# INSIDE P&C INSURANCE™

Part of the
Inside Financial Services Curriculum
developed by:

Performance Solutions International

# Course Introduction

This course is designed for professionals serving the property & casualty insurance industry, and it will provide you with a fundamental understanding of the P&C insurance industry and your clients. Upon completing this course, you will be able to:

- Explain customer needs met by financial institutions
- Identify different types of P&C insurance providers and other financial institutions
- Describe products and services offered by P&C insurance companies
- Discuss customer delivery channels used by P&C insurance companies
- Recognize risks facing P&C insurance companies and techniques used to manage these risks
- Understand how P&C insurance companies make money
- Identify key industry regulators
- Use additional sources of industry information

This fundamental understanding will help you identify opportunities and position your company's solutions within the context of your account's own business challenges and pressures.

We also encourage you to use this program as an ongoing reference guide after you have completed the initial course.

## Course Structure

This program contains seven units in addition to this introduction:

- Customer needs
- Providers
- Products and services
- Delivery channels
- Risk management
- Making money
- Industry Challenges

# CUSTOMERS

P&C insurance companies typically organize their customers into:

- Personal customers, which includes individuals and families
- Commercial customers, which includes businesses, other financial institutions and other organizations

## Customer Needs and Values

P&C insurance protects personal and commercial customers from financial losses associated with:

- Property damage or loss to physical property - Property includes buildings and contents, automobiles, boats etc. Property damage or loss can be caused by:
  - Fire
  - Theft
  - Natural disasters (earthquakes, floods, etc.)
  - Automobile collisions
- Insurance covering these losses is referred to as property insurance.
- Financial liability for damaging someone else's property - Examples of **financial liability** for damaging someone else's property include:
  - Damaging someone else's automobile in a collision
  - Causing property damage because of a faulty product
- Insurance covering these losses is referred to as casualty insurance.
- Financial liability for causing injury or death to another person - Examples of **financial liability** for causing injury or death to another person include:
  - Medical negligence from a doctor
  - Injuries caused by the customer's products
  - Injury because of the customer's automobile
- Insurance covering these losses is referred to as liability insurance.

While protecting against financial loss meets the basic need of customers, what customers' value in choosing a P&C insurance company varies. The value factors typically evaluated by customers include:

- Price
- Professional advice
  - Large corporations often self-insure many of their own risks, but turn to insurance companies and brokers to **help them insure complicated or new risks**.
  - Small business owners often rely on brokers to identify and evaluate various insurance options.
- Product innovation

- As technology, business and society changes, the need for **new and special forms of insurance** is created. In many cases, technology and other advances cannot be realized without insurance (e.g., companies cannot afford the risk of launching satellites without insurance to cover potential property and liability losses).

- Technology
  - Leading edge insurance providers are using the Internet to provide customers with real-time tracking of claim information. Providers are also using the Internet to link to agents, allowing agents to provide customers with real-time quotes and faster underwriting decisions.
- Financial strength
  - Over the past few years, there has been a movement by customers from less stable insurance companies to more **financially sound companies** (referred to as a "flight to quality").

## Understanding Your Clients

As you learned in this section, general insurance customers are very diverse and have a variety of needs. The first step to understanding your client's strategy and business objectives is to understand its customer base.

- Who are its primary customers?
- What do these customers need or want?
- How does your client try to meet the needs of these customers?

# PROVIDERS

There are many different types of organizations providing P&C insurance services, including:

- P&C insurance companies
- Reinsurance companies
- Captive insurance companies
- Self-insurers
- Brokers
- Insurance exchanges
- Residual markets

## P&C Insurance Companies

P&C insurance companies are the primary providers of property, casualty and liability insurance. P&C insurance companies can be can be structured as either:

- Stock companies
  - **Stock companies** are owned by shareholders, like any other public corporation. In some cases, stock insurance companies are completely owned by a single company (i.e., the insurance company is a subsidiary of another company).
- Mutual companies
  - **Mutual companies** are owned by policyholders who share in any profits generated by the insurer. Mutual companies often issue **participating contracts** that entitle policyholders to policy dividends when the insurer earns a profit.

Some P&C insurance companies are part of **mixed insurance groups** that offer both life and P&C.

P&C insurance companies are typically organized along three lines of business:

- Personal lines
  - The **Personal Lines** group provides P&C insurance to individuals, primarily focused on domestic customers.
- Commercial lines
  - The **Commercial Lines** group offers products and services to companies and organizations, and is typically global in its reach (for large P&C insurers).
- Special risks
  - The **Special Risks** group offers specialized products and services to companies and organizations (e.g., directors' and officers' liability insurance, medical malpractice insurance), and is typically global in its reach (for large P&C insurers).

Many P&C insurance companies also offer consulting and risk management services. These services are based on a P&C insurance company's experience and knowledge in controlling and reducing losses. These services are offered (for a fee) to companies to help them reduce their own losses and improve employee safety.

Today the largest P&C insurance companies in the US include State Farm, Allstate and Travelers.

## Reinsurance Companies

Reinsurance companies do not offer products and services directly to consumers. Instead, reinsurers offer reinsurance to insurance companies and other reinsurance companies.

Insurance companies, referred to as direct writing companies or **direct writers**, obtain reinsurance as a way of passing on (or "laying off") a portion of the risk they assumed when issuing (or "writing") policies. In other words, the reinsurer agrees to accept a portion of the direct writer's risk in return for reinsurance premiums paid by the direct writer.

You can think of reinsurance as insurance for insurance companies. Since reinsurance spreads risk among multiple insurance and reinsurance companies, reinsurers play a vital role in the industry. Most direct writers have specific policies and procedures in place regarding the use of reinsurance and consider it an important tool in managing risk.

Reinsurance is a global business, with most activity occurring in the US, Bermuda, London, Germany, Switzerland and France.

The largest reinsurers today are Munich Re, Swiss Re, Gen Re (a subsidiary of Berkshire Hathway) and Hannover Re.

## Captive Insurance Companies

Captive insurance companies (commonly referred to as "captives") are closely privately held insurance companies, owned primarily by corporations to insure their own risks. Captives may also be formed to provide insurance exclusively to the members or customers of the controlling corporate or organizational entity (e.g., a professional association).

Examples of captives include:

- A manufacturing company that forms a captive to insure all of its property and equipment against damage and/or loss
- A pharmaceutical company forming a captive to insure against product liability claims

In Bermuda, a major center for captive insurance companies, there are two types of captive insurance companies:

- Class 1 captives

- The most common, known as **Class 1 captives**, are single parent captives that insure only the risks of the parent company and its affiliates.

- Class 2 captives
  - **Class 2 captives** (which are growing in popularity) may have either a single owner or multiple owners. In addition to insuring the risks of the owners, these captives may derive up to 20% of net premiums written from unrelated risks. This allows these captives to diversify their risk through the inclusion of other types of risk in their portfolios.

An important part of the Bermuda insurance market is the management and operation of these captive insurance companies on behalf of their owners by specialty management firms, some of who are subsidiaries of large international insurance brokers.

## Self-Insurers

Companies or independent groups of individuals may decide to cover their own losses under a self-insurance structure. With this type of structure, the company or group establishes a fund that is sufficient to cover any property, casualty or liability losses that might occur to the company or members. The company or group adds to the self-insurance fund as needed to ensure it is large enough to cover potential losses.

Some self-insurers assume the entire risk of financial loss. Other self-insurers only cover losses up to a certain amount on each occurrence and purchase insurance (or reinsurance) to cover any amounts above this established threshold. This approach allows the self-insurer to obtain a higher level of coverage at a lower cost.

**Risk retention groups** are a form of self-insurance. They are created by groups of companies or individuals within the same profession or business. These groups are allowed by law to join together to insure their own risks through a pooling of resources. This structure allows members to receive a favorable income tax treatment on their contributions to the pool and the related loss reserves that must be set aside to pay future claims. Risk retention groups are used primarily to provide coverage for product liability and property and casualty losses.

## Brokers

Insurance brokers put the buyers and sellers of insurance together. Since the customers in the insurance industry are confronted with a complex product offering and a multitude of providers, they typically need guidance in selecting the right product and the right company. Insurance brokers fulfill this need by using their specialized knowledge of the industry to advise customers on their purchase of insurance.

Brokers in the P&C insurance industry solicit business from clients by selling their advisory capabilities and their knowledge of risk management. Brokers act on behalf of clients and do not function as agents for any insurance company. This maintains their independence, placing them in a better position to advise the customers appropriately and to negotiate the best terms for the customer.

However, this also creates a degree of tension between the brokers and the insurance companies, who must work together to provide insurance coverage to customers. Competition between the broker and the underwriter in setting terms, acceptable risk levels and rates can cause this tension.

Although a one-person entrepreneur with the proper credentials can act as a broker, large multinational brokerage companies are an important part of the P&C insurance industry.

These companies (including Marsh, Aon and Willis) provide a wide range of services to their corporate customers, including:

- Placing risks with insurance companies
- Providing risk management advice
- Assisting clients in the establishment and management of self-insurance and captive operations, including administration, information and record keeping and fund management
- Business consulting for specialized areas

## Insurance Exchanges

Similar to other types of exchanges, an insurance exchange functions as a centralized point from which insurance and reinsurance contracts are sold. Insurance exchanges can be structured in two ways.

One type of exchange operates through an "attorney in fact" structure. This central structure is responsible for the day-to-day running of the exchange, which includes setting rates and adjusting losses among members. The profit and losses of the exchange are distributed among the members in direct proportion to the amount of insurance each member purchases from the exchange.

In the second type of exchange, the exchange brings underwriters and brokers together to negotiate insurance and reinsurance contracts. An example of this type of structure is Lloyd's of London. Follow this link to see more information on Lloyd's of London.

## Lloyd's of London

Lloyd's origins date back to the 17$^{th}$ century when merchants, ship captains and wealthy individuals would meet in London (in Edward Lloyd's coffee house) to share shipping information and insure ships and their cargoes. Wealthy individuals provided insurance to the ship captains and merchants by signing their names on the bottom of a piece of paper (leading to the term "underwriting) describing the risk, the coverage and the amount each individual was willing to assume.

Over time, Lloyd's evolved into an insurance exchange specializing in marine insurance and became a competitive market where individual underwriters accepted risk on behalf of various syndicates. Wealthy individuals (known as "Names"), who were able to meet personal wealth thresholds established by the exchange, financed these syndicates and provided the security behind Lloyd's policies. Under the structure of the exchange, individual underwriters were not responsible for the assumed risk or loss of any other underwriter. However, to provide additional security backing to all Lloyd's policies, all underwriters in the Lloyd's market contributed to a Central Fund, from which policyholders' claims were paid if any Lloyd's member was unable to meet an underwriting commitment.

This system worked relatively well until the late 1980's when some Lloyd's syndicates experienced significantly higher losses than ever before. Many Names were financially ruined, and Lloyd's had to make significant changes in the way the business of the exchange was conducted. Specifically, Lloyd's:

- Established an independent reinsurance company (Equitas) to reinsure the liabilities of the Lloyd's syndicates
- Changed the membership structure, which is now a mix of investment institutions, international insurance companies and specialist insurance investors, which include some individual Names
- Required that corporate members deposit a minimum amount of capital as Funds at Lloyd's (FAL) to provide additional capital backing to Lloyd's policies.
- Created a separate legal entity, the Corporation of Lloyd's, to provide operational support and services, such as managing accounting and claims data.
- Required that all premiums be paid into a restricted use trust fund held by the managing agent of a syndicate
- This fund is used to pay underwriting expenses and to meet policyholder claims

Another aspect of the restructuring of the Lloyd's exchange was the establishment of three distinct types of agents. **Managing agents** continue to be responsible for running the Lloyd's syndicates. **Lloyd's agents** provide worldwide shipping information and assist underwriters in the settlement of claims. Acting as a link between members and their syndicates, **member agents** advise individual members on underwriting commitments.

Today, Lloyd's is a global insurance exchange for more than marine insurance. It is a major market for:

- Aviation insurance, which includes coverage for physical damage and liability, business and war risks
- Motor insurance covering standard and high-value vehicles, as well as non-standard risks
- Non-marine insurance, including all other risks from natural disasters, fire, theft, product liability and professional negligence
- Some larger and more unusual risks, such as certain war risks and the risks associated with satellites, which are typically unattractive to most P&C insurance companies

## Residual Markets

In the US almost every state has established special markets (known as residual markets, shared markets or involuntary markets) to provide insurance coverage to high-risk individuals who cannot qualify for insurance from insurance companies. Depending upon the individual state, these residual markets provide automobile insurance, homeowners insurance, workers' compensation and/or medical malpractice insurance.

Although individuals insured through these markets pay higher premiums than directly insured customers, the premiums are not sufficient to cover the entire risk (plus expenses). To make up the shortfall, states require P&C insurance companies writing the same type of coverage in their state on a direct basis to contribute to the insurance fund. The amount of funding required of any one insurance company is based on the type of insurance involved and is typically in proportion to the overall amount of that type of business written in the state by the insurance company.

Many insurance companies have chosen to exit certain types of business or have refused to write additional business in these areas as a result of these state requirements. To encourage insurance companies to participate in these residual markets, several groups and/or alternative approaches have been created:

- Insurance pools
  - **Insurance pools** act as insurance companies by providing a particular type of insurance and administering that insurance.
- Joint Underwriters Associations (JUAs)
  - **Joint Underwriters Associations**, which have been established by statute, require all insurance companies providing similar insurance to participate in the cost of coverage for high-risk customers.
- Market Assistance Plans (MAPs)
  - **Market Assistance Plans** attempt to distribute the cost of these residual market plans by establishing voluntary, temporary groups of insurance companies that agree to take a portion of this business on a rotating basis.

## Understanding Your Clients

You can apply the information covered in this section to better understand the client(s) you serve. You should consider the following questions:

- What type of financial institution is your client?
- Who do they consider their primary competitors in P&C insurance?

# PRODUCTS AND SERVICES

Almost every individual and organization needs some form of P&C insurance. Consequently, the range of P&C insurance products is as broad as the client base served by this segment. P&C insurance policies range from broad coverage designed to cover many types of risks to policies written to cover very specific risks.

P&C insurance products are typically organized into:

- Personal line products
- Commercial line products

Most P&C insurance providers write policies for both personal and commercial lines, although they may not offer all of the products available and may often specialize in one of these lines. In addition, there are monoline companies that offer products in only one line of business.

In addition, reinsurance and alternative risk transfer products play an important role in P&C insurance.

However, to understand the different types of P&C insurance offered, you must first understand the key product characteristics of P&C insurance.

## Product Characteristics

While the scope of P&C insurance products is broad, they all contain the following basic characteristics:

- For a risk to be insurable, there must be a potential economic loss that is measurable and could affect large numbers of customers with similar exposures
  - Unlike the life insurance business, the events that cause exposure to property loss or liability are unexpected. For example, it is very difficult to predict when, where and to what extent the next hurricane will occur, let alone trying to predict the losses that will be realized. P&C insurance companies apply probability tools based on the law of large numbers and statistical modeling in an attempt to forecast (within a reasonable degree of accuracy) the possibility of such events occurring and to quantify the amount of the resulting losses.
- Policies are usually written for one year
  - P&C insurance policies are usually written for one year with the payment (premium) for the policy being paid in full at the beginning of the policy year. However, to offer clients additional payment flexibility, many P&C insurance providers offer installment plans for the payment of premiums. These policies are typically renewable on an annual basis at the sole discretion of the company providing the policy.
- Generally, the payment for insured losses is made to the party that suffered the loss

- Property insurance is known as first party coverage because the insured suffers the loss and therefore receives the claim payment. Since someone other than the insured suffers the loss and receives payment in the case of casualty and liability insurance, these lines are referred to as third party coverage. P&C insurance companies also typically cover the costs of being sued for damages related to a casualty or liability insurance claim.

- Claims are settled by providing a cash payment or by replacing or repairing the damaged property
  - When a claim occurs, insurance providers may settle the claim by providing a cash payment or by replacing or repairing the damaged property. No matter how the claim is settled, the amount of coverage will depend on the way in which the policy was written.
  - If a policy is written on an actual cash value basis, the amount of the settlement will take into account the depreciation on the property due to wear and tear and obsolescence.
  - A policy written on the basis of replacement cost reimburses the insured for the current cost of replacing the damaged property. Since the replacement cost of damaged property is typically higher than the depreciated value, replacement cost policies will have a higher premium rate than an equivalent policy written on an actual cash value basis.
- Liability policies usually have maximum policy limits
  - In addition to maximum policy benefits specific in the policy, liability policies also include deductibles representing the portion of a claim to be paid by the customer.

## Personal Lines

The line of products offered to individual customers is referred to as an insurer’s personal lines business. These products include:

- Homeowners’ insurance
- Automobile insurance
- Other personal insurance

## Homeowners’ Insurance

Homeowners’ insurance is written as a single policy that covers a broad range of risks associated with personal property. These policies protect individuals and families from losses incurred as a result of personal property that is destroyed, damaged or stolen. The losses that are typically covered occur as a result of various events (known as **perils**), such as:

- Fire
- Windstorms
- Vandalism
- Theft or mysterious disappearance of personal property

- Water damage from broken or frozen pipes

Floods, earthquakes and other natural disasters can also result in losses. Policyholders can cover these risks at an additional cost by having a specific clause, known as a **rider** or **endorsement**, added to a policy. Most homeowners' policies only cover high value items, such as jewelry, art and computers, on a limited basis. To provide additional coverage for these items, customers can obtain a separate personal articles policy linked to their homeowners' insurance.

Another aspect of homeowners' insurance is personal liability coverage, which is often included up to a specific limit under the general terms of the policy. Lawsuit defense and medical costs are included in the coverage. Separate policies, often known as **umbrella policies**, can be obtained to increase the amount of personal liability coverage.

Policyholders pay a premium that covers all of the exposures stated in the policy. This premium is an all-in-rate that cannot typically be broken down on the basis of each type of risk insured. The amount of coverage for each type of exposure, dwelling, contents, medical expenses and liability, is stipulated on the policy schedule. In some instances, various events of loss may be subject to a deductible that requires the policyholder to pay the amount of the deductible on a related loss before the insurance company pays any additional amounts.

Homeowner policies do not typically cover business property or business liability for individuals who work at home. In most instances, a rider can be added to the homeowners' policy to cover this risk. Since the number of people working at home has grown rapidly in recent years, specially designed policies are now being offered to home-based businesses.

Although the majority of homeowners' policies are issued to owner occupants of residences, there are other specialized types of homeowners' insurance that cover non-owner occupied dwellings, renters and owners of condominiums, townhouses or cooperatives.

## Automobile Insurance

Automobile insurance provides coverage of property and liability losses associated with motor vehicles. These policies primarily cover personally owned cars, small trucks and vans. Coverage of special purpose vehicles (such as antique cars) usually requires a special insurance form or a specific rider to the normal automobile insurance policies.

Typical automobile insurance policies:

- Cover several individuals
  Automobile insurance policies typically cover:
  - The person named in the policy (the insured)
  - Any other driver resident in the insured's household
  - Any person who uses the insured's owned vehicle with the insured's permission
- Include specific policy limits for the exposures covered

- The **exposures covered** include damage to the vehicle, theft of the vehicle, physical damage to the property of others (including vehicles) and bodily injury to the insured, passengers in the insured's vehicle, other drivers and their passengers.

Most states in the US have established automobile insurance as a mandatory form of coverage that must, at a minimum, cover liability losses. In an effort to avoid the high costs of litigation and the resulting increases in premiums, some states have adopted **no-fault** insurance. This type of automobile insurance covers the damages to both parties without determining who caused the accident.

In addition to automobile insurance, many P&C insurance companies offer similar insurance for motorcycles, boats and other vehicles.

## Other Personal Insurance

Other personal property and liability insurance, which is offered to supplement the basic forms of homeowners' and automobile insurance, includes:

- Personal articles floaters
  - **Personal articles floaters** cover an insured's high value items that are not covered by a basic homeowners' policy.
- Personal property floaters
  - **Personal property floaters** cover additional property owned by an insured or members of the insured's household that are not covered in a basic homeowners' policy.
- Personal excess liability policies
  - **Personal excess liability policies** provide liability coverage in excess of a customer's homeowners and automobile policy limits. This relatively inexpensive coverage may also be used to include liabilities not protected in the basic policies.
- Flood insurance
  - **Flood insurance** covers the damage and clean-up expenses caused by natural flooding. While P&C companies offer flood insurance to their customers, coverage is actually provided (and premium rates set) by the US government through its National Flood Insurance Program. The insurance company receives a service fee.
- Special personal policies
  - **Special personal policies** are used to cover damage and liability for watercraft and recreational vehicles, mobile homes, private passenger aircraft, and sail and motorboats.

In some areas, insurance to cover the damage and liability caused by earthquakes can be obtained. However, like flood insurance, this is a very expensive policy for those living in areas where earthquakes are known to occur.

Credit insurance is another product offer by many P&C insurance companies. It covers an insured's debt (primarily in the form of mortgages and credit card debt) in the event that the insured is unable to work as a result of sickness, injury, unemployment or death.

## Commercial Lines

The line of products offered to businesses and other organizations is referred to as an insurer's commercial lines business. These products include:

- Commercial property insurance
- Commercial liability insurance
- Marine, aviation and transportation insurance
- Other commercial insurance

## Commercial Property Insurance

Commercial property insurance covers the risk of loss due to damage or liability from perils such as fire, theft, floods and breakage. In addition, because business or other entities can suffer a loss of business or an interruption of services when one of these events occurs, commercial insurance also covers these associated losses.

Standard policies are often used in writing commercial property insurance. However, these policies must often be changed to reflect the inherent hazards or risks in a specific type of business, such as a manufacturing process that produces toxic waste.

The different types of commercial property insurance are:

- Fire and allied insurance
  - **Fire and allied insurance** is a standard form of insurance that protects businesses and other commercial entities from losses arising from:

    Damage to buildings and their contents (property damage)

    Business interruption
- Specialty fire and allied insurance
  - **Specialty fire and allied insurance** provides coverage to organizations that are not protected by standard fire and allied insurance policies, such as:

    Farms

    Public and institutional properties

    Gas stations and refineries
- Business interruption coverage
  - **Business interruption coverage** protects businesses from a loss of income due to physical damage to or the loss of use of their real property. Income losses can occur from an inability to generate revenue (e.g., a store closed from a fire) or an increase in costs (moving an operations center after an earthquake).
- Pecuniary loss insurance
  - **Pecuniary loss insurance** protects businesses from losses resulting from uncollected accounts receivable. These policies specifically define the type of receivable covered. An example of using pecuniary loss insurance is a bank that insures a portion of the credit card debt outstanding on their books.

- Crime insurance
  - A broad range of losses that can occur as a result of a burglary or robbery is covered by **crime insurance**. These policies not only cover the loss of money, securities and merchandise, but also the losses that can occur from forgeries and the unknowing acceptance of counterfeit money.
- Ocean marine insurance
  - **Ocean marine insurance** covers losses to commercial goods while in transit over water, including both oceans and inland waterways. Any exposures that occur when a vessel is in port or dry dock for construction or repair are also covered. These policies also provide some liability coverage for ship collisions.
- Inland marine insurance
  - **Inland marine insurance** covers losses to any moveable property and is not limited to the transport of goods by water. Inland marine insurance covers:

    Household furnishings being moved by a professional mover

    Commercial and personal property in commercial storage facilities
- Fidelity insurance
  - **Fidelity insurance**, issued in the form of a fidelity or surety bond, protects businesses against losses resulting from employee dishonesty, such as theft or embezzlement. Given the nature of their business, financial institutions are among the primary purchasers of fidelity insurance.

## Commercial Liability Insurance

Commercial liability insurance protects business entities from the financial losses caused by any injuries, deaths or property damage to others that occurs in the process of conducting business. The various types of commercial liability insurance are:

- General liability insurance
  - Property damage or injury to others that occurs on the insured's premises or in the course of conducting operations is covered by **general liability insurance**.
  - The most common general liability coverage includes negligence and strict liability (i.e., when the insured exposes others to an unreasonable risk of harm).
- Commercial umbrella insurance
  - **Commercial umbrella insurance** provides additional coverage beyond the limits of the insured's general liability and motor vehicle insurance. This is also referred to as **excess liability insurance**.
- Product liability insurance
  - **Product liability insurance** protects a business against losses from property damage or injury or death caused by its products. This is a rapidly growing area for many insurers.
- Contractual liability insurance
  - When a business decides to assume the contractual liability of others, they may obtain **contractual liability insurance** to protect against any claims related to these contracts.

- Workers’ compensation
  - **Workers’ compensation** is required in most states for the payment of compensation to employees for injuries resulting from their employment. No suit is necessary and negligence does not have to be proved. Workers' comp laws differ from state to state, and the actual coverage in each plan varies with state law.
- Motor vehicle insurance
  - **Motor vehicle insurance** provides the same type of coverage for property damage and personal injury caused by the operation of vehicles as is provided in personal automobile insurance. The basic difference here is that the vehicles covered by these policies are owned by the commercial entity and not by individuals.
- Professional liability insurance
  - Also known as malpractice insurance, **professional liability insurance** covers the liability of a practitioner of a specific profession (law, medicine, etc.) for damages, injuries or death caused by the improper practice of their profession. If a suit for damages occurs, the insurance will bear the cost of any necessary legal defense.
- Directors’ and officers’ liability insurance (D&O)
  - **Directors' and officers' liability insurance** provides individuals within a company with protection from personal liability and financial loss arising out of acts committed in their capacity as corporate officers and/or directors.
- Errors and omissions insurance (E&O)
  - The losses to others caused by an error or unintentional omission by the insured and/or the insured’s employee can be covered by **errors and omissions insurance**. E&O insurance is commonly used by doctors (i.e., **medical malpractice insurance**), lawyers, accountants, architects and engineers.
- Aviation liability insurance
  - **Aviation liability insurance** protects companies from losses arising from aircraft owned by the company, including bodily injury or property damage.
- Surety bonds
  - Independent contractors and construction companies are often required to pay the contracting party if the terms of a contract are not met. To assure they can make this payment, a **surety bond** is bought, ensuring that the monetary compensation will be available if there is a failure to perform under the terms of the contract.

## Marine, Aviation and Transportation Insurance

An important part of international trading for centuries, the marine insurance market centered in London was the first organized coinsurance market. The coinsurance aspect of the market was based on several individual insurers taking a portion of the risk associated with large ships and their cargoes facing the dangers of the sea. This structure allowed insurers to reduce their exposure to any one ship by taking a small share of the risk for each ship setting out on the high seas.

Today, to accommodate the increase in world trade and travel, ships and planes are larger, carrying more people and more cargo than ever before. These methods of transport need to be insured against:

- Damage or loss to the vessel (i.e., **hull insurance**)
- The goods being transported (i.e., **cargo insurance**)
- Injury or loss of life to individuals traveling on ships and planes (i.e., **liability insurance**)

This area of commercial insurance is referred to as marine, aviation and transport (or MAT) insurance.

The marine and aviation transport industry continues to change at a rapid rate. Faster cargo handling techniques, greater cargo values, the just-in-time filling of cargo holds, transshipments and ship re-routing are just some of the developments that are challenging insurers to create new products and processes to cover the risks associated with these changes in the transport of goods and people.

## Other Commercial Insurance

Beyond property, liability and MAT insurance, other types of commercial P&C insurance are offered to cover additional commercial risks, including:

- Property-related insurance
  - Property-related insurance includes **title insurance** (which protects against loss from a defective title to real property), **boilers and machinery coverage** (for equipment that generates energy) and **earthquake coverage**.
- Agricultural insurance
  - Agricultural insurance includes **livestock insurance** (which covers the death of horses and cattle from natural or accidental causes) and **crop hail insurance** (which covers damage to crops).
- Specialized insurance
  - Examples of specialized insurance include **excess or special risks coverage**, **accident and sickness insurance** (usually in the form of short term disability income insurance) and **mortgage and financial guarantees** to cover loan defaults.

## Reinsurance

The terminology used in the reinsurance business is quite specific to each segment of the industry. However, in general:

- Selling risk to a reinsurer is referred to as **ceding** risk
- The company selling risk to a reinsurer if often referred to as the **ceding company** or **cedant**
- The agreement under which these risks are purchased is known as a **reinsurance treaty**
- The reinsurance company receives a fee (the reinsurance **premium**) as compensation for the transfer of the insured risk (known as a **cession**)
- Some reinsurance agreements include additional compensation arrangements, such as:

- **Ceding commissions**, which are commissions paid by reinsurance companies to ceding companies for placing the business with the reinsurer and to cover the ceding company's acquisition costs
- **Profit sharing**, in which the two parties agree to a formula for calculating and sharing profit
- **Return commissions**, in which ceding companies are required to compensate the reinsurer for a portion of the losses exceeding a certain amount

- The amount of insurance coverage retained by the **direct writer** (i.e., the insurance company underwriting the original insurance policies) is called the **retention**

A reinsurance company may then cede further portions of this risk to other reinsurance companies. As such, reinsurance companies provide a useful service in distributing or diversifying any given risk or pool of risks among several different insurance companies.

Consequently, the reinsurance market is a useful risk management tool for P&C insurance companies, which typically have clearly defined levels of risk that they are willing to maintain. By being able to distribute (sell) this risk to reinsurance companies, P&C insurance companies are able to continue to write policies while managing the level of risk they hold.

## Types of Reinsurance

In general, there are four different types of reinsurance:

- Facultative reinsurance
  - With **facultative reinsurance** the direct writer offers all or part of the risk to a reinsurer, and they negotiate the specific premiums and retention before the direct writer writes the policy with its customer. The legal liability to the insured remains with the direct writer.
- Automatic reinsurance
  - **Automatic reinsurance** is when a reinsurance company agrees in advance to accept a portion of a direct writer's business, as long as it meets pre-established underwriting parameters, including risk evaluation and pricing. The legal liability to the insured remains with the direct writer.
- Retrocession
  - **Retrocession** occurs when a reinsurer cedes a portion of risk already purchased to another reinsurance company. The legal liability to the insured remains with the direct writer.
- Assumption reinsurance
  - **Assumption reinsurance** allows a direct writer to exit a line or class of business by transferring all risk and legal liability to another insurance company that deals directly with customers. The ceding company and the assuming company enter into an agreement that details the value of the business and the transfer of reserves to cover future liabilities (e.g., claims).

## Reinsurance Structures

There are several different structures that can be used when entering into reinsurance treaties. Decisions as to which structure to use are made by the top management of the direct writer (including the Chief Financial Officer, the Chief Underwriter and the Chief Actuary) and will be based on the company's overall strategy and business outlook. The different structures of reinsurance are:

- Proportional reinsurance
  - **Proportional reinsurance** is a sharing of a percentage of the total risk (and premiums) between the direct writer and the reinsurer. The term proportional reinsurance (or pro-rata reinsurance) is common in the P&C insurance industry. In life insurance, this type of reinsurance is more commonly called **quota share reinsurance** or **coinsurance**.
- Non-proportional reinsurance
  - With **non-proportional reinsurance** (also known as **excess reinsurance**), the reinsurer indemnifies (covers) the direct writer for any claim amounts in excess of a predetermined limit. This type of reinsurance is commonly used to protect the direct writer against large losses associated with natural catastrophes (e.g., earthquakes).
- Stop loss reinsurance
  - **Stop loss reinsurance** (or **aggregate excess of loss reinsurance**) treaties establish the direct writer's total loss exposure at a specific amount. When this amount is reached, the reinsurer becomes liable for all future claims payments. This structure allows insurance companies to set a maximum level of exposure.
- Experience rated reinsurance
  - With **experience rated reinsurance**, reinsurance fees and commissions are adjusted over time based on the actual loss experience of the business.

## Alternative Risk Transfer

Alternative risk transfer (ART) is a term used to describe the financing of risk through means other than the conventional insurance market. Depending on how the term is used (and who is using it), ART can include:

- Captives and self-insurance
  - **Captives** and **self-insurance** are an "alternative" to insurance provided by insurance companies. ART solutions involving self-insurance usually include insurance or reinsurance policies to handle losses above a certain level.
- Certain forms of reinsurance
  - **Finite risk reinsurance** contracts include:

    Multiple years of coverage (most P&C insurance and reinsurance policies only provide coverage for a year)

    Coverage of multiple risks

    Profit sharing in which profits may be shared with the buyer
- Insurance risk securitization

- With **insurance risk securitization**, a portfolio of insurance contracts is packaged together and sold as securities to capital market investors. The most common type of risk securitization are bonds associated with insurance policies used to protect against natural catastrophes (referred to as catastrophe bonds or **cat bonds**).

- Contingent capital
  - **Contingent capital** are agreements by insurance companies or investors to provide the issuer with capital if a certain event (or condition) occurs, such as a hurricane.
- Custom derivatives
  - An example of a **custom derivative** is a weather derivative. Weather derivatives allow buyers to hedge against the impact on profitability caused by unusual weather conditions.
- Structured finance
  - **Structured finance** solutions include a number of different, interwoven financing sources, including equity and/or debit issuance, asset securitization, project financing, derivatives and/or commercial insurance

ART solutions are highly customized and often address not only insurance risks, but also financial risks (e.g., currency risk, interest rate risk). They are provided by insurers, reinsurers, banks and investment banks, accelerating the convergence between corporate financial services and commercial insurance.

ART activity has been growing in recent years for a number of reasons:

- Direct writers and corporations are looking for ways to reduce costs associated with managing insurance and financial risks
- Buyers want to lock in multi-year rates
- Businesses have become more aware of risk management needs and are taking a more enterprise-wide view of their risks
- Direct writers are under pressure from investors to “smooth out” results (i.e., reduce volatility in earnings from one year to another)

New ART solutions are expected to continue as advances in computing power and complex model building allow providers to quantify an expanding list of risks.

## Understanding Your Clients

You can apply the information covered in this section to better understand the client(s) you serve. You should consider the following questions:

- What personal insurance products and services does your client offer?
- What commercial insurance products and services does your client offer?
- Is your client active in reinsurance?

# Delivery Channels

P&C insurance is sold through a number of different delivery channels, including:

- Dedicated agents
- Independent agents and brokers
- Direct sales
- Banks

## Dedicated Agents

Dedicated agents are employees of an insurance company, and only write business for the company that employs them. However, if the company does not provide a specific type of coverage, these agents may be allowed to act as brokers by placing this business with another company.

Agency offices are owned and managed by the company, which bears the full expense of the operations. Agents who work in these agencies are provided with workspace, secretarial and administrative support and IT support (e.g., laptops). These agents participate in company benefit plans, company-sponsored training and sales incentive programs. Their compensation includes a base salary and commissions based on sales volume.

Since these agencies represent fixed costs for the insurance company, productivity must be at a high level to offset the high costs to the company. Increasingly, insurance companies are emphasizing the need to use technology effectively to further enhance productivity.

Despite the higher fixed costs, a large proportion of P&C insurance business is still distributed through dedicated agents. There are several reasons for this:

- The two largest P&C companies (State Farm and Allstate) rely primarily on dedicated agents
- Dedicated agents have expanded their business from primarily personal lines to now include policies for small and middle market businesses
- Premiums from commercial lines (distributed primarily through other channels) have fallen as a percentage of overall premiums, because larger companies have been expanding their captive and self-insurance operations

## Independent Agents and Brokers

**Independent agents** represent and distribute the products of one or more insurance companies on a contract basis. Independent agents also own and control the policy records associated with their customers.

Independent agents that represent one company only for any one product are known as **exclusive agents**. Exclusive agents may have more than one such arrangement and/or represent other insurance companies as long as the products offered do not overlap. This allows exclusive agents to offer the entire range of P&C insurance products since all companies do not underwrite all products. In exchange for this exclusive representation, the company may also give exclusive rights to cover a specific territory to the agent. In an exclusive agent arrangement, control and ownership of the policy records belongs to the insurance company.

**Brokers** act on behalf of the customer seeking insurance. As a result, brokers offer the products and services of multiple companies, but are not affiliated with any one company.

Both independent agents and brokers receive commissions and fees for policies sold and serviced. Independent agents and brokers can be either one-person local operations or international firms with a network of offices. The small local independent agents and brokers tend to write mostly personal line business and commercial line business for small, local firms and organizations. The larger firms tend to focus more on the commercial line business, and also providing consulting and administrative services to captives and self-insurance funds for a fee.

## Direct Sales

Direct sales (also known as **direct marketing** or **direct response**) channels are channels in which an insurance company sells products directly to consumers without the services of an agent or broker. Direct sales channels include mail, telemarketing and the Internet.

Although this is still a relatively small part of the industry, some companies are increasingly using this method for relatively standard products, such as automobile insurance. Foreign insurers are beginning to use direct sales channels as a way to enter domestic markets with very competitive premium rates.

Direct sales is a growing part of the industry, and some companies (e.g., Geico, Progressive) have been very successful using direct sales for relatively standard products.

Direct sale approaches typically include the use of print and broadcast media that offer Internet sites and/or toll-free phone numbers. Initial customer information is gathered at the website or by service representatives at the call center, and any necessary inspections are arranged. Proposals, applications and final policies are mailed to customers for signatures.

## Banks

Banks are a growing distribution channel for insurance products, although their efforts have been focused more on life insurance, which is a natural extension of a bank’s investment management activities. Many banks have purchased independent insurance agencies in an effort to grow this business. Banks are a common distribution method in other countries, where it is usually referred to as **bancassurance**.

While banks are prohibited from underwriting insurance themselves, national banks can be part of financial holding companies. This allows bank holding companies to convert to financial holding companies and acquire or create insurance company subsidiaries to underwrite insurance. However, few banks have done this, preferring to partner with existing insurance companies to distribute their products.

## Understanding Your Clients

You can apply the information covered in this section to better understand the client(s) you serve. You should consider the following questions:

- What are your client's primary distribution channels?
- What is their most important distribution channel?
- How have their distribution channels changed in the past few years?
- How do you think their distribution channels will change in the next few years?

# Risk Management

Since the business of insurance is about accepting and managing risk, understanding the risks insurance companies face is important. These risks include:

- Underwriting risk
- Catastrophe risk
- Operational risk
- Political and regulatory risk

## Underwriting Risk

Underwriting risk is the risk that an insurance company will issue (or **underwrite**) an insurance contract with a premium that is too low for the amount of risk assumed.

To manage underwriting risk, insurers use:

- Risk-selection procedures
- Renewal underwriting
- Reinsurance

## Risk-Selection Procedures

The first step in managing underwriting risk is to identify the insurer's exposure, such as the potential exposure and degree of litigation associated with a liability insurance policy. Errors in building these risk assumptions can have a major impact on the company's results.

In evaluating the risk, the company needs to ensure it avoids:

- Concentration of risk
  - Premium rates are established based on the insurer's ability to spread risk over a large number of customers, thereby reducing the magnitude of the loss as a percentage of the total business written.
  - Without diversification, the insurer may be overexposed to any one event or sector.
- Anti-selection
  - **Anti-selection** (or **adverse selection**) occurs when an applicant for insurance knows more than the insurance company about factors affecting the premium rates or terms of coverage.
  - An example of anti-selection in P&C insurance is a homeowner who does not reveal past water damage to the underwriter.

Underwriters need to weigh the value of information they gather versus the time and cost of gathering that information. If the time period between application submission and underwriting decision is too long, the company may lose a potential customer, particularly when coverage is needed to meet personal, business or contractual obligations. Consequently, insurance companies need to have very specific procedures in place that provide guidelines to the underwriters in dealing with the review of each individual risk.

Once the risk is identified, and the underwriter decides to accept the risk, an appropriate premium is established that is in line with the amount of risk assumed.

The setting of premium rates is a delicate balancing act. Setting rates too low will result in premium levels that are inadequate to pay customer claims. However, setting rates too high makes it difficult for the company to sell its products. Insurance is different than many businesses in that insurers do not know their costs before they determine the price of their product. The largest elements of an insurance company's costs (i.e., claims) can be unpredictable, and they are not known for certain until the end of a policy term. This risk of pricing a product without knowing all of the expenses is often referred to as **pricing risk** or **expense risk**.

Premium rates are often a function of current market conditions. When claim losses are low and competition is high, the result is tremendous pressure on insurers to lower rates. This is known as a **soft market**. When claims are high and some insurers limit new policies to manage their risk, the remaining providers are able to raise rates. This is known as a **hard market**. P&C insurers typically make more money in hard markets.

## Renewal Underwriting

Most P&C insurance policies are renewed on a yearly basis. This allows the underwriter to review the policy each year and provides an opportunity to adjust pricing or cancel coverage.

Pricing is a key aspect of renewal underwriting. Insurers need to balance customer desires for stable pricing against dramatic year-to-year changes in claims paid. Although it may seem a rate reduction is justified if the loss experience has been favorable over the term of the policy, it is always possible the claim trend will reverse. Once that happens, it is very difficult to raise the premium rate to make up for any loss. As a result, most underwriters attempt to maintain an even premium rate over time.

## Reinsurance

Reinsurance allows insurance companies to reduce their exposure by "laying off" some (or all) of the risk to a reinsurer. Direct writers typically set limits on the amount of risk they are willing to accept for a specific product, specific customer group, geographic region etc. Reinsurance is used to cover any excess risk above these levels. These decisions are based on the company's business strategy, regulatory capital requirements, appetite for risk and the availability of reinsurance for the various types of risks or policies.

An effective reinsurance program helps insurance companies in many ways. By selling risks to reinsurers, insurance companies are able to:

- Write more business without increasing their levels of regulatory capital

- Accept risks that might be outside their parameters
- Maintain earnings stability by reducing their exposure to losses in any one area of their business

In addition, insurance companies often use reinsurance when entering new markets or first using innovative policies.

## Catastrophe Risk

Catastrophe risk refers to potential events that result in sudden and severe losses, where large numbers of insureds are simultaneously affected and the claims involve very high monetary amounts. Some examples of catastrophe risk are:

- A nuclear plant accident that impacts the surrounding area
- Extensive injuries caused by an industrial plant explosion
- Loss of life and property due to natural disasters, such as earthquakes
- Severe hurricane that causes extensive property damage

The reinsurance market has traditionally been a source of loss protection for localized catastrophes through excess of loss and stop loss catastrophe coverage. Coverage for natural disasters is a specialized segment of the reinsurance industry and is commonly referred to as **Catastrophe Excess of Loss Cover per Event or CatXL**.

- CatXL is based on the concept of **insurance density**, which refers to the estimate of the proportion of private property insured against natural hazards in a given area. A high density indicates a high level of participation in catastrophe coverage by the insurance industry. Therefore, the measure of insurance density incorporates the:
    - Willingness of a population in a defined area to take risks
    - Government's role in activities related to catastrophe losses
    - Role and degree of insurance company activity in insuring catastrophe losses

**Natural catastrophe risk** can be managed by simply choosing not to write insurance in certain high risk zones, by limiting the level of business in these zones, or avoiding concentration of risk in these zones by writing a large book of business in low risk zones. However, local insurance companies in these high-risk zones may not have these options available to them in the management of catastrophe risk. They may not have alternative business opportunities or they may be required by local governments to provide this type of insurance.

- To manage catastrophe risk, insurance companies can also use sophisticated modeling techniques to make various loss assumptions over long periods of time. Satellite computer mapping of hazard zones, population and property densities can also be incorporated in these models. These models can then be used to project the:
    - Level of exposure that is acceptable to the insurance company
    - Capital that should be allocated to cover losses if reserves are exceeded
    - Amount of reinsurance needed to reduce exposure levels

- Given the specialized nature of risk management in this area, insurance companies often utilize the expertise of a knowledgeable reinsurance company and/or a professional consultant.

## Operational Risk

Operational risk is the risk of direct or indirect financial losses caused by:

- Inadequate internal controls, policies and/or procedures
- Systems failures
- Fraud
- Human error
- External catastrophes

Some examples of operational risk include:

- Transferring premium payments into the wrong account because of a data entry error
- Allowing a hacker to disrupt the company's website
- Inability to process customer transactions because a network is damaged by an earthquake or other natural disaster

In insurance, fraud risk is an important component of operational risk.

## Fraud Risk

Fraud risk is the risk an insurance company will:

- Make an underwriting and/or pricing decision on intentionally incorrect information (i.e., anti-selection)
- Pay money in settlement of a fraudulent claim

Fraud costs insurance companies billions of dollars annually, which results in additional premium costs for customers. Fraud can occur as:

- An unplanned opportunity for an individual to "get rich quick", such as an injury claim from a relatively minor automobile accident
- Organized criminal fraud schemes, often involving arranged accidents and doctors willing to validate injuries when none exist

Insurance companies may manage fraud by merely paying claims and then canceling the policy at renewal. This approach is often justified because of the high costs associated with investigating and contesting a claim.

However, as the magnitude of insurance fraud has grown, insurance companies and local authorities have become increasingly aggressive in their attempts to manage fraud, including:

- Educating customers about the cost of fraud and asking them to report fraud

- Better training of staff in the identification of fraud
- Offering lower settlements when fraud is suspected
- Stricter underwriting and claims investigations
- Improved information sharing among insurance providers on customers and claims in an effort to identify any consistent problems
- Establishing special fraud detection and prevention units that work closely with local law enforcement authorities
- Strengthening enforcement laws and increasing penalties for insurance fraud
- Using claims analysis software to identify and analyze sources of fraud
- Changing policies to require deductibles, coinsurance or indemnity payments when opportunities for fraud are greater

Specialized companies and industry agencies now compile claim information and investigate fraud in close cooperation with special law enforcement units. This information is used by both authorities and insurance companies themselves.

## Political/Regulatory Risk

Political risk and regulatory risk are closely related in that they both address risk associated with governments or government agencies.

**Political risk** (often referred to as **country risk**) is the risk of governmental interference in the operations of private financial institutions. For example, governments have regulated interest rates and insurance premiums in the past. Governments have also decided to delay or stop paying on their bonds (which are often owned by insurance companies).

To manage political risk, most financial institutions with large exposures have an economics and/or political analysis group that closely monitors the ongoing attitudes of governments in other countries.

**Regulatory risk** (sometimes referred to as **legal risk**) includes the risks that:

- A financial institution may violate a law or industry regulation, resulting in fines or damage to the institution's reputation
- Changes in laws or regulations will make an existing activity of the financial institution illegal or non-compliant

To manage this risk, insurance company establish centralized compliance units that report to the highest management levels and have the authority to take both preventive and remedial action in ensuring compliance with regulations.

Regulations that govern the private insurance industry typically relate to:

- Company solvency
- Minimum capital requirements for the establishment and operation of insurance companies

- Licensing and qualifications of insurance agents and intermediaries
- Insurance contract law

Since an insurance policy is a promise to pay in the future if and/or when certain events occur, regulatory authorities want to ensure that insurance companies will be able to fulfill this promise, thereby maintaining the public trust. As a result, solvency requirements are used to establish and maintain minimum levels of capital available to meet these future obligations.

To ensure that policies are understandable to the general public, regulators must review and approve insurance contracts before the product can be offered to the public. In some markets, purchasers of insurance products may also have a period of time after signing to review and reject policies, receiving a full refund for any premiums already paid. Regulatory authorities must also approve product and sales material prior to distribution to the public to ensure that a fair and understandable description of the product is presented.

## Understanding Your Clients

As you learned in this section, risk management is an important part of P&C insurance operations, and requires the careful management of:

- Underwriting risk, to ensure long-term profitability
- Catastrophe risk, to manage exposure due to a large catastrophic event
- Operational risk, to minimize fraud and other losses
- Political and regulatory risk to ensure regulatory compliance

As you go forward, be sure to align your efforts with your clients' risk management needs.

# MAKING MONEY

In P&C insurance, profitability is a function of:

- Underwriting gains
- Investment income
- Other expenses

## Underwriting Gains

A P&C insurer's underwriting gain (or loss) is the profitability (or loss) associated with the company's core insurance activities. It is determined by taking:

- Premiums earned
  - **Premiums earned** are the portion of premiums received from customers that can be recognized as revenue in the reporting period
- Subtracting claims paid
  - **Claims paid** include the costs associated with the investigation and settlement of claims.
- Subtracting underwriting expenses
  - **Underwriting expenses** include:

    Ongoing customer service and administrative expenses

    Employee salaries and compensation

    Marketing costs

    Information technology

Included in underwriting gains are:

- Salvage payments
  - When the insurance company pays for an entire asset as part of a claim, it receives ownership of the property. Any money received for selling this property (i.e., a **salvage payment**) is included in underwriting gains (either as additional revenue or as an offset against claims paid).
- Subrogation
  - In some cases, the insurance company will pay a claim to a customer even though a third party (i.e., not the insurer's customer) was at fault. The insurer will then seek to collect payments from the third party. These payments are **subrogation payments** and are included as an offset against claims paid.

One of management's most important responsibilities is to ensure that sufficient reserves have been established to meet existing and future claims. P&C insurance companies refer to these reserves as **claim reserves** or **loss reserves**.

In measuring their underwriting profitability, P&C insurers use three ratios:

- Loss ratio
  - The **loss ratio** measures underwriting losses divided by premiums earned. Underwriting losses are claims paid to customers, and premiums earned is the amount of premium revenue recognized by the company for the period. For example, if a company had $900 million in underwriting losses and $1 billion in premiums, its loss ratio would be 90%.
- Expense ratio
  - The **expense ratio** measures a company's operating expenses divided by its premiums earned. Operating expenses represent the costs of acquiring, writing and servicing the business.
  - For example, if a company had $80 million in operating expenses and $1 billion in premiums earned for the year, its expense ratio would be 8%.
- Combined ratio
  - The **combined ratio** is the sum of the loss ratio and the expense ratio. For example, a company with a loss ratio of 90% and an expense ratio of 8% would have a combined ratio of 98%. A combined ratio lower than 100% represents a profitable period of business. P&C insurers typically experience combined ratios between 95% and 105%.

## Investment Income

Investment income is generated from dividends, interest and capital gains received from the insurance company's investment activities. From this investment income, investment losses are typically subtracted to generate net investment income.

While not as important for P&C insurance companies as it is for life insurers, investment income is still a significant part of revenue. For example, a company with $1 billion in premium income may experience:

- $920 million in claims (i.e., a loss ratio of 92%)
- $130 million in expenses (i.e., an expense ratio of 13%)
- Resulting in a $50 million underwriting loss (i.e., a combined ratio of 105%)

However, this same company would expect to have investment income around $200 million, giving the company $150 million in profits before other expenses.

## Other Expenses

Most expenses associated with running the business are included in the insurer's underwriting gain (or loss), including:

- Expenses associated with processing claims
- Ongoing customer service and administrative expenses
- Employee salaries and compensation
- Marketing costs
- Information technology

However, there are other expenses not included in underwriting gains because they are not considered a core expense of running the business, including:

- Policyholder dividends paid on participating policies
- Taxes
- Insurance fees

## Understanding Your Clients

You can apply the information covered in this section to better understand the client(s) you serve. Look at your client's annual report from last year, and consider the following:

- What was your client's Loss Ratio?
- What was your client's Expense Ratio?
- What was your client's Combined Ratio?
- How much did their Underwriting Gains change over the past year?
- How much did Premiums Earned change over the past year?
- What does this tell you about your client's business?

# Current Issues

While the current issues or challenges facing each insurance company vary depending upon the company's strategy, customer base and competitive environment, some of the key long-term issues facing the P&C insurance industry today are:

- Cyclical financial performance
- Improving risk management
- Improving efficiency

If you would like to learn more about current issues facing the life insurance industry, please see PSI's Business of General Insurance course.

## Cyclical Financial Performance

Revenues and costs fluctuate year-to-year for P&C insurance companies.

On the revenue side, net investment income is a significant source of revenue for P&C insurance companies. Insurance companies invest primarily in fixed income securities (such as bonds). When interest rates are low, as they are today as central banks around the world attempt to stimulate national economies, insurance companies do not earn as much net investment income as they do when interest rates are high.

Of course, a P&C insurance company's costs also vary dramatically from one year to the next, primarily because of claims associated with natural catastrophes. According to Swiss Re, insured losses associated with natural catastrophes worldwide were around $43 billion in 2010, much more than the $27 billion experienced in 2009. However, catastrophe losses are highly volatile. In general, the long-term trend is towards higher catastrophe losses for insurance companies, caused by increasing wealth, a higher concentration of wealth in loss-prone regions, higher insurance coverage and the higher risk of extreme weather conditions caused by global warming.

## Improving Risk Management

Risk management is an important part of success in P&C insurance.

The P&C insurance industry continues to try to improve risk modeling related to catastrophes, although it is difficult to model. As with any statistical modeling, the accuracy of risk modeling is driven in large part by the accuracy of the data coming into the model. As a result, insurance companies are looking closely at improving their data warehouses and ensuring they've got clean data going into their models to maximize their accuracy.

Beyond catastrophe risk, P&C insurance companies also worry about other large risks that are difficult to predict today. This includes the next generation of risks, which includes potential risks related to areas such as climate change, pandemics and biotechnology.

However, one of the biggest goals in risk management today is to not only improve the way individual risks are managed, but to improve overall risk management through **enterprise risk management**. Enterprise risk management (ERM) is the name commonly given to efforts to integrate all of risk management across an insurance company. These efforts will allow insurers to better understand their overall risk exposures. Rating agencies that rate the financial strength of insurance companies are also beginning to take a closer look at insurance companies' enterprise risk management frameworks.

## Improving Efficiency

Insurers are under increasing pressure to improve efficiency, lower costs and improve customer service. To do this, some insurance companies are:

- Improving their claims processing operations
  - Claims payments and related processing costs account for 70% - 80% of a P&C insurer's costs, and reducing these costs can have a dramatic impact on an insurer's profitability
  - Paying claims more quickly reduces claims payments and enhances customer service by improving customers' claims experience
  - Most claims processing systems in place today are old and have been custom-built
  - In addition, the claims process itself typically involves many manual, redundant processes
- Equipping their claims adjusters (and sales force) with mobile devices
- Building Internet portals to better serve agents, brokers and customers
- Improving underwriting technology (e.g., improving automation to lower costs, implementing knowledge management systems to improve underwriting consistency)
- Upgrading their call centers to improve service
- Replacing (or upgrading) core IT systems (e.g., policy administration) to lower costs and improve time-to-market for new products
- Outsourcing non-core business processes (e.g., facilities management, IT, accounts payable) and even some core business processes (e.g., claims processing)

## Understanding Your Clients

You can apply the information covered in this section to better understand the client(s) you serve. You should consider the following question:

- What are the primary issues and concerns facing your client in its P&C insurance business?

# SUMMARY

Well, you are almost done.

Let's look back on the information you've learned. You learned about:

- P&C insurance customers and their needs
- The types of financial institutions that provide P&C insurance
- The products and services offered by P&C insurance companies, including:
  - Personal lines
  - Commercial lines
  - Reinsurance
- Delivery channels used to sell to and service P&C insurance customers
- The risks involved in P&C insurance, and how financial institutions manage these risks
- The sources of revenue and expense in the P&C insurance business
- The current issues facing the P&C insurance segment of the financial services industry

There was a lot to learn, but P&C insurance is an important part of the financial services industry.