auto liability coverage. • Does not replace normal channels of insurance; is only for consumers who could not obtain coverage in the private market.

[DA07628]

WHY INSURANCE OPERATIONS ARE REGULATED

When purchasing insurance, consumers may have many questions and concerns about whether the coverage they are purchasing will really protect them. Insurance regulation is meant to address many of these concerns.

Insurance consumers' concerns include whether the policy forms give them the coverage they expect and need, whether the price is appropriate, and whether the insurer will have the resources needed to pay losses that may occur months or even years after a policy has been purchased. To protect individuals, organizations, and entire communities from these kinds of problems, all of the states in the United States regulate insurance. Regulation varies considerably from state to state. However, most states focus their regulatory efforts on the same key areas of insurer operations: licensing, insurance rates, insurance policies, market conduct, and insurer solvency.

Insurers are regulated primarily for three reasons:

- To protect consumers
- To maintain insurer solvency
- To prevent destructive competition

Protect Consumers

Insurance is regulated to protect consumers. Many insurance policies are complex legal documents that may be difficult for some consumers to analyze and understand. Regulators help protect consumers by reviewing insurance policy forms to determine whether they benefit consumers. Regulators can set coverage standards, specify policy language for certain insurance coverages, and disapprove unacceptable policies.

Insurance regulators also protect consumers against fraud and unethical market behavior by insurers and producers, such as selling unnecessary insurance, misrepresenting coverage to make a sale, or refusing to pay legitimate claims.

Regulators try to ensure that insurance is readily available, especially the insurance that is viewed as a necessity. For example, all states try to make personal auto insurance available by restricting the rights of insurers to cancel or refuse to renew personal auto insurance policies.

Maintain Insurer Solvency

Solvency

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.

Insurance is regulated to maintain insurer **solvency**. Insurance regulators try to maintain and enhance the financial condition of private insurers for several reasons:

- Premiums are paid in advance, and the period of protection extends into the future. If an insurer becomes insolvent, future claims might not be paid even though the premium has been paid. Consumers may find it difficult to evaluate insurers' financial ability to keep their promises.
- Regulation is needed to protect the public interest. Large numbers of individuals are adversely affected when insurers become insolvent. For example, an unusually large catastrophe that affects a large area can

make an insurer's financial ability to pay claims uncertain, such as when Hurricane Andrew struck Florida in 1992 and caused seven insurer insolvencies.

- Insurers hold substantial funds for the ultimate benefit of policyholders. Government regulation is necessary to safeguard such funds.

Despite regulatory reviews, insurers have become insolvent. However, sound regulation minimizes the number of insolvencies.

Prevent Destructive Competition

Insurance is regulated to prevent destructive competition. Therefore, regulators are responsible for determining whether insurance rates are adequate.

At times, some insurers price their policies too low in an effort to attract customers away from higher-priced competitors. This practice drives down price levels in the whole insurance market. Therefore, when insurance rate levels become inadequate, some insurers may not collect enough money to pay all of their insureds' claims and may become insolvent. Other insurers might lose so much profit that they withdraw from the market or stop writing new business. An insurance shortage can then develop, and individuals and organizations might be unable to obtain the coverage they need.

For example, following periods of intense competition among insurers, pharmaceutical companies have found it difficult to obtain commercial liability insurance to cover the risk of product defects in the drugs they manufacture.

INSURER LICENSING

Most insurance companies must be licensed by the state insurance department before they are authorized to write insurance policies in that state.

In the United States, insurers are licensed as domestic insurers in the states where they are domiciled. When insurers wish to operate in additional states, they become licensed as foreign insurers. Insurers domiciled outside the U.S. are licensed as alien insurers. Surplus lines insurers typically operate through a specially licensed producer.

In addition to requiring that insurance companies (most commonly stock, mutual, or reciprocal exchange insurers) be licensed, states also generally require that certain individual insurance professionals, such as producers and claim representatives, be licensed.

Insurer's Licensing Status

An insurer's licensing status in a given state may assume any one of several forms: that of a **domestic insurer**, a **foreign insurer**, or an **alien insurer**. Licensing standards vary among these several forms. For example, a domestic

Foreign insurer
An insurer licensed to operate in a state but incorporated in another state.

Domestic insurer
An insurer doing business in the jurisdiction in which it is incorporated.

Alien insurer
An insurer domiciled in a country other than the United States.

insurer's license generally has no expiration date, whereas licenses of a foreign insurer and an alien insurer generally must be renewed annually.

Becoming Licensed as a Domestic Insurer

Domestic insurers usually must meet the conditions imposed on corporations engaged in noninsurance activities as well as some additional conditions imposed on insurers. An applicant for a domestic insurer license must apply for a corporate charter and provide specific information, including (but not limited to) these items:

- The insurer's form of ownership
- The names and addresses of the individual incorporators
- The name of the proposed corporation and the territories and types of insurance it plans to market
- The insurer's total financing, including authorized capital stock (the total number of shares, if any, that a corporation can sell to raise money), and its policyholders' surplus

Forms of Ownership

Insurers can be classified by legal form of ownership. The three most common forms of insurer ownership in the U.S. are stock insurance companies, mutual insurance companies, and reciprocal insurance exchanges.

Insurers formed for the purpose of making a profit for their owners are typically organized as stock insurers. Stockholders supply the capital needed to form the insurance company or the additional capital the insurer needs to expand its operations. Stockholders expect to receive a return on their investment in the form of stock dividends, increased stock value, or both. Stockholders have the right to elect the board of directors. The board of directors creates and oversees corporate goals and objectives and appoints a chief executive officer (CEO) to carry out the insurer's operations.

A mutual insurer is a corporation owned by its policyholders. Because a traditional mutual insurer issues no common stock, it has no stockholders. Its policyholders have voting rights similar to those of a stock company's stockholders, and, like stockholders, they elect the insurer's board of directors. Although initially formed to provide insurance for their owners, mutual insurers today generally seek to earn profits in their ongoing operations, just as stock companies do. A mutual insurer needs profits to ensure the future financial health of the organization. Mutual companies include some large national insurers and many regional insurers.

A reciprocal insurance exchange, also referred to as a reciprocal, is organized as an unincorporated association of members, called subscribers, that agree to insure one another and share profits and losses. The term "reciprocal" comes from the reciprocity of responsibility of all subscribers to each other. Each member of the reciprocal is both an insured and an insurer. Because the subscribers are not experts in running an insurance operation, they contract with an individual or organization to operate the reciprocal. This manager, called an attorney-in-fact, is typically a corporation with a board of directors that manages the reciprocal. See the exhibit "Forms of Insurer Ownership."

Forms of Insurer Ownership

Type of Insurer	Form of Ownership	Managed by
Stock insurer	Corporation owned by its stockholders	Board of directors, elected by the stockholders
Mutual insurer	Corporation owned by its policyholders	Board of directors, elected by the policyholders
Reciprocal insurance exchange	Unincorporated association of subscribers	Attorney-in-fact chosen by the subscribers

[DA07488]

Capital and Surplus

Information about capital stock and surplus is important to licensing regulators because it indicates the insurer's financial soundness. A domestic insurer that is also a stock insurer must meet certain minimum capital and surplus requirements, which vary widely by state and by amounts and types of insurance written. A domestic insurer that is also a mutual insurer has no capital derived from the sale of stock. Therefore, the minimum financial requirement applies only to surplus. Most states require mutual insurers to have an initial surplus equal to the minimum capital and surplus requirement for stock insurers writing the same type of insurance.

Becoming Licensed as a Foreign or an Alien Insurer

In the U.S., an insurer is typically licensed as a domestic insurer in one state and as a foreign insurer in all other states where it wishes to operate. Less commonly, an insurer is domiciled outside the U.S. and is licensed as an alien insurer in the U.S. states where it wishes to operate.

To be licensed in an additional state (that is, as a foreign insurer), an insurer first must show the regulator in the additional state that it has satisfied the requirements imposed by its home state (its state of domicile, or the state where it is a domestic insurer). A foreign insurer also must generally satisfy the minimum capital, surplus, and other requirements imposed on domestic insurers within the state in which it is seeking to be licensed.

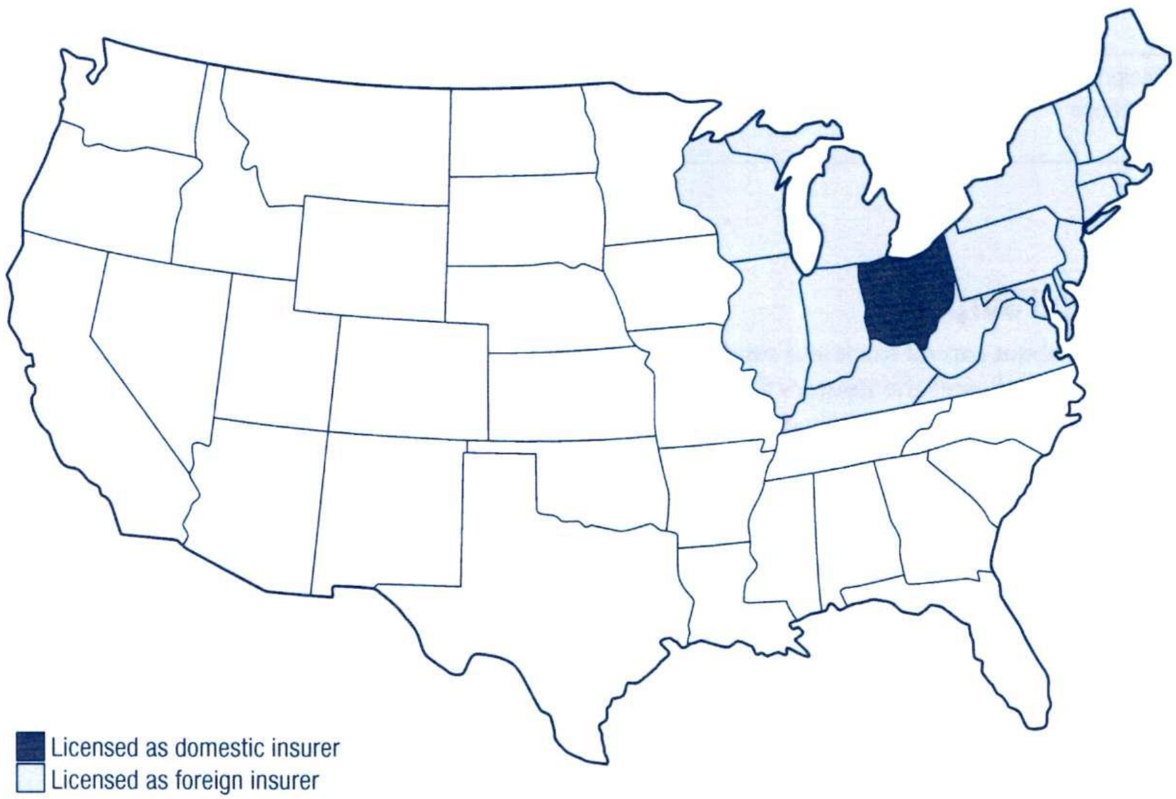
Admitted insurer

An insurer to which a state insurance department has granted a license to do business within that state.

Alien insurers must satisfy the requirements imposed on domestic insurers by the state in which they want to be licensed. Additionally, they must usually establish a branch office in any state and have funds on deposit in the U.S. equal to the minimum capital and surplus required. The funds on deposit are available, if necessary, to pay claims asserted against the alien insurer through the U.S. legal system. See the exhibit "Licensing Status of a Hypothetical Insurer."

Licensing Status of a Hypothetical Insurer

Insurer A, a regional insurer domiciled in Ohio, is licensed as a domestic insurer in Ohio and is licensed as a foreign insurer in its other states of operation.



[DA07504]

Admitted Insurers and Nonadmitted Insurers

Nonadmitted insurer

An insurer not authorized by the state insurance department to do business within that state.

Insurers that are licensed to do business in a state, whether as domestic, foreign, or alien insurers, are collectively referred to as **admitted insurers**. Under special circumstances, insurers that are not licensed in the particular state, referred to as **nonadmitted insurers**, may be permitted to sell insurance within that state. A nonadmitted insurer may be an admitted insurer in other states, or it may even be an alien insurer.

Nonadmitted insurers are frequently referred to as surplus lines insurers. Surplus lines insurers are usually permitted to sell only insurance that is not readily available from admitted insurers because of specialty, risk, or several other factors. Under **surplus lines laws**, a nonadmitted insurer is permitted to transact business only through a specially licensed surplus lines producer. The nonadmitted insurer must still meet some of the regulatory requirements of a licensed insurer, but these do not typically include restrictions on rates and policy forms.

Surplus lines laws
State laws that permit producers with a surplus lines license to write business for an acceptable "nonadmitted insurer when protection from admitted insurers is not available."

Producers and Claim Representatives

In addition to licensing insurers, all states require licensing of certain insurer representatives or employees. Agents, brokers, and claim representatives are often required to pass an examination on insurance laws and practices to earn a license. These examinations, along with continuing education requirements, are an attempt to ensure that these insurance professionals have a minimum level of insurance knowledge and meet ethical standards.

INSURANCE RATE AND FORM REGULATION

Individual states in the United States regulate insurance rates to strike a balance between reasonable profits for insurers and reasonable prices for consumers. Additionally, states regulate insurance policy forms to ensure that they are readable, understandable, and fair.

A solvent, profitable insurance market that provides insurance products at affordable rates is important to the citizens of every state. From coverage on their homes and autos to workers compensation, individuals need insurance. Organizations of all types and sizes cannot operate without insurance. Because insurance is important and often required for individuals and businesses, states enact laws to ensure that rates are sufficient for insurers and reasonable for consumers.

In addition to being able to afford to purchase insurance, consumers also need to be able to understand the insurance products they purchase. Therefore, states typically regulate insurance policy forms to enable consumers to read and understand them. Methods of regulation include requiring certain language or provisions, or mandating that a particular policy form be used. Most states review policy provisions to ensure that they are fair and reasonable.

There are, however, certain types of insurance, such as coverage for complex commercial organizations or unique risks, exempted from regulation.

Insurance Rate Regulation

Setting insurance rates is the regulatory area that may receive the most public attention. It is important to insurers that rates allow them to collect sufficient premiums to pay for the insured losses that occur, to cover the insurer's costs of operating, and to allow a reasonable profit.

When deciding to approve or disapprove an insurer's request for a rate, a state insurance commissioner usually considers three major criteria:

- Adequate—Rates should be sufficient to pay all claims and the expenses related to those claims, helping to maintain insurer solvency.
- Not excessive—Insurers are entitled to a fair return but not to excessive or unreasonable profit.
- Not unfairly discriminatory—Insurers are permitted to adjust premium rates based on the risk profile of different groups of insureds, but these rates must be fair and consistent. Insureds with similar loss exposures should be charged similar rates.

Different states meet these criteria by different types of rating laws that vary in the type and extent of control the state asserts over insurers' rates:

- **Mandatory rate law**—Rate law that imposes the strictest control of an insurer's rates.
- **Prior-approval law**—Insurers cannot charge a rate until it is approved by state regulators.
- **File-and-use law**—Insurers must file proposed rates but can use the rates while state approval is pending.
- **Use-and-file law**—Variation of the file-and-use law that provides more flexibility for insurers in setting rates.
- **Flex rating law**—Increases the amount of flexibility for insurers in their rate determinations.
- **Open competition**—Market prices driven by the economic laws of supply and demand, rather than regulatory decisions, determine insurance rates. However, state insurance departments typically have the authority to monitor competition and disapprove rates if deemed necessary. The major criteria that rates must be adequate, not excessive, and not unfairly discriminatory continue to apply.

Mandatory rate law

State law under which insurance rates are set by a state agency or rating bureau and all licensed insurers are required to use those rates.

Prior-approval law

An insurance rating law in which the rates and supporting rules must be filed with and approved by the state insurance department before they can be used.

File-and-use law

An insurance rating law in which the insurer must file rates and supporting rules with the state insurance department prior to their use, but the rates can then be used immediately without specific approval.

Use-and-file law

An insurance rating law in which the rates must be filed with the state insurance department within a specified period after they are put into use.

Flex rating law

An insurance rating law under which prior approval is required only if the new rates exceed a certain percentage above (and sometimes below) the rates previously filed.

Open competition (no-file law)

An insurance rating law that allows insurers to develop and use rates without having to file with or get approval from the state insurance department.

Insurance Policy Form Regulation

Another area of insurance regulation involves insurance policy forms. Because many insurance policies are difficult to interpret and are often sold on a take-it-or-leave-it basis, many states require insurers to file their policy forms with the state insurance department.

Regulations regarding insurance policy forms are intended to meet two major objectives. The first objective is that insurance policies be clear and readable to insurance consumers. The second major objective is to detect and address any policy provisions that are unfair or unreasonable.

Some state legislatures enact laws that control the structure and content of insurance policies. Such laws may require the use of a specific form or provision in all policies of a certain type that are sold in the state. For example, many states require the use of a standard workers compensation policy that provides coverage for on-the-job injuries. Some state laws require insurance policies to meet a readability test. The requirements for readability may include the use of common, easily understood language and specific policy style, form, and print size.

Exemptions From Rate and Form Regulation

State insurance regulations do not apply to all insurers and insurance. Some insurers and some types of insurance policies are exempt from regulation regarding premium rates and policy forms.

Surplus lines insurers are generally exempt from insurance regulations pertaining to policy forms and rates. These insurers are willing to provide coverage for risks that admitted insurers are unable or unwilling to offer. Because these insurers increase the availability of insurance, they have the freedom to use policy provisions and rates that are appropriate for a particular risk.

There are various types of coverage related to unique or difficult-to-place risks that are also exempt from regulation in some states. Examples of these coverages include inland marine, ocean marine, and aviation. Inland marine originated and evolved in order to cover risks that were considered uninsurable under standard commercial policies, such as coverage for works of art and other valuable property.

Many states have deregulated some commercial insurance coverages for large, sophisticated purchasers. There is significant variation in the definition of the size of business to qualify for exemption from rate and form regulation. One state, for example, may require an aggregate annual premium of $500,000, while another state could require $25,000. Many states do not exempt certain types of commercial coverage, such as workers compensation or commercial property, from regulation.

MARKET CONDUCT AND SOLVENCY REGULATION

States regulate how insurers conduct themselves in the marketplace and monitor their financial strength for the protection of the public and insurance consumers.

States have consumer protection laws that apply directly to insurers conducting business within their borders. Solvency regulations that establish insurer financial requirements and monitoring systems seek to protect the public from loss of insurance coverage in the event of an insurer's financial failure.

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.

Unfair trade practices law

State law that specifies certain prohibited business practices.

Market conduct regulation focuses on insurers' treatment of applicants for insurance, insureds, and others who present claims for coverage. Most states have statutes that address market conduct, often called **unfair trade practices laws**. These laws usually involve three areas of insurance company operations: sales, underwriting, and claim handling.

Sales and Underwriting

State regulators can suspend or revoke the licenses of sales agents or brokers who engage in unfair trade practices, such as embezzling premiums. Similarly, an insurer that is guilty of unfair underwriting practices could be fined, or its operating license in a state could be suspended or revoked. Under the unfair trade practices acts, examples of improper underwriting include unfair discrimination and canceling or not renewing policies, contrary to state regulations.

Claims

Most states also have statutes that prohibit unfair claim practices and assess fines against claim representatives and insurers that engage in practices such as intentionally making unfairly low settlement offers, failing to provide reasonable explanations for denying a claim, misrepresenting important policy provisions, or failing to approve or deny coverage within a reasonable time period.

Regulatory examinations of insurers identify some of these abuses, but others are exposed only when an insured or a claimant lodges a complaint. Every state insurance department has a consumer complaints division to enforce its consumer protection objectives and to help insureds deal with problems they have encountered with insurers and their representatives. State insurance departments investigate consumer complaints and may hold formal hearings as part of the investigation process.

Insurer Solvency

Another area of insurance regulation is insurer solvency. A noninsurance company is considered solvent if it has resources to pay its bills and meet similar financial obligations. Because an insurer has promised to pay many unknown losses in the future, states require it to have financial reserves well in excess of its ordinary expenses in order to be considered solvent. See the exhibit "Causes of Insurer Insolvencies."

> **Causes of Insurer Insolvencies**
>
> Mismanagement in some form is at the root of most insurer insolvencies. Primary causes of insurer insolvencies in recent years have been deficient loss reserves, inadequate pricing, and rapid growth. Less frequent causes include investment problems, alleged fraud, and catastrophe losses.

A.M. Best Company, 2010 Special Report: U.S. Surplus Lines—Market Review (Oldwick, N.J.: A.M. Best Company, September 2010), p. 29. [DA07446]

Solvency for an insurer is its ability to meet its financial obligations as they become due, even those resulting from insured losses that might be claimed several years in the future. To verify insurer solvency, insurance regulators conduct **solvency surveillance**.

Solvency surveillance

The process, conducted by state insurance regulators, of verifying the solvency of insurers and determining whether their financial condition enables them to meet their financial obligations and to remain in business.

Regulators use four methods to verify the solvency of insurers:

- Establish financial requirements by which to measure solvency
- Conduct on-site field examinations to ensure regulatory compliance
- Review annual financial statements
- Administer the Insurance Regulatory Information System (IRIS)

Establish Financial Requirements

Regulators establish financial requirements against which all similarly licensed insurers are measured. To obtain and keep a license as an admitted insurer, each insurer must meet certain minimum financial requirements, such as capital and surplus requirements. Specific financial requirements vary widely by state.

Conduct Field Examinations

State laws usually require that insurers undergo on-site field examinations at least once every three to five years. This examination usually occurs under the direction of the insurance department of the state where the insurer's home office is located.

A team of state examiners, working at the insurance company home office, reviews a wide range of activities, including claim, underwriting, marketing, and accounting procedures. Of particular interest to the examiners is the insurer's financial condition. The examining team carefully analyzes the insurer's financial records to ensure that the company is meeting all state financial reporting requirements.

National Association of Insurance Commissioners (NAIC)

An association of insurance commissioners from the fifty U.S. states, the District of Columbia, and the five U.S. territories and possessions, whose purpose is to coordinate insurance regulation activities among the various state insurance departments.

NAIC Annual Statement

The primary financial statement prepared by insurers and required by every state insurance department.

Review Annual Statements

Insurers are required to submit annual financial statements to state insurance departments in a prescribed format. The **National Association of Insurance Commissioners (NAIC)** has prescribed a format called the **NAIC Annual**

Statement, which requires detailed information on premiums, expenses, investments, losses, **reserves**, and other financial information. Regulators analyze these statements to assess insurers' financial strength.

Reserve

The amount the insurer estimates and sets aside to pay on an existing claim that has not been settled.

Administer IRIS

Insurance Regulatory Information System (IRIS)

An information and early-warning system established and operated by the NAIC to monitor the financial soundness of insurers.

Regulators administer the **Insurance Regulatory Information System (IRIS)**, which helps them identify insurers with potential financial problems. Designed by the NAIC, IRIS uses data from an insurer's financial statements to develop financial ratios that assess the insurer's overall financial condition. If the insurer has ratios that are outside predetermined norms, IRIS identifies the company for regulatory attention. IRIS is meant to be an early warning system that might enable regulators to rehabilitate an insurer or, if rehabilitation is not practical, to minimize the losses from liquidation.

If regulators determine that an insurer is insolvent, the state insurance department places it in receivership. If the insurer cannot be rehabilitated, it is liquidated according to the state's insurance code. At that point, the state's **guaranty fund** may be available to reduce the effects of the insurer insolvency. A guaranty fund cannot prevent insurer insolvency, but it does provide funds to pay unpaid claims of insolvent insurers licensed in a particular state.

Guaranty fund

A state-established fund that provides a system for the payment of some of the unpaid claims of insolvent insurers licensed in that state, generally funded by assessments collected from all insurers licensed in the state.

Under a special provision in state insurer licensing laws, state regulators are empowered to partially or completely take over the operation of an insurer that has been determined to be in danger of failing to meet its financial obligations. In extreme cases, a state may even dissolve an insurer and assign administration of the existing policies to another insurer.

THE SURPLUS LINES MARKET

In most cases, the standard insurance market provides the policies necessary to meet the property-casualty insurance needs of the public. Surplus lines insurance addresses unique or unusual exposures that the standard market is unwilling or unable to insure.

Most property-casualty insurance policies are standardized, and many insurers use essentially the same policy forms. The **standard market** writes the majority of property-casualty insurance in the United States.

Standard market

Collectively, insurers who voluntarily offer insurance coverages at rates designed for customers with average or better-than-average loss exposures.

Surplus lines insurance

Insurance obtained from nonadmitted insurers when protection is not available from admitted insurers.

The term "surplus lines market," also known as the excess and surplus market, is often used to identify the nontraditional market. **Surplus lines insurance** consists of insurance coverages unavailable in the standard market. Poor loss experience or expected losses associated with certain classes of business might not meet standard-market insurers' underwriting requirements. 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.

Classes of Surplus Lines Business

These classes of business are often insured in the surplus lines market:

- Unusual or unique loss exposures
- Nonstandard business
- Insureds needing high limits of coverage
- Insureds needing unusually broad coverage
- Loss exposures that require new forms

Surplus lines insurers are willing and able to insure these classes of business because they can apply their expertise in underwriting them without the constraints of rate and form filing regulations.

Unusual or Unique Loss Exposures

One of the usual requirements of a commercially insurable loss exposure is that a large number of similar exposure units exists. If an exposure does not meet this requirement, the coverage is difficult to price. Therefore, standard market insurers are often unwilling to provide coverage. For example, suppose a singer does not show up for a concert. The sponsors of the concert can suffer a financial loss if they have to refund money to ticket holders. A coverage known as "non-appearance insurance," written by surplus lines insurers, covers the losses of the show sponsors if the performer named in the policy fails to appear because of a covered cause, such as the performer's injury or illness, a natural disaster, unavoidable travel delays, or other specified causes beyond the performer's control.

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 market insurers normally charge are not adequate to cover these exposures. For example, consider the case of a restaurant that has a history of grease fires in its kitchen. Its standard market insurer has decided not to renew its policy because of poor loss experience and no other standard market insurer will accept an application for coverage. A surplus lines insurer may be willing to write insurance for this restaurant with a premium substantially higher than a standard market insurer would charge.

Insureds Needing High Limits of Coverage

Some businesses demand extremely high limits of coverage, especially for liability insurance. For example, a manufacturer of hazardous chemicals may want to purchase higher liability limits than those available in the standard market. A standard market insurer may not be willing to offer limits as high as an insured needs. The surplus lines market often provides the needed limits in excess of the limits written by a standard market insurer.

Insureds Needing Unusually Broad Coverage

The standard insurance market uses standard coverage forms developed through advisory organizations, such as Insurance Services Office (ISO) and the American Association of Insurance Services (AAIS). When broader coverage is necessary, however, producers and insureds often seek such coverage from the surplus lines market. For example, standard commercial general liability (CGL) policies contain an exclusion that eliminates coverage for most pollution liability claims. This exclusion would create a serious coverage gap for a contractor that specializes in removal of hazardous substances, such as asbestos or lead, from buildings. The contractor's insurance agent might be able to obtain, from the surplus lines market, a CGL policy that omits asbestos or lead from the policy definition of pollutants, thus broadening the contractor's liability coverage and solving the contractor's problem.

Loss Exposures That Require New Forms

As new insurance needs arise, the surplus lines market responds. Producers and consumers often turn to the surplus lines market when they have an immediate need for a new type of coverage. Surplus lines insurers can often respond quickly to these developing needs, while standard market insurers often take longer to analyze the need for new or revised coverage, and to file policy forms and rates for state approval.

Surplus Lines Regulation

Surplus lines insurance is written by nonadmitted insurers, which are not licensed in the insured's home state. Nonadmitted insurers are not required to file their rates and policy forms with state insurance departments, providing them with more flexibility than that of standard (or admitted) insurers, which are licensed to do business within the state.

Although nonadmitted insurers are exempt from rate-and-form filing laws and regulations, the surplus lines market is subject to regulation. Some states maintain lists of nonadmitted insurers that are approved to accept business from the state; others keep lists of nonadmitted insurers that are not approved. A nonadmitted insurer that is eligible to accept business from a state is referred to as a **surplus lines insurer**.

Surplus lines insurer

A nonadmitted insurer that is eligible to insure risks that have been exported by a surplus lines licensee in accordance with a surplus lines law.

Most states have surplus lines laws requiring that all surplus lines business be placed through a specially licensed surplus lines broker, also referred to as a surplus lines licensee. When an insurance producer who is not a surplus lines licensee seeks to insure a customer with a surplus lines insurer, he or she must arrange for a surplus lines licensee to handle the transaction.

Surplus lines laws require the surplus lines licensee to fulfill certain requirements. Before a particular risk can be "exported" to a surplus lines insurer, the surplus lines licensee must document that a diligent search for coverage in the standard (admitted) market has been performed. The diligent-search requirement makes sure that the standard (admitted) market has had the first opportunity to insure the risk. After placing insurance with a surplus lines insurer, the surplus lines licensee must collect the surplus lines premium tax stipulated by the surplus lines law and remit the tax to the insured's home state.

SUMMARY

These are types of private insurers: stock insurers, mutual insurers, reciprocal insurance exchanges, Lloyd's, captive insurers, and reinsurance companies.

Like many businesses, insurers pursue their goals by segmenting operations into functional areas, or departments. These departments must cooperate to serve the primary function of transferring the financial consequences of loss exposures and to meet other insurer goals. An insurer's key functions are marketing, underwriting, claims, risk control, and premium audit. Each department must interact effectively with other departments for the insurer to achieve its goals.

Government insurance programs exist to fill unmet needs in the private insurance market, to facilitate compulsory insurance purchases, to provide efficiency in the market and convenience to insureds, and to achieve collateral social purposes. There are three levels at which the government can participate in an insurance program—as an exclusive insurer, as a partner with a private insurer, or as an insurer that competes with private insurers. Government-run insurance programs may operate at the state or federal level.

Insurers are regulated primarily for these three reasons:

- To protect consumers
- To maintain insurer solvency
- To prevent destructive competition

Insurers must meet various requirements to be licensed as domestic insurers in the states where they are domiciled. Additionally, insurers must also be licensed as foreign insurers in other states where they wish to operate. Nonadmitted insurers may transact certain types of business through licensed surplus lines producers. In addition to requiring that insurers be licensed, states also require that certain insurance professionals, including producers and claim representatives, become licensed.

States regulate insurance rates to ensure that they are adequate, not excessive, and not unfairly discriminatory. States also regulate insurance policy forms to meet standards of clarity, fairness, and readability. However, there are certain types of insurance, such as large commercial policies or unique coverages, that are exempt from state regulation.

States regulate insurers' market conduct, focusing on insurers' treatment of applicants for insurance, insureds, and others who present claims for coverage. Market conduct regulation, which includes unfair trade practices laws and unfair claim practices laws, usually applies to three areas of insurance company operations: sales, underwriting, and claim handling.

State solvency laws seek to ensure the financial strength of insurers so that they can meet their obligations to insureds and claimants. Solvency regulators establish insurer financial requirements, conduct field examinations, review annual financial statements, and administer the Insurance Regulatory Information System, which identifies insurers in danger of becoming insolvent.

Surplus lines insurance meets the needs of various classes of business that are often unable to find insurance in the standard insurance market. Surplus lines insurance is written by insurers not licensed to do business within the insured's home state.

ASSIGNMENT NOTE

1. Lloyd's, www.lloyds.com/Lloyds/Offices/Americas/US-homepage (accessed May 9, 2011).

Direct Your Learning

3

Insurer Financial Performance

Educational Objectives

After learning the content of this assignment, you should be able to:

- Explain how the management of a property-casualty insurer's income and expenses determines its profitability.
- Describe the typical items found on the balance sheet and the income statement of a property-casualty insurer.
- Analyze a property-casualty insurer's profitability information using these financial ratio calculations:
  - Loss ratio
  - Expense ratio
  - Combined ratio
  - Investment income ratio
  - Overall operating ratio
- Given a case regarding a property-casualty insurer's financial ratio calculation(s), determine the significance of those calculation(s) on the insurer's overall financial performance.

Outline