Direct Your Learning

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Underwriting and Ratemaking

Educational Objectives

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

- Describe the purpose of underwriting.
- Describe the underwriting activities typically performed by line and staff underwriters.
- Describe the steps in the underwriting process.
- Given the insurance rate and exposure units for a particular insurance policy, calculate the policy premium.
- Describe the responsibilities of underwriting management.
- Explain how individual states in the United States regulate underwriting activities through restrictions on unfair discrimination, cancellation, and nonrenewal.
- Explain how insurance rates are developed.

Outline

Underwriting and Ratemaking

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PURPOSE OF UNDERWRITING

Insurance companies assume billions of dollars in financial risk annually, risk that is transferred to them from individuals and businesses via the insurance transaction. Insurance underwriters, using the underwriting process and various supporting underwriting tools, are employed by insurers to assess both their new and current business. An insurance company's overall profitability can depend significantly on the quality of its underwriting.

Underwriting has multiple purposes. The overarching purpose is to develop and maintain a profitable **book of business** for the insurer. Underwriting is crucial to an insurer's success; underwriting goals flow directly from the insurer's corporate strategies and objectives. Favorable underwriting results are necessary for an insurer's ability to sustain profitable growth.

Book of business

A group of policies with a common characteristic, such as territory or type of coverage, or all policies written by a particular insurer or agency.

To achieve profitability, the underwriting function serves additional purposes:

- Guarding against adverse selection
- Ensuring adequate policyholders' surplus
- Enforcing underwriting guidelines

Guarding Against Adverse Selection

Underwriters are an insurer's guard against **adverse selection**. These are examples of adverse selection:

Adverse selection

In general, the tendency for people with the greatest probability of loss to be the ones most likely to purchase insurance.

- Some property owners in areas prone to coastal storms purchase windstorm coverage or increase their limits only before a hurricane season, when they expect severe losses.
- A disproportionate percentage of property owners in an earthquake-prone zone purchase earthquake insurance, as compared to property owners in areas less prone to earthquakes.

Underwriters minimize the effects of adverse selection by carefully selecting the applicants whose loss exposures they are willing to insure, charging appropriate premiums for the applicants that they do accept with premiums that accurately reflect the loss exposures, and monitoring applications and books of business for unusual patterns of policy growth or loss.

Ensuring Adequate Policyholders' Surplus

Capacity

The amount of business an insurer is able to write, usually based on a comparison of the insurer's written premiums to its policyholders' surplus.

An insurance company must have adequate policyholders' surplus if it wishes to increase its written premium volume. An insurer's **capacity** is limited by regulatory guidelines and often by its own voluntary constraints, which are frequently more conservative than those imposed by regulators. If an insurer's underwriting practices generate policy premiums that exceed losses and expenses, the policyholders' surplus will increase, thereby increasing capacity.

Underwriters ensure the adequacy of policyholders' surplus by adhering to underwriting guidelines, making certain that all loss exposures are correctly identified, and charging adequate premiums for the applications that are accepted.

Enforcing Underwriting Guidelines

Underwriting authority

The scope of decisions that an underwriter can make without receiving approval from someone at a higher level.

Underwriting guidelines (underwriting guide)

A written manual that communicates an insurer's underwriting policy and that specifies the attributes of an account that an insurer is willing to insure.

Underwriting guidelines reflect the levels of **underwriting authority** that are granted to varying levels of underwriters, producers, and managing general agents (MGAs). Exactly who has what level of underwriting authority varies considerably by insurer and by type of insurance.

Underwriting ensures that applicants accepted adhere to underwriting guidelines. If loss exposures, risks, or policy limits on an application exceed an underwriter's authority, he or she will seek approval through supervisory and management ranks within the underwriting department.

UNDERWRITING ACTIVITIES

In insurance organizations, underwriting responsibilities are delegated by members of senior management to line and staff underwriters who coordinate the day-to-day risk selection decisions and the management-level underwriting activities. This coordinated effort is crucial to the achievement of the insurer's profitability goals.

Line underwriter

Underwriter who is primarily responsible for implementing the steps in the underwriting process.

Staff underwriter

Underwriter who is usually located in the home office and who assists underwriting management with making and implementing underwriting policy.

The focus of **line underwriters** is evaluating new submissions and performing renewal underwriting. Line underwriters work directly with insurance producers and applicants. The focus of **staff underwriters** is managing the risk selection process. Staff underwriters work with line underwriters and coordinate decisions with other departments to manage the insurance product, pricing, and guidelines. See the exhibit "Underwriting Activities Performed by Line and Staff Underwriters."

Line Underwriting Activities

Line underwriters evaluate individual accounts for acceptability and execute underwriting policy by following practices and procedures outlined by staff underwriters. The specific tasks line underwriters perform may vary by insurer;

Underwriting Activities Performed by Line and Staff Underwriters

Line underwriters	Staff underwriters
• Select insureds	• Research the market
• Classify and price accounts	• Formulate underwriting policy
• Recommend or provide coverage	• Revise underwriting guidelines
• Manage a book of business	• Evaluate loss experience
• Support producers and insureds	• Research and develop coverage forms
• Coordinate with marketing efforts	• Review and revise pricing plans
	• Arrange treaty reinsurance
	• Assist others with complex accounts
	• Conduct underwriting audits
	• Participate in industry associations
	• Conduct education and training

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however, most line underwriters are responsible for the major activities specified in the exhibit.

Select Insureds

Line underwriters select new and renewal accounts that meet the criteria established in underwriting guidelines. They also monitor accounts to ensure that they continue to be acceptable and may cancel or nonrenew an account if risk control recommendations made at the policy's inception are not implemented or if the insured fails to take corrective action to control loss frequency. The account selection activity is essential to attaining these goals:

- Avoiding adverse selection
- Charging adequate premiums for accounts with a higher-than-average chance of loss
- Selecting better-than-average accounts for which the premium charged will be more than adequate
- Rationing an insurer's available capacity to obtain an optimum spread of loss exposures by location, class, size of risk, and line of business

Classify and Price Accounts

Line underwriters are responsible for account classification, which is the process of grouping accounts with similar attributes so that they can be priced appropriately. The price charged must not only be adequate to permit the insurer to continue to write profitable business, but also it must be competitive. A consequence of misclassification is that the premium charged is not commensurate with the risk transferred.

Insurers must submit classification and rating plans to state insurance regulators. For some lines of business and in some states, line underwriters may not have any discretionary latitude in policy pricing. In other lines of insurance, the line underwriter can use individual rating plans to apply debits and credits to the account that will adjust the premium to reflect the characteristics of the individual insured. The line underwriter must be sure that the account characteristics justify the adjustment and must document that the account complies with the insurer's individual rating plan filed with regulatory authorities.

Recommend or Provide Coverage

Line underwriters support producers and policyholders by inquiring about an insured's risk management program to ensure that the insured is using other risk management techniques to address gaps in insurance coverage. Additionally, sometimes an underwriter must narrow an insured's coverage if a producer requests broader coverage for the loss exposures of a particular applicant than the insurer is willing to provide.

Line underwriters also have a role in ensuring that applicants obtain the coverage they request. The task of providing requested coverage often involves collaboration with the producer. Because each account is unique, producers and applicants often want to know how coverage will respond to a specific type of loss. Line underwriters respond to these requests (usually through the producer) by explaining the types of losses the coverage forms are designed to cover and the endorsements that must be added to provide the coverage desired. For most accounts, however, the line underwriter simply ensures that the policy is being issued with the appropriate forms and endorsements that provide the requested coverage.

Manage a Book of Business

Frequently, line underwriters are expected to manage a book of business. Underwriting management usually reinforces departmental goals through individual line underwriters. Some insurers also make line underwriters responsible for the profitability of a book of business accepted from a producer, or written in a territory or line of business. The line underwriter works to ensure that each book of business achieves established goals, such as product mix, loss ratio, and written premium.

Support Producers and Customers

The services that line underwriters are expected to provide to producers and customers vary. Some insurers rely on customer service departments to respond to routine inquiries and requests. Insurers operating through independent agents often rely on their sales force to perform many policy service functions. Because customer service activities and underwriting are often interwoven, line underwriters have an active interest in ensuring that producers' and insureds' needs are met. Line underwriters are usually directly involved with producers in preparing policy quotations.

Coordinate With Marketing Efforts

An insurer's marketing efforts and underwriting policy should be compatible. That is, line underwriters should not reject applications that meet insurer underwriting guidelines simply because of an underwriter's bias against a particular class of business.

Supporting the insurer's marketing objectives can have broader implications for the line underwriter. Some insurers rely on special agents or field representatives to market the insurer and its products to agents and brokers. Some insurers have blended the responsibilities of special agents and line underwriters into the position of production underwriter. Production underwriters usually confer personally with producers and assist them with developing accounts that are acceptable to the insurer.

Staff Underwriting Activities

Staff underwriters work closely with underwriting management to perform activities essential for profitable risk selection, as specified in the "Underwriting Activities Performed by Line and Staff Underwriters" exhibit.

Research the Market

Insurers must continually research fundamental issues such as potential target markets. Staff underwriters typically share these research responsibilities with actuarial and marketing departments. Research includes an ongoing evaluation of these items:

- Effect of adding or deleting entire lines of business
- Effect of expanding into additional states or retiring from states presently serviced
- Optimal product mix in the book of business
- Premium volume goals

Formulate Underwriting Policy

Underwriting policy translates an insurer's mission and goals into specific strategies that, in turn, determine the composition of the insurer's book of business. Staff underwriters work with employees from other departments to formulate underwriting policy. No single underwriting policy is appropriate

Underwriting policy (underwriting philosophy)
A guide to individual and aggregate policy selection that supports an insurer's mission statement.

for all insurers. Insurers often develop their underwriting policy within the context of the market(s) they serve, which could include any of these:

- Standard market—Better-than-average accounts for which the average premium is more than adequate
- Nonstandard market—Higher-risk applicants, who are charged a higher-than-average premium
- Specialty market—Accounts that have unique needs, such as professional liability, that are not adequately addressed in the standard market

Beyond these broad market selections, the goals for an insurer's book of business and resulting underwriting policy may be established by types of insurance and classes of business to be written; territories to be developed; or forms, insurance rates (such as filed rates and surplus lines pricing), and rating plans to be used.

Revise Underwriting Guidelines

Staff underwriters are usually responsible for revising underwriting guidelines so that they accurately reflect changes in underwriting policy. Some underwriting guidelines include systematic instructions for handling particular classes of commercial accounts. Such guidelines may identify specific hazards to evaluate, alternatives to consider, criteria to use when making the final decision, ways to implement the decision, and methods to monitor the decision. The guidelines may also provide pricing instructions and reinsurance-related information. Other insurers use underwriting guidelines that are less comprehensive.

Evaluate Loss Experience

Staff underwriters evaluate an insurer's loss experience to determine whether changes should be made in underwriting guidelines. Insurance products that have losses greater than those anticipated are usually targeted for analysis. Staff underwriters research loss data to determine the specific source of the excess losses. Part of this research includes an analysis of insurance industry loss experience that may reveal trends affecting the insurer's products. Based on their evaluation, staff underwriters, usually with the agreement of other key departments, adjust the insurer's underwriting guidelines.

Research and Develop Coverage Forms

Advisory organization

An independent organization that works with and on behalf of insurers that purchase or subscribe to its services.

Coverage forms are developed by both insurance **advisory organizations** and individual insurers. Insurance advisory organization-developed coverage forms are usually constructed by coverage experts who consider the scope of coverage being provided, coverage provided by other policies, and legal restrictions that apply to coverage-form development. When an insurer develops its own forms, staff underwriters collaborate with the insurer's actuarial and legal departments. Insurers develop new coverage forms to meet changing consumer needs and competitive pressures. Additionally, insurers modify existing coverage forms (either their own forms or those created by advisory organizations) so that the coverage being provided by the insurer will respond as anticipated. An unfavorable court decision, for example, may cause an insurer to rewrite a coverage form to limit the coverage being provided.

Review and Revise Pricing Plans

Staff underwriters review and update rates and rating plans continually, subject to regulatory constraints, to respond to changes in loss experience, competition, and inflation. Historical loss data are gathered by the insurer or by advisory organizations to develop **prospective loss costs**. Then, each insurer examines its own operational profit and expense requirements. Staff underwriters combine prospective loss costs with an insurer-developed profit and expense loading to create a final rate used in policy pricing. For any coverages for which advisory organizations do not develop loss costs, the insurer must develop its own rates. In such situations, reviewing and revising rating plans become even more crucial to ensure that the loss costs adequately reflect **loss development** and **trending**.

Prospective loss costs

Loss data that are modified by loss development, trending, and credibility processes, but without considerations for profit and expenses.

Trending

A statistical technique for analyzing environmental changes and projecting such changes into the future.

Loss development

The increase or decrease of incurred losses over time.

Arrange Treaty Reinsurance

Staff underwriters are responsible for securing and maintaining **treaty reinsurance**. For many insurers, treaty reinsurance limitations are directly reflected in their underwriting guidelines. For example, staff underwriters specify in the underwriting guidelines the maximum coverage limits that can be offered when higher limits of treaty reinsurance are not purchased. Additionally, some types of accounts cannot be insured because the insurer's treaty reinsurance agreements specifically exclude the account's classification. For commercial property accounts, many staff underwriters maintain a line authorization guide, which serves as a control on the property limits accepted based on the treaty reinsurance agreement. When **facultative reinsurance** is required for a particular account, the reinsurance transaction may be handled by either a staff underwriter or a line underwriter, depending on the insurer's procedures.

Treaty reinsurance

A reinsurance agreement that covers an entire class or portfolio of loss exposures and provides that the primary insurer's individual loss exposures that fall within the treaty are automatically reinsured.

Facultative reinsurance

Reinsurance of individual loss exposures in which the primary insurer chooses which loss exposures to submit to the reinsurer, and the reinsurer can accept or reject any loss exposures submitted.

Assist Others With Complex Accounts

Staff underwriters often serve as consultants to other underwriters. Generally, staff underwriters have significant first-hand line underwriting experience. They regularly see complex and atypical accounts, unlike most line underwriters. Staff underwriters also function as "referral underwriters"—that is, when an application exceeds a line underwriter's authority, a referral underwriter can review and approve the risk.

Conduct Underwriting Audits

Underwriting audit

A review of underwriting files to ensure that individual underwriters are adhering to underwriting guidelines.

Staff underwriters are often responsible for monitoring line underwriter activities and adherence to underwriting authority by conducting **underwriting audits**. The audits focus on proper documentation, adherence to procedure and classification and rating practices, and conformity of selection decisions to the underwriting guide and bulletins.

Staff underwriters also monitor underwriting activity by analyzing statistical results by type of insurance, class of business, size of loss exposure, and territory. Statistical data show the extent to which underwriting goals are met, but they do not conclusively demonstrate whether the results are a product of implementing the insurer's underwriting guidelines.

Participate in Industry Associations

Many insurers are members of national and state associations that address insurance industry concerns. Additionally, insurers often share in the operation of residual market mechanisms, such as automobile joint underwriting associations and windstorm pools. Staff underwriters typically represent the insurer as a member of these organizations. Staff underwriters may also serve on an advisory organization's committees that study standard policy forms and recommend changes.

Conduct Education and Training

Staff underwriters are usually responsible for determining the education and training needs of line underwriters. Sometimes, these training needs are addressed through a formal training program that all newly hired underwriters must complete. At other times, the training need is transitory and is provided through classes that address a specific underwriting issue or procedure.

Some training needs are met through programs provided by the insurer's human resources department. However, staff underwriters often develop courses and serve as instructors in technical insurance subjects.

THE UNDERWRITING PROCESS

An underwriter engages in a series of steps and tasks to help the insurer achieve its business goals.

The underwriting process is a series of steps and tasks incorporating these underlying concepts:

- The purpose of underwriting is to develop and maintain a profitable book of business.
- Underwriting activities include line underwriting activities and staff underwriting activities.

- Levels of underwriting authority are based on experience and knowledge.
- Underwriting policy should support an insurer's mission.

After a producer submits an application for insurance to an insurer, the application must be qualified for acceptance. Underwriters qualify an application by following the steps in the underwriting process. In addition to applications, the underwriting process is also applied to renewal policies as well as certain policy changes, such as a request to add a new location to a property policy. In this section, applications, renewals, and policy changes to which the underwriting process is applied are referred to as underwriting submissions. Typically, an insurance company underwriter makes decisions regarding underwriting submissions for commercial lines. Underwriters use **expert systems, or knowledge-based systems**, to help them make better and more consistent underwriting decisions.

Although experienced underwriters do not always follow each of the steps in the underwriting process in strict order, the sequence of steps provides a sound framework within which underwriters can make decisions. See the exhibit "Steps in the Underwriting Process."

Steps in the Underwriting Process

1. Evaluate the submission
2. Develop underwriting alternatives
3. Select an underwriting alternative
4. Determine an appropriate premium
5. Implement the underwriting decision
6. Monitor the underwriting decision

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Evaluate the Submission

The first step in the underwriting process is evaluating a submission's loss exposures and associated **hazards**. Hazards fall into four categories: **physical hazards**, **moral hazards**, **morale hazards**, and **legal hazards**. Underwriters must understand the activities, operations, and character of every applicant. To evaluate a submission, underwriters perform two tasks: weighing the need for information and gathering the necessary information.

Weigh the Need for Information

Underwriters apply **information efficiency** to weigh the need for information against the cost to obtain it. For example, an underwriter is likely to investigate a chemical manufacturer extensively, but may require much less

Expert systems, or knowledge-based systems

Computer software programs that supplement the underwriting decision-making process. These systems ask for the information necessary to make an underwriting decision, ensuring that no information is overlooked.

Physical hazard

A tangible characteristic of property, persons, or operations that tends to increase the frequency or severity of loss.

Hazard

A condition that increases the frequency or severity of a loss.

Morale hazard (attitudinal hazard)

A condition of carelessness or indifference that increases the frequency or severity of loss.

Moral hazard

A condition that increases the likelihood that a person will intentionally cause or exaggerate a loss.

Legal hazard

A condition of the legal environment that increases loss frequency or severity.

Information efficiency

The balance that underwriters must maintain between the hazards presented by the account and the information needed to underwrite it.

information to underwrite a gift shop. Sometimes, an account's premium size determines the amount of information gathered or the resources used to gather it. An account with a small premium volume may not justify expensive research. Underwriters may also categorize information as essential, desirable, or available when determining whether it should be obtained.

Gather the Necessary Information

Underwriters compile information from many sources to develop a profile of a submission. Underwriters pay close attention to a submission's hazards to determine whether those hazards are typical of similarly classified accounts.

These are the principal sources of underwriting information:

- Producers—Underwriters rely more on the producer than on any other source because the producer has personal contact with an applicant, has firsthand knowledge of the applicant's business operations, knows the applicant's reputation in the community, and has determined the applicant's coverage needs.
- Applications—Insurance applications provide general information required to process, rate, and underwrite loss exposures of the applicant.
- Inspection reports—Independent inspections or risk control reports provide underwriting information about the property's physical condition, the business operations' safety record, and the policyholder's management.
- Government records—Government records that provide underwriting information include motor vehicle reports; criminal court records; and civil court records, including records of suits filed, mortgages and liens, business licenses, property tax records, United States Securities and Exchange Commission (SEC) filings, and bankruptcy filings.
- Financial rating services—An applicant's financial status provides important underwriting information. Dun & Bradstreet (D&B), Standard & Poor's, and Experian are some of the major financial rating services that provide data on the credit ratings of individual businesses, together with industry averages for comparison.
- Loss data—Loss data, such as that contained in loss runs, are a significant underwriting tool for predicting future losses. The loss experience of a commercial policyholder might be extensive enough to be statistically significant on its own.
- Field marketing personnel—Insurers often employ field marketing personnel (such as marketing representatives or special agents) who can provide both specific and general underwriting information.
- Claim files—When renewing existing policies, an underwriter can obtain insights into the policyholder's character by reviewing the policyholder's claim files. Claim representatives typically accumulate a significant amount of underwriting information during their investigations.

Many tools are available to help underwriters evaluate, select, and price submissions. Examples of these tools include telematics, **predictive analytics**, **predictive modeling**, and **catastrophe modeling**. Underwriters choose and balance the tools available to make the decision, which requires a holistic understanding of all of the information available in evaluating submissions.

Predictive analytics

Statistical and analytical techniques used to develop models that predict future events or behaviors.

Catastrophe model

A type of computer program that estimates losses from future potential catastrophic events.

Predictive modeling

A process in which historical data based on behaviors and events are blended with multiple variables and used to construct models of anticipated future outcomes.

Develop Underwriting Alternatives

The second step in the underwriting process is developing underwriting alternatives. The underwriter must consider each alternative carefully and choose the optimal one for the circumstances. The underwriter may accept a submission as is, reject the submission, or accept the submission subject to certain modifications. Determining the modification that best meets the needs of the insurer, producer, and applicant can be a challenge. There are four major ways an underwriter can modify a submission:

- Require risk control measures
- Change insurance rates, rating plans, or policy limits
- Amend policy terms and conditions
- Use facultative reinsurance

The first type of modification for an unacceptable submission is a **counteroffer** with a requirement for the applicant to implement additional risk control measures. Some risk control measures are relatively inexpensive and simple to implement, while others, such as fire detection and suppression (sprinkler) systems, require considerable capital investment. An underwriter should make sound recommendations accompanied by well-reasoned and convincing explanations and follow up to ensure that required risk control measures are implemented and that submissions meet underwriting guidelines.

Counteroffer

A proposal an offeree makes to an offeror that varies in some material way from the original offer, resulting in rejection of the original offer and constituting a new offer.

The second type of modification for a submission is a counteroffer to change insurance rates, rating plans, or policy limits. A rate modification could either increase or decrease the premium. A rate increase compensates the insurer for potential increases in loss severity or frequency. A rate decrease might prevent an applicant from buying coverage from a competitor. Good judgment plays an important role in selecting a rate that earns a reasonable profit and is competitive enough to obtain the account.

In addition to changing rates, this type of modification also includes changing rating plans. Several rating plans are available for commercial applicants: **experience rating**, **schedule rating**, and **retrospective rating**.

Experience rating

A ratemaking technique that adjusts the insured's premium for the upcoming policy period based on the insured's experience for the current period.

Schedule rating

A rating plan that awards debits and credits based on specific categories, such as the care and condition of the premises or the training and selection of employees, to modify the final premium to reflect factors that the class rate does not include.

Retrospective rating

A ratemaking technique that adjusts the insured's premium for the current policy period based on the insured's loss experience during the current period; paid losses or incurred losses may be used to determine loss experience.

Changing policy limits also falls into this type of modification. An insurer's underwriting guidelines usually specify the maximum limits of insurance that an underwriter can approve. The limits usually reflect reinsurance limitations or availability and possible catastrophic loss from a single loss exposure. If high policy limits are requested, the underwriter may suggest lower limits or may use facultative reinsurance as a way of providing the requested limits.

The third type of modification for an unacceptable submission is a counteroffer to amend policy terms and conditions. An unacceptable submission may become acceptable by modifying the policy to exclude certain causes of loss, add or increase a deductible, or make another coverage change. Increasing a deductible might make coverage more viable for a small commercial account in which a large number of small losses has caused unsatisfactory loss experience in the past.

The fourth type of modification for an unacceptable submission is an insurer's internal decision to use facultative reinsurance if treaty reinsurance is not available. The underwriter may be able to transfer a portion of the liability for the applicant's loss exposure to a facultative reinsurer. An alternative to purchasing facultative reinsurance is to ask the producer to divide the insurance among several insurers—an approach sometimes called "agency reinsurance."

Select an Underwriting Alternative

The third step in the underwriting process is selecting an underwriting alternative. An underwriter must decide whether to accept a submission as offered, reject it, or accept it subject to modifications. Rejection is sometimes unavoidable; however, rejections produce neither premium nor commission, only expense. Therefore, underwriters try to make the submission acceptable because one of an insurer's goals is to produce profitable business.

Selecting an alternative involves weighing a submission's positive and negative features, including loss exposures contemplated in the insurance rate, risk control measures, and management's commitment to loss prevention. These additional factors need to be considered before selecting an underwriting alternative:

- Underwriting authority—If the underwriter lacks authority, the submission must be referred to a higher underwriting authority.
- Supporting business—A submission that is marginal by itself might be acceptable if the other insurance components of the applicant's account—the supporting business—are desirable.
- Mix of business—The underwriting policy determined by management and specified in the underwriting guidelines frequently indicates the insurer's **mix-of-business** goals.
- Producer relationships—The relationship between the underwriter and the producer should be based on mutually shared goals. Differences of opinion are common, particularly because some of the goals of producers and underwriters conflict when producers focus on production and underwriters focus on strict adherence to selection standards.
- Regulatory restrictions—An underwriter must be aware of state regulations that restrict underwriters' ability to accept or renew business. Additionally, federal and state privacy laws restrict the type and the amount of information about an applicant that an underwriter can obtain.

Mix of business
The distribution of individual policies that compose the book of business of a producer, territory, state, or region among the various lines and classifications.

Determine an Appropriate Premium

The fourth step in the underwriting process is determining an appropriate premium. An underwriter must ensure that each loss exposure is properly classified so that it is properly rated.

Insurance loss costs are typically based on an elaborate classification system in which similar loss exposures are combined into the same rating classification. This enables the insurer to appropriately match potential loss costs with an applicant's particular loss exposures and develop an adequate premium to pay losses and operating expenses and to produce a profit.

For most types of personal insurance, workers compensation, and some other commercial insurance, proper classification automatically determines the premium. For some types of commercial insurance, such as general liability, an underwriter might have the option of adjusting the premium based on the characteristics of the account's loss exposures.

Implement the Underwriting Decision

The fifth step in the underwriting process is implementing the underwriting decision. Implementing underwriting decisions generally involves three tasks:

- Communicate the decision—If the decision is to accept the submission with modifications, the reasons must be clearly communicated to the producer and applicant, and the applicant must agree to accept or implement any modifications made as a counteroffer. If the underwriter decides to reject the application, he or she must communicate the rejection to the producer in a positive way to preserve their long-term relationship.
- Issue documents—In accepting a submission, an underwriter might need to issue a **binder** and prepare **certificates of insurance**.
- Record information—Information about the policy and the applicant are recorded for policy issuance, accounting, statistical, and monitoring purposes.

Binder

A temporary written or oral agreement to provide insurance coverage until a formal written policy is issued.

Certificate of insurance

A brief description of insurance coverage prepared by an insurer or its agent commonly used by policyholders to provide evidence of insurance.

Monitor the Underwriting Decision

The sixth step in the underwriting process is monitoring the underwriting decision. After an underwriting decision has been made on a new-business submission or a renewal, the underwriter has two tasks to ensure that satisfactory results are achieved: monitor activity for individual policies, and monitor books of business.

Monitor Individual Policies

An underwriter must be alert to changes in insureds' loss exposures. Changes in the nature of an insured's business operation, for example, could significantly raise or lower the policyholder's loss potential. The monitoring of existing policies usually occurs in response to any of these triggering events:

- Substantive policy changes—Adding a new location to a property policy or a new driver to an auto policy can cause the underwriter to investigate whether the additions significantly change the loss exposures.
- Significant and unique losses—A notice of loss provides the underwriter with another opportunity to review the account and to determine whether that loss is the type the underwriter expected. Summary information about the claim or a review of the claim file provides valuable information about the nature of the loss and the insured's operations.
- Preparation for renewal—As a policy's expiration date approaches, an underwriter must determine whether any changes to the account have occurred, and, if so, repeat the underwriting process.
- Risk control and safety inspections—A risk control and safety inspection might have contained recommendations that were requirements for policy issuance. A follow-up investigation could reveal that only some of the requirements were met.
- Premium audits—Premium audits usually lag behind a renewal policy by several months. The audit report could disclose larger loss exposures than originally contemplated, unacceptable operations, new products, new operations, or financial problems.

Monitor Books of Business

Monitoring a book of business entails evaluating the quality and profitability of all the business written for any group of policies. The evaluation should identify specific problems for each type of insurance, which can be subdivided into class of business, territory, producer, and other policy subgroups. Additionally, the insurer is concerned that the premium volume covers fixed costs and overhead expenses for each book of business.

Underwriters use premium and loss statistics to identify aggregate problems in a deteriorating book of business. Reviewing the book of business can also help determine compliance with underwriting policy and detect changes in the type, volume, and quality of policies that may require corrective action.

Special attention is given to some books of business when they are defined by these characteristics:

- Class of business—A poor loss ratio in a particular class of business can indicate inadequate pricing or a disproportionate number of high-hazard policyholders relative to the average loss exposure in the classification.
- Territories or geographic areas—Monitoring territorial underwriting results can help the insurer to target areas for future agency appointments in profitable regions. Poor results could indicate areas from which

the insurer might withdraw or in which the insurer might raise rates, if permitted by regulators.

- Producers—The producer's premium volume, policy retention, and loss ratio are evaluated both on an overall basis and by type and class of business. That evaluation should include the balance or mix of business desired between personal and commercial insurance and the projected growth factor. Key considerations are the goals that the insurer and producer established and the progress made toward achieving them.

PREMIUM DETERMINATION

One of the main activities performed by the underwriting department is pricing, or determining the policy premium, an activity commonly called "rating."

An insurance premium is a periodic payment by the insured to the insurer in exchange for insurance coverage. "Periodic" means that the payment must be made at certain time intervals. Each premium payment buys insurance protection for a particular time period, such as one year.

Although the terminology is different, insurance premiums are determined in much the same way as the prices of other products. For example, in many grocery stores, the "unit price" for each item is shown on the shelf. If an eighteen-ounce jar of peanut butter costs $2.34, the unit price is $0.13 per ounce and the final price is $2.34. In this case, one ounce is the unit.

In insurance, the premium (final price) is calculated by multiplying the insurance rate (unit price) by the number of exposure units. Depending on the type of coverage being rated, additional steps may be needed, such as adding charges for optional coverages.

Insurance Rates

An insurance **rate** is the "unit price" for insurance. Multiplying the rate by the number of exposure units determines the premium. Typically, an insurer has a separate rate in its **rate manual** for each of the rating classifications it uses. An insurer may have hundreds of rating classifications for a particular type of insurance. Rating classifications are based on characteristics of the insured and the loss exposures being insured.

Rate

The price per exposure unit for insurance coverage.

Rate manual

A resource for classifying accounts and developing premiums for given types of insurance; includes necessary rules, factors, and guidelines to apply those rates.

The ISO *Commercial Lines Manual (CLM)* provides classification tables that contain hundreds of classifications of commercial business operations. When calculating the premium for commercial accounts, underwriters typically determine the insured's business operation and then find the appropriate rating classification in the applicable classification table. See the exhibit "Classification Table."

Classification Table

51300 Baby Food Mfg. – In glass containers

Class Code: 51300

Premium Base: Gross Sales

10100 Bakeries

Class Code: 10100

Premium Base: Gross Sales

Note: This classification includes baking operations at the same location as the store, if the products baked are sold principally in that store.

51315 Bakery Plants

Class Code: 51315

Premium Base: Gross Sales

Note: Risks shall be classified and rated as bakeries, if products baked are sold principally in the insured's own retail store at the same location.

10111 Barber or Beauty Shop Supplies Distributors

Class Code: 10111

Premium Base: Gross Sales

Exposure Units

Exposure unit (unit of exposure)

The unit of measure (for example, area, gross receipts, payroll) used to determine an insurance policy premium.

The fundamental measures of the loss exposures used in insurance rating are referred to as **exposure units**. Insurers use standardized exposure units for rating most types of insurance. For example, in homeowners insurance, exposure units are normally expressed as $1,000 of insured value. In the case of a home insured for $400,000, the number of exposure units is 400. In the case of a home insured for $200,000, the number of exposure units is 200. See the exhibit "Examples of Exposure Units."

Calculation of Premium (Rate x Exposure Units)

After the insurance rate and number of exposure units are known, calculating the premium involves a relatively simple mathematical formula. This type of calculation is similar to that used in pricing many products that consumers purchase.

Apply Your Knowledge

ABC Company is a new business that provides Internet marketing services to commercial clients. ABC is applying for workers compensation insurance for its seven employees who are classified as clerical employees. The manual rate is $0.30 per $100 of payroll. ABC's annual payroll is $500,000.

Calculate the basic premium that would be charged for ABC's seven employees, ignoring any additional rating factors that might apply.

a. $300

b. $3,000

c. $1,500

d. $10,500

Feedback: c. Rate × Exposure units = Premium. $0.30 × ($500,000 ÷ $100) = $1,500.

UNDERWRITING MANAGEMENT

To meet its goals, an insurer must adjust its underwriting rules and standards to respond to shifting business conditions. An insurer's underwriting management implements these adjustments.

The underwriting management role entails various responsibilities:

- Participating in the overall management of the insurer in making broad business decisions
- Arranging reinsurance, which can be either treaty reinsurance (on all eligible policies) or facultative reinsurance (involving a separate transaction for each reinsured policy)
- Delegating underwriting authority, which establishes the types of decisions an underwriter can make without receiving approval from someone at a higher level
- Developing and enforcing underwriting guidelines that reflect the insurer's overall underwriting objectives
- Monitoring underwriting results to determine whether the underwriting guidelines have had the desired effect

Participating in Insurer Management

An insurer's senior management generally includes officers responsible for marketing, product development, claims, finance, actuarial services, and other functions in addition to underwriting. The head of an insurer's underwriting department participates with other members of the insurer's management team in making broad business decisions about the insurer's goals, including annual written premium and loss ratio goals, and in devising plans to meet those goals.

Decisions at this level might determine what type of marketing system the insurer uses, office locations, the emphasis that will be placed on personal and commercial insurance, and so forth. Given senior management consensus on the insurer's broad goals and how the insurer's capacity should be allocated, underwriting management must decide how underwriting activities can contribute to these goals. An insurer's underwriting management must then develop underwriting goals that complement or support the organization's overall goals.

Arranging Reinsurance

One of underwriting management's responsibilities is purchasing reinsurance. Reinsurance (sometimes referred to as "insurance for insurers") serves several purposes, including stabilizing the insurer's loss experience, providing protection against catastrophic losses, and allowing an insurer to provide a large amount of insurance under a single policy. Reinsurers also can provide the insurer with additional underwriting information and expertise. There are two general types of reinsurance: treaty and facultative.

Treaty reinsurance is an arrangement in which a reinsurer agrees to automatically reinsure a portion of all eligible insurance of the primary insurer. The treaty is a contract that defines the eligible insurance. The primary insurer is required to reinsure—and the reinsurer must accept—all business covered by the treaty. Policies are not selected individually. Primary insurers and reinsurers periodically renegotiate the reinsurance treaty. Before entering into a treaty and agreeing on pricing, the reinsurer carefully evaluates the primary insurer's past performance and expected future underwriting results. Because the treaty is based on all eligible insurance written by the primary insurer, the reinsurer is more concerned with the group of insureds as a whole than with the individual accounts that compose the group.

Conversely, facultative reinsurance is not automatic but involves a separate transaction for each reinsured policy. That is, the reinsurer evaluates each policy it is asked to reinsure. Underwriters for the primary insurer decide which policies to submit for reinsurance, and underwriters for the reinsurer decide which policies to reinsure. Pricing, terms, and conditions of each policy are individually negotiated.

Delegating Underwriting Authority

In contrast with underwriters, who deal with individual applications for insurance, an insurer's underwriting management focuses on the entire group of insureds. Underwriting management must determine how much underwriting authority to grant to those underwriters. The authority given to an underwriter usually reflects the underwriter's experience and responsibilities and the types of insurance handled.

With some insurers, underwriting authority is highly decentralized; that is, underwriting management delegates extensive underwriting authority to field office personnel. Other insurers are highly centralized, with many or all final underwriting decisions made in the home office. For insurers with centralized underwriting authority, field offices serve as a point of contact where insurer personnel gather information, accept applications, and provide policyholder services. Many insurers are neither completely centralized nor completely decentralized; these insurers strive to maintain a balance between the underwriting authority given to underwriters in field offices and the underwriting authority reserved for home office underwriters.

Many insurers also grant some underwriting authority to the agents who represent them. These agents, known as front-line underwriters, make the initial underwriting decision about applications and then forward those applications that meet underwriting guidelines to the insurer's underwriter. Agents usually have the authority to accept applications and bind coverage for the insurer if the applicant clearly meets the guidelines and if the limit of insurance is within a predetermined amount. The extent of the authority granted to an agent generally depends on the agent's premium volume and loss experience with the insurer.

Developing and Enforcing Underwriting Guidelines

Underwriting management develops the guidelines that underwriters use in the underwriting process. Organization-wide rules guide underwriters toward consistent decisions that enable the insurer to meet its overall underwriting goals. Underwriting guidelines and bulletins explain how underwriters should approach each application. The guidelines list the factors that should be considered by the underwriter for each type of insurance, the desirable and undesirable characteristics of applicants relative to those factors, and the insurer's overall attitude toward applicants that exhibit those characteristics. Based on the guidelines, underwriters evaluate the applications they receive, decide how to handle the applications, and act on those decisions.

Underwriting management extends beyond the development of underwriting guidelines. The guidelines must be clearly communicated to all underwriters. This may require training programs. In addition, underwriting management must communicate guideline revisions whenever changes are made.

Monitoring Underwriting Results

Underwriting management must also monitor underwriting results to determine whether underwriting guidelines have produced the desired effect. Monitoring includes steps to ensure that underwriters are following underwriting guidelines and that underwriting goals are being met. If the guidelines are not followed, a determination of their effectiveness cannot be made. Periodically, underwriting management sends underwriting audit teams to visit field offices to perform an underwriting audit. If the audit reveals that guidelines are being followed, it is then necessary to determine whether they have produced the desired results.

For example, assume an insurer has broadened its homeowners insurance policies by adding extra coverages (such as an additional theft limit on jewelry) in an attempt to attract new customers. Monitoring would reveal the extent to which insured losses increase because of the coverage addition, whether sales have increased, and whether revenues from the increased sales more than offset the costs of claims.

Many factors affect an insurer's success. Constant monitoring of underwriting results enables underwriting management to adjust underwriting guidelines to accommodate changing conditions, goals, and results.

REGULATION OF UNDERWRITING ACTIVITIES

In the interest of protecting the public, every state in the United States regulates insurers' underwriting activities and places some constraints on the terms and conditions that insurers offer.

Two important examples of underwriting activity regulation are these:

- Prohibition of unfair discrimination
- Restrictions on cancellation and nonrenewal

Prohibition of Unfair Discrimination

The ability to discriminate fairly among applicants is one of the most important elements of underwriting. However, state insurance regulations prohibit unfair discrimination in insurance. This prohibition also applies to insurance underwriting activities. The challenge lies in distinguishing between fair discrimination and unfair discrimination.

Despite the common assumption that discrimination always has negative connotations (as in, for example, sexual or racial discrimination), discrimination itself can be a neutral act. For example, teachers discriminate—that is, they finely distinguish—when they assign different grades to students with different levels of performance. Schools discriminate categorically when they admit kindergarten students based on age rather than rating them individually on the basis of physical or mental maturity.

Similarly, underwriting entails distinguishing among properties, businesses, and people and grouping them into categories. An insurer's ability to discriminate fairly is essential if insureds are to be charged a premium commensurate with their loss exposures. According to state insurance laws, unfair discrimination is prohibited as an unfair trade practice. Examples of unfair discrimination include refusing to issue, canceling, or nonrenewing coverage for an applicant or an insured solely on the basis of geographic location (sometimes known as "redlining"), gender, marital status, or race.

The examples of unfair discrimination all entail some kind of prejudice—judging, with no further information, that property in a given area, persons of a particular gender or marital status, or members of a certain race are likely to have unacceptable levels of losses. Further information in each case may indicate that the applicant or insured does not meet the insurer's underwriting standards, regardless of address, gender, marital status, or race. Therefore, if coverage is denied after objective underwriting criteria have been applied, it is not likely that unfair discrimination has occurred. See the exhibit "Market Conduct Examinations."

Market Conduct Examinations

Market conduct examinations are a process of evaluation used by state insurance departments to determine that an insurer's practices and procedures are in compliance with state laws and regulations and to help ensure equitable treatment of insureds and claimants.

Such examinations focus on the business practices of insurers and producers and are designed to monitor sales and advertising, underwriting, ratemaking, and claims practices. For underwriting practices, a market conduct examination might analyze one or more of these activities:

- Unfair discrimination in underwriting practices
- Improper cancellation and nonrenewal
- Failure to file rates and/or forms
- Inaccurate application of filed rating plans
- Improper classification of accounts
- Inaccurate application of account classifications
- Anticompetitive practices

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Restrictions on Cancellation and Nonrenewal

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

For example, after widely publicized claims involving allegations of child abuse caused insurers to become concerned about the legal hazards of operating daycare centers, some policies providing coverage to these centers were canceled or nonrenewed. At the same time, insurer capacity was severely restricted for other reasons as well, affecting many kinds of insurance. Insurers canceled or nonrenewed some policies in an attempt to reallocate their available capacity. In response, several states enacted laws prohibiting insurers from canceling insurance policies during the policy term and restricted insurers' rights to nonrenew policies. Even when such noncancellation laws had not been passed, underwriters became much more reluctant to exercise cancellation rights to avoid adverse reaction that could have led to further regulatory restrictions on underwriting activities.

RATEMAKING

Many insurers have a separate department that is responsible for the development of insurance rates, commonly called ratemaking. In some instances, underwriters may be responsible for ratemaking.

Ratemaking is a complex process that requires analysis of both external and internal data. Most insurers employ **actuaries** who perform the analyses, usually as part of a separate actuarial department.

Insurance rates, the basic price of insurance for each unit of exposure, are developed through **insurance rating systems** established by insurers and independent insurance advisory organizations. Typically, insurance rating systems are primarily based on insurers' **loss costs**. Insurance advisory organizations develop loss cost information by using either class or individual rating methodologies to analyze and categorize insureds.

In determining the final rate for a particular loss exposure, an insurer adds an allowance for expenses and profits to the basic rate that has been developed from loss costs. The insurer's underwriting department then determines the final premium by multiplying the final rate by the number of exposure units.

Ratemaking

The process insurers use to calculate insurance rates, which are a premium component.

Actuary

A person who uses mathematical methods to analyze loss data and develop insurance rates.

Insurance rating system

The price per exposure unit determined by adjusting the prospective loss costs for expenses, profits, and contingencies.

Loss costs

The portion of the rate that covers projected claim payments and loss adjusting expenses.

Insurance advisory organization

An independent corporation that works with and on behalf of insurers that purchase or subscribe to their services, which include developing prospective loss costs and standard policy forms.

Insurance Advisory Organizations

Insurance advisory organizations work with insurers in developing insurance rating systems. The largest insurance advisory organization is Insurance Services Office, Inc. (ISO), which provides analytical and decision-support products and services to the property-casualty industry. The National Council on Compensation Insurance (NCCI) is an insurance advisory organization that manages a database of workers compensation insurance information, analyzes industry trends, prepares workers compensation rate recommendations, and assists in developing state-specific workers compensation forms and endorsements. Other insurance advisory organizations that operate on a countrywide basis include the American Association of Insurance Services and the Surety and Fidelity Association of America.

Insurance Rating Systems

Insurance advisory organizations help develop insurance rating systems by collecting reliable loss data that insurers use in establishing their rates and premiums. Insurance advisory organizations continually collect loss information from many insurers. For example, to assist insurers in determining an appropriate rate to charge for automobile insurance during a certain period, insurance advisory organizations may gather data on insurers' loss costs for automobile accidents involving certain types of vehicles during a particular year.

Insurance rating systems combine loss data from many insurers, an approach based on the **law of large numbers**. Including losses of a large number of exposure units makes the resulting loss data more reliable than an individual insurer's loss data.

Law of large numbers

A mathematical principle stating that as the number of similar but independent exposure units increases, the relative accuracy of predictions about future outcomes (losses) also increases.

Insurance advisory organizations then analyze the loss data to determine the average loss costs per exposure unit used in class rating. See the exhibit "Rate Development Process."

Loss Costs

Loss data reflect historical loss costs—costs that occurred in the past. Insurers often adjust data on historical loss costs in anticipation of losses that can be expected in the future as a result of inflation or other measurable trends. These prospective loss costs indicate the amount of money an insurer can expect to pay for future claims for each exposure unit. However, it is not enough for insurers to collect money only to pay claims. An insurer must also cover its expenses and allow for profits and **contingencies**. Therefore, each insurer uses loss cost information to develop its own set of rates per exposure unit, determining how much to add to basic rates to arrive at the final rate it will charge.

Contingencies

A provision in an insurance rate for losses that could not be anticipated in the loss data.

Once determined, rates are published in an insurer's rating manual or stored in the insurer's rating system. These rates are also filed with the state insurance department where required. In many cases, the state insurance department might also reject, modify, or approve the rates that will be used.

Class Rating

Insurers develop loss costs for many different lines (or types) of business and many different groups or classes of insureds within those lines. Many kinds of insurance are priced using **class rating**. All members of a class are charged the same rate for insurance, although their premiums will be different if they have different numbers of exposure units. For example, a homeowner with a $400,000 home will pay more for homeowners insurance than a homeowner with a $200,000 home.

Class rating

A rating approach that uses rates reflecting the average probability of loss for businesses within large groups of similar risks; the predominant method used for rating commercial properties.

The basic premise of an insurance classification and rating system is that insureds with similar characteristics have similar potential loss frequency

Rate Development Process

Insurance advisory organization or insurer gathers historical loss costs.

↓

Insurance advisory organization or insurer establishes prospective loss costs.

↓

Insurer enters loss cost data into rating system.

↓

Insurer adjusts for expenses, profits, and contingencies.

↓

Insurer determines final rate.

Note: After the final rate is determined, the insurer multiplies it by the number of exposure units to determine the final premium.

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and severity. Even though wide variation in actual losses may occur from one insured to the next, aggregate losses among all members of the class should be predictably different from the losses of all members of another class who have different characteristics. For example, an employer will pay more for workers compensation insurance for a construction worker than for a clerical worker because construction workers as a class are more likely to become injured or disabled on the job than clerical workers as a class.

While no two risks are identical, grouping them enables an insurer to take advantage of pooling. The groupings or classes should be big enough to reflect the law of large numbers but small enough that all members share characteristics related to frequency and severity of loss.

Individual Rating

When insureds cannot be readily assigned to the same class, the insured loss exposure is rated individually. For example, an **individual rate, or specific rate**, might be developed for fire insurance on a large, unique factory building. The specific building is inspected by an underwriting professional using a point system that adds or subtracts points for such things as type of construction (masonry, wood, and so on), number and type of fire extinguishers, nature of the occupancy, capabilities of the local fire department, and the supply of water available at nearby hydrants. The number of points determines an insurance rate for that particular building. The rate is applied "per $100 of insurance" to determine the premium for fire insurance.

Individual rate, or specific rate

A type of insurance rate that reflects the unique characteristics of an insured or the insured's property.

Sometimes it is necessary to insure an exposure for which there is no established premium-determining system. In such cases, the underwriter has to rely heavily on his or her judgment, a practice that is referred to as **judgment rating**. Judgment rating is a type of individual rating.

Judgment rating

Rating used by underwriters to rate one-of-a-kind risks.

Judgment rating does not mean that an underwriter arbitrarily sets a rate for a particular exposure. The underwriter usually has experience with insurance covering comparable exposures and a resulting sense of what premium amount would be appropriate. For example, successful experience in insuring cross-country rail shipments of coal and iron ore might help an underwriter to decide the premium to charge for insuring the shipment of some other bulk cargo.

Final Rate and Premium Determination

Final rates result from prospective loss costs that move through the rating system and become adjusted for expenses, profits, and contingencies. Insurance rating systems assist insurers in determining rates based on past and expected future losses. The rating systems also account for other factors that affect insurers' final rate determination.

Final rate

The price per exposure unit determined by adjusting the prospective loss costs for expenses, profits, and contingencies.

To conduct business, insurers pay not only loss costs but also other expenses, such as underwriting and loss adjustment expenses, and plan for profits and contingencies. To set the final rates, they charge insureds for particular loss exposures. Individual insurers, therefore, add an allowance for factors such as expenses, profits, and contingencies to the basic insurance rates developed through insurance rating systems.

After the final rate has been calculated, it is multiplied by the number of exposure units to determine the final insurance premium.

SUMMARY

The overarching purpose of underwriting is to develop and maintain a profitable book of business for the insurer. To accomplish this, underwriting serves additional purposes:

- Guarding against adverse selection
- Ensuring adequate policyholders' surplus
- Enforcing underwriting guidelines

Line underwriters are primarily responsible for making day-to-day risk selection decisions. Staff underwriters assist underwriting management with making and implementing underwriting policy.

The underwriting process is a series of steps with related tasks applied to determine what submissions will be insured and for what amount of insurance, at what price, and under what conditions. The underwriting process consists of six decision-making steps:

- Evaluate the submission
- Develop underwriting alternatives
- Select an underwriting alternative
- Determine an appropriate premium
- Implement the underwriting decision
- Monitor the underwriting decision

Insurers calculate premium by determining the insured's rate classification from a rate manual and multiplying the rate by the number of exposure units. Exposure units are based on the type of coverage and, for commercial insureds, the type of business. Various factors can either increase or decrease the standard rate for a particular insured.

An insurer's underwriting management has many responsibilities:

- Participating in the insurer's overall management
- Arranging reinsurance
- Delegating underwriting authority
- Developing and enforcing underwriting guidelines
- Monitoring underwriting results

In the interest of protecting the public, every state regulates insurers' underwriting activities by prohibiting unfair discrimination. In addition, most states require that insurers provide notification to the insured within a specified period before a policy can be canceled or nonrenewed.

Insurers and independent insurance advisory organizations develop insurance rates through insurance rating systems. Insurance advisory organizations gather historical loss costs from insurers to develop prospective loss costs. Some kinds of insurance are class rated by grouping insureds with similar characteristics into the same rating class to capture potential loss frequency and severity of the group. When an insured cannot be readily assigned to the same class, the insured loss exposure is rated individually.

Insurers add their allowance for their expenses, profits, and contingencies to the basic rate to arrive at the final rate they charge insureds for a particular loss exposure. After the final rate has been calculated, it is multiplied by the number of exposure units to determine the final insurance premium.