Chapter 5

Underwriting

Educational Objectives

After studying this chapter, you should be able to:

1. Identify and describe the major underwriting activities of insurers. (pp. 5-4 to 5-12)
2. Identify and describe the ways in which insurers protect their available capacity. (pp. 5-6 to 5-7)
3. Describe the following types of insurance rates, and explain which type would be more appropriate in a given situation: (pp. 5-9 to 5-10)
   a. Class rates
   b. Individual rates
4. Explain the role of underwriting management. (pp. 5-12 to 5-15)
5. Identify and describe the steps in the underwriting process that an underwriter follows in making an underwriting decision. (pp. 5-15 to 5-22)
6. Identify and describe sources that underwriters use in making underwriting decisions. (pp. 5-16 to 5-18)
7. Identify and describe four categories of hazards that underwriters must evaluate. (pp. 5-18 to 5-19)
8. Identify and explain the underwriting options an underwriter has in evaluating an application for insurance. (pp. 5-20 to 5-21)
9. Describe ways in which states regulate underwriting activities. (pp. 5-22 to 5-24)
10. Define or describe each of the Key Words and Phrases for this assignment. (All Key Words and Phrases appear in bold print in the text and in boxes in the margins throughout this chapter.)

Chapter 5

Underwriting

Underwriting is the heart of the insurance business. The function of underwriting is to determine who an insurance company's customers will be, what the company's products will be, and at what price those products will be sold. To a large extent, a company's success in achieving its goals depends on the effectiveness of its underwriting.

Underwriting is the process of selecting insureds, pricing coverage, determining insurance policy terms and conditions, and then monitoring the underwriting decisions made.

Insurance companies themselves, rather than their employees, are sometimes referred to as underwriters. However, the term **underwriter** is usually reserved for insurance company employees whose job is to make underwriting decisions for the insurer.

An **underwriter** is an insurance company employee who evaluates applicants for insurance, selects those that are acceptable to the insurer, prices coverage, and determines policy terms and conditions.

A Brief History of Underwriting

In the seventeenth century, English traders and merchants sent ships on hazardous voyages to the New World and the Far East to trade for goods that were in demand in Europe. While the rewards were great, much uncertainty accompanied these endeavors. When merchants or shipowners undertook such ventures, they often obtained a contract of indemnification from independent business people who agreed, in exchange for a fee, to share in the loss if certain perils of the sea destroyed the ship or its cargo.

Seventeenth-century merchants and shipowners gathered at Edward Lloyd's coffeehouse in London to find individuals who would be willing to provide them with a contract of indemnity (an insurance policy). These early "insurers" risked their personal fortunes on their ability to judge the dangers associated with a particular voyage. To enable these potential insurers to evaluate the hazards of a venture, the shipowner described the details of the venture, including the ship and its cargo, the destination, the route to be traveled, and the experience of the captain. If the venture was deemed acceptable, a contract of indemnity was drafted, *under* which each insurer *wrote* his name along with the percentage of the venture he would assume. These individual insurers became known as "underwriters," and each underwriter then collected a fee, known as a premium, from the shipowner in proportion to the percentage of the venture the underwriter assumed.

With their personal fortunes at stake, these early underwriters were not interested in ventures that were likely to fail. They were selective, and they concerned themselves with the history of the shipowners, the captain, the ship, the planned route, the time (season) of the voyage, and the cargo. Through an informal communication network, they monitored the physical, political, and financial condition of various ports and countries around the world. When a problem became known, the underwriters increased their premiums. In the case of a major problem, insurance could become difficult or impossible to obtain because no underwriter was willing to risk his fortune against a likely disaster.

Underwriters' fortunes rose and fell as reports of completed voyages and occasional sinkings and shipwrecks came back to Lloyd's. Some underwriters became wealthy through good luck and good judgment in deciding which ventures to insure. Others, through a combination of bad luck and bad judgment, lost their fortunes.

While people still risk their fortunes at Lloyd's of London today, the insurance industry has become more complex and institutionalized. In most cases, the corporate insurer has replaced the individual insurer. Modern insurers look to their underwriters to perform most aspects of the underwriting function for them. The modern insurance company is similar to the early entrepreneurs at Lloyd's in that its assets increase and decrease according to the soundness of the decisions its underwriters make. The insurer's assets, rather than the underwriter's own funds, are used as a guarantee that covered losses will be paid. Without the insurer's ability to make good on its promise to pay legitimate claims, an insurance policy would be a worthless piece of paper.

Educational Objective 1

Identify and describe the major underwriting activities of insurers.

Underwriting Activities

Underwriting includes the following activities:

- Selecting insureds
- Pricing coverage

- Determining policy terms and conditions
- Monitoring underwriting decisions

The first three activities are not performed in sequence but occur simultaneously. The last, monitoring underwriting decisions, is an ongoing activity. Underwriters attempt to select insureds to whom the insurer can offer reasonable policy terms and conditions. Of course, the price charged for coverage must be high enough to enable the insurer to pay claims and to provide the insurer a reasonable profit or gain.

Selecting Insureds

Insurers must carefully screen applicants to determine which ones it desires to insure. If insurers do not properly select policyholders and price coverages, some insureds might be able to purchase insurance at prices that do not adequately reflect their loss exposures. The underwriting selection process is not limited to underwriters but also includes producers and underwriting managers. All these participants exert a joint effort in the underwriting process.

Insurance companies receive many applications, but not all applications result in the issuance of policies. An insurance company cannot accept all applicants for two basic reasons:

- The insurer can succeed only if it selects applicants who, as a group, present loss exposures that are proportionate to the premiums that will be collected. In other words, insurers try to avoid *adverse selection.*
- An insurer's ability to provide insurance is limited by its *capacity* to write new policies.

Adverse Selection Considerations

Insurance companies expect to pay claims; without claims, insurance would be unnecessary. However, insurers try to select applicants who are not likely to have covered losses greater than the insurance company anticipated when it calculated its insurance rates. On the other hand, people with the greatest probability of loss are the ones most likely to purchase insurance, a situation referred to as **adverse selection.** Poor underwriting results might occur if too many of the applicants accepted for insurance are those most likely to incur serious losses. Underwriters try to avoid adverse selection by screening applicants to identify, and decline coverage to, those who present loss potentials that would be inadequately reflected in the rates.

Adverse selection is a situation that occurs because people with the greatest probability of loss are the ones most likely to purchase insurance. Adverse selection normally occurs if the premium is low relative to the loss exposure.

An extreme example of adverse selection would involve a burning building. No insurer would knowingly write fire insurance to cover a building that is already burning, but the owner of an uninsured building that is on fire would probably be glad to purchase fire insurance on the building.

Adverse selection is particularly prevalent with some kinds of insurance. For example, owners of property next to a river would be more likely to purchase flood insurance than those who own property on a hilltop with no flood exposure.

Educational Objective 2

Identify and describe the ways in which insurers protect their available capacity.

Capacity Considerations

Capacity refers to the amount of business an insurer is able to write, usually based on a comparison of the insurer's written premiums to the size of its policyholders' surplus. An insurer must have adequate policyholders' surplus to be able to increase the volume of insurance it writes.

Reminder

As discussed in Chapter 3, *policyholders' surplus* is the insurer's total admitted assets minus its total liabilities. A commonly used measure of an insurer's capacity is the *capacity ratio*, or *premium-to-surplus ratio* (written premiums divided by policyholders' surplus).

The term **capacity** refers to the volume of business an insurer is able to handle. Capacity is often measured by comparing the insurer's written premiums to its *policyholders' surplus*. Insurance companies often impose voluntary capacity constraints that are more conservative than those used by regulators. This voluntary constraint on capacity provides a buffer or cushion to allow for variability in the insurer's underwriting and investment results.

An insurer's capacity limits its ability to write new business. Selling new policies creates insurer expenses, such as agents' commissions, that reduce the policyholders' surplus in the short term. Reduced policyholders' surplus leads to reduced capacity. Yet, in the long term, if the new policies generate premiums that exceed losses and expenses, the new policies will increase the policyholders' surplus. Barring serious underwriting or investment losses, an insurer can increase its capacity through steady, orderly growth in sales of policies that contribute to the insurer's profits. Planned growth is generally one of the goals of an insurance company.

Insurers attempt to protect their available capacity in three primary ways:

- Maintaining a spread of risk
- Optimizing use of available resources
- Arranging reinsurance

Maintaining a Spread of Risk

Jargon Alert!

The word *risk* has many meanings. In this text, risk is generally used to mean the chance or possibility of financial loss. Risk can also mean the subject matter insured or being considered for insurance. (In other words, a commercial building on which an application for insurance has been submitted is often called a risk.)

Since every insurer has limited capacity, insurance companies must allocate their available capacity. Like businesses of many kinds, insurance companies prefer not to put all their eggs in one basket. In other words, by spreading their risk among various types of insurance and different geographic areas, insurance companies reduce the chances that overall underwriting results will be adversely affected by a large number of losses in one type of insurance or one territory. In other words, an insurer must diversify the coverage it writes and spread its policies among different types of coverage and different geographic areas. For example, a tornado might require an insurer to pay extensive property claims in one community, but these claims would be balanced against premiums from other communities that do not experience a tornado in the same year, as well as from other types of insurance written by the insurance company.

Insurance companies also allocate capacity by setting limitations on the amount of insurance they write for any one insured. Generally, limitations are more restrictive for some types of business than for others, depending on the exposures presented. For example, an insurance company might place a lower limit on the maximum amount of fire insurance it will provide on a rural home with no fire hydrants nearby and no fire department within ten miles than on a home located within a city with excellent public fire protection.

Optimizing Use of Available Resources

In addition to its financial resources, every insurance company depends on other resources. Among these are physical resources, which include offices and equipment, and human resources, which include underwriters, claim representatives, producers, and service personnel.

Underwriting and servicing some kinds of insurance require special skills or experience, and many insurers offer only certain types of insurance and not others. For example, an insurer might choose not to solicit or accept applications for insurance on farms if that insurer does not have personnel experienced in handling farm business. Without some expertise, recognizing unusual hazards that might exist in a farm operation is difficult. Without experienced farm claim representatives, it can be very difficult and expensive to settle farm claims. On the other hand, another insurance company might have personnel capable of handling farm business, and that insurer might wish to use its available capacity to increase the amount of insurance it writes for farmers.

Arranging Reinsurance

In *reinsurance*, the reinsurer receives a portion of the premiums from the primary insurer's policies and assumes some of the losses on those policies. The primary insurer usually retains a portion of the premiums and pays the insured losses on reinsured policies and is then reimbursed by the reinsurer for losses for which the reinsurer is contractually responsible. If reinsurance is readily available, insurance companies can increase the number of new policies they write by transferring some of the premium and loss exposures to reinsurers. Thus, the availability of reinsurance can affect an insurance company's capacity to write business.

Reminder

Remember from Chapter 2 that *reinsurance* is a contractual arrangement whereby one insurer, the primary insurer, transfers some or all of the loss exposures from policies written for its insureds to another insurer, the reinsurer.

Commensurate means showing an appropriate relationship. A premium is **commensurate with the exposure** when an appropriate relationship exists between the size of the premium and the exposure assumed by the insurer.

Pricing Coverage

The underwriting pricing objective is to charge a premium that is **commensurate with the exposure**. In other words, each insured's premium should be set at a level that is adequate to enable the total premiums paid by a large group of similar insureds to pay the losses and expenses of that group and to allow the insurance company to achieve a reasonable profit or gain. Pricing insurance involves classifying the applicant according to its loss exposures and then determining a premium by applying an appropriate rate to the applicant's exposure units.

Premium Determination

As discussed in earlier chapters, the *rate* is the price of insurance charged per exposure unit, and an *exposure unit* is a measure of loss potential used in rating insurance. The exposure unit used depends on the type of insurance, as illustrated below:

Type of Insurance	Exposure Unit
Workers compensation	Each \$100 of payroll
Property insurance	Each \$100 of insurance
Auto liability insurance	Each car insured

The premium is determined by multiplying the rate by the number of exposure units. For example, the premium for property insurance with a limit of \$250,000 at a rate of \$.40 per \$100 of insurance is \$1,000, calculated as follows:

$$\frac{\$250{,}000}{\$100} = 2{,}500 \text{ units} \times \$.40 \text{ per unit} = \$1{,}000$$

The premium is the total amount of money an insured pays the insurance company for a particular policy or coverage for a stated period. For example, an insurer might charge a premium of \$400 to provide a one-year property insurance policy with a \$250 deductible for a \$100,000 brick home located in Anytown, U.S.A. The same insurer might charge \$400 to provide identical coverage on an \$80,000 brick home located five miles outside Anytown. While the total premium would be the same in both cases, the rate per \$100 of insurance is different, probably reflecting a difference in fire protection in the two locations.

Of course, accurately predicting what losses a particular insured will have during a given policy period is impossible. A very good driver might have several auto accidents in a year because of a streak of bad luck. A careless driver might get through the same year without any accidents. However, according to the law of large numbers, prediction becomes more accurate as the number of similar insureds increases. Although one very good driver might have a worse year than one very bad driver, it is highly unlikely that a group of one hundred cautious drivers will have more insured losses than a group of one hundred careless drivers. Each group of drivers should be charged a premium commensurate with the exposure to loss it presents. Therefore, drivers with good driving records are generally charged less than those with poor driving records.

Educational Objective 3

Describe the following types of insurance rates, and explain which type would be more appropriate in a given situation:

a. Class rates

b. Individual rates

Types of Rates

In determining the appropriate premium to charge for coverage, insurers use either class rates or individual rates.

Class Rates

Class rates are common in property and liability insurance. Most personal lines and many commercial lines of insurance involve large numbers of similar insureds grouped into rating classes. Each insured in a given rating class has approximately the same exposures to loss and would therefore be charged approximately the same rate for insurance coverage. Class rates have traditionally been published in rating manuals—books used by underwriters, raters, and producers in pricing individual policies; therefore, class rates are sometimes called **manual rates**. Increasingly, insurers are replacing rating manuals with computerized rating systems based on class rates formerly published in traditional rating manuals. The rating of most personal lines and a growing number of commercial lines of insurance is now computerized. Class rates are based on the loss statistics of the large number of insureds that constitute a rating class. In many different situations, the use of class rates provides a uniform approach to pricing coverage for similar insureds.

Class rates, also called **manual rates**, are rates that apply to all insureds in the same rating category, or rating class. Insureds with similar loss exposures are grouped into rating classes.

Many insureds within a rating class have loss characteristics that might not be fully reflected in class rates. **Merit rating plans** modify class rates to reflect these characteristics. Merit rating serves two purposes:

- It enables the insurer to fine-tune the class rate to reflect certain identifiable characteristics of a given insured.
- It encourages loss control activity by rewarding safety-conscious insureds with a lower premium or rate than those who do not practice loss control.

Merit rating plans are rating plans that modify class rates to reflect loss characteristics of a particular insured.

The following are illustrations of the use of merit rating plans:

- In personal auto insurance, insurers use *safe driver insurance plans* (rating plans in which premiums are based on the insured's driving record) to lower the premiums for drivers with a history of accident-free driving and no major traffic convictions.

- In homeowners insurance, insurers typically provide *premium discounts* for insureds with fire alarms or burglar alarms.
- In commercial insurance, insurers often use *experience rating*. That is, premiums are increased for insureds whose loss experience has been worse than average, and premiums are decreased for insureds whose loss experience has been better than average.
- In commercial insurance, *schedule rating* allows an underwriter to "schedule" (list) credits or debits based on certain characteristics that are not reflected in the class rate. An example of such a characteristic is the attitude of the insured's management toward loss control. If the insured's management encourages loss control activities, the insurer could apply a schedule credit to the property insurance rate. Schedule debits or credits are expressed as percentage increases or decreases from the class rate.

Individual Rates

Class rates are not suitable for some types of insurance. For example, an underwriter would not be able to use a rating manual to determine the rate for fire insurance on a factory building that has an unusual construction and is occupied for a unique purpose. In such a situation, the underwriter would analyze various characteristics of the building to develop a rate that reflects the building's unique characteristics and occupancy. Such a rate is called an individual (or specific) rate.

Individual rates, also called **specific rates**, are used to assign a specific insurance rate that reflects the unique characteristics of an insured or the insured's property.

Individual rates, or **specific rates**, are used for commercial property insurance on unique structures. The rate is developed only after a detailed inspection of the structure and its contents. Each individual rate reflects characteristics such as the building's construction (brick or frame), its occupancy (warehouse or manufacturing), public and private fire protection (distance to the fire department and existence of a sprinkler system), and external exposures (proximity to other buildings or to brush that could spread a fire to the building).

A **judgment rate**, a type of individual rate, is used to develop a premium for a unique exposure for which there is no established rate. With judgment rating, the underwriter relies heavily on his or her experience.

The pricing of insurance coverage for one-of-a-kind exposures must often be based primarily on an underwriter's experience and judgment. An experienced underwriter might examine rates for comparable exposures to determine appropriate rates before arriving at the premium that will actually be charged for the unique exposure. Therefore, a **judgment rate**, a type of individual rate, is not simply arbitrary but is based on the underwriter's experience in covering various unusual exposures. Judgment rating is often used in rating ocean marine insurance covering many types of cargo being transported to ports worldwide.

Insurance Advisory Organizations

In the past, insurer-supported organizations such as Insurance Services Office (ISO) and the American Association of Insurance Services (AAIS) were known as *rating bureaus*. These rating bureaus collected premium and loss statistics from many insurance companies and developed a set of rates based on those statistics. In addition to calculating rates, rating bureaus also prepared rate filings for their members and submitted the filings to state regulatory authorities for approval.

ISO, AAIS, and similar organizations are now called *insurance advisory organizations*. These organizations no longer calculate and file rates for insurers. Instead, they calculate and file *loss costs*, which are the portion of the rate that covers projected claim payments and claim handling expenses. These loss costs now form the basis of rates developed by individual insurers. Each insurer adds a charge (called an expense loading) to the loss costs to cover other predicted expenses that the insured will incur (such as underwriting expenses, marketing costs, and taxes). Insurers generally develop their rates by adding these expense loadings to the loss costs calculated by the advisory organization.

Determining Policy Terms and Conditions

Selection and pricing are intertwined with a third underwriting activity—determining policy terms and conditions. The insurer must decide exactly what types of coverage it will provide to each applicant and then charge a premium appropriate to that coverage.

In addition to developing loss costs, insurance advisory organizations develop policy forms using standard insurance wording. These policy forms, referred to as **standard forms**, can be used by insurance companies that subscribe to the services of the advisory organization. Since many insurers use standard forms, the policy issued by one insurance company is often identical to the policy that would be issued by a competing insurer.

Standard forms are insurance forms that contain standardized policy wording. Insurance advisory organizations develop standard forms that many insurers use in their insurance policies. Some insurers develop their own standard forms that they use in policies for their insureds.

For each type of insurance it handles, an insurer needs to decide whether to use standard forms developed by the advisory organizations or to develop its own policy language, possibly providing coverages that differ in some ways from coverages provided by other insurers. For some types of insurance, such as professional liability insurance, there is no standard form, and many differences in coverage exist among policies.

When advisory organizations develop insurance policies, they also develop rules specifying what kinds of insureds will be eligible for certain policies. Insurers need to decide whether they will adhere to these rules or whether they will modify them.

Monitoring Underwriting Decisions

Underwriters periodically monitor the hazards, loss experience, and other conditions of specific insureds to determine whether any significant changes have occurred. Since underwriting decisions involve an assessment of loss potential, hazards and other conditions must be reviewed periodically.

If an underwriter made loss control recommendations (such as installing fire extinguishers) to a particular insured, follow-up is necessary to ensure that the insured has carried out the recommendations. An increase in hazards might change an acceptable insured into an unacceptable one for the coverage and premium charged. For example, if an insured converts a garage into a laboratory for producing toxic chemicals, the coverage and premium would have to be changed to reflect the increase in hazard, or continued coverage might be denied. Monitoring helps underwriters discover such changes and alter coverage and premium as necessary.

A **book of business** (or **portfolio**) is a group of policies with a common characteristic, such as territory or type of coverage. A book of business can also refer to all policies written by a particular insurer or agency.

Monitoring also applies to underwriting decisions on an entire book of business. A **book of business** (also called a **portfolio**) can refer to all policies in a particular territory or to all policies providing a particular type of insurance. A book of business can also refer to all policies of an insurance company or agency as a whole.

Educational Objective 4

Explain the role of underwriting management.

Underwriting Management

The role of an insurance company's underwriting management involves various responsibilities:

- Participating in the overall management of the insurance company
- Arranging reinsurance
- Delegating underwriting authority
- Making and enforcing underwriting guidelines
- Monitoring the results of underwriting guidelines

Only by constantly adjusting to a changing environment can an insurance company meet its objectives. Insurance companies change underwriting rules and standards as business conditions change. Underwriting management is the conduit for implementing these changes.

Participating in Insurance Company Management

An insurance company's top management team generally includes officers responsible for marketing, product development, claims, finance, actuarial services, and other functions, as well as underwriting. The head of an insurer's underwriting department participates with other members of the insurer's top management team in making broad business decisions regarding the company's objectives and how it plans to meet those objectives. Decisions at this level might determine what type of marketing system will be used, where offices will be located, what emphasis will be placed on personal and commercial insurance, and so forth. Given a top management consensus on the insurer's broad goals and how its capacity should be allocated, underwriting management must decide how underwriting activities can contribute to these goals. An insurer's underwriting management must develop underwriting objectives that complement or support the company's overall goals and then inform underwriters how to implement these specific objectives.

Arranging Reinsurance

Another aspect of underwriting management is arranging reinsurance. There are two broad categories of reinsurance: treaty reinsurance and facultative reinsurance.

Treaty reinsurance is an arrangement whereby a reinsurer agrees to reinsure automatically 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. There is no individual selection of policies.

Treaty reinsurance is an arrangement whereby a reinsurer agrees to reinsure automatically a portion of all eligible insurance of the primary insurer.

Primary insurers and reinsurers periodically renegotiate the agreement on which treaty reinsurance is based. Before entering into a treaty and agreeing on pricing arrangements, 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 individual accounts that compose the group.

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 reinsurance company decide which policies to reinsure. Pricing, terms, and conditions of each policy are individually negotiated.

Facultative reinsurance involves a separate transaction for each reinsured policy. That is, the reinsurer evaluates individually each policy it is asked to reinsure.

Delegating Underwriting Authority

Underwriting authority is the limit on decisions that an underwriter can make without receiving approval from someone at a higher level.

Decentralized means that activities are moved away from a central location; for insurance companies, *decentralization* usually means that processes and decision-making authority are moved geographically closer to the insured, usually to a field office.

Centralized means that activities are in a central location; for insurance companies, *centralization* involves many decisions being made in the home office.

Underwriting management focuses on the entire group of insureds of the insurance company. *Line underwriters*, who usually work in field offices, must deal with individual applications. Underwriting management must determine how much underwriting authority to grant to the line underwriters. **Underwriting authority** limits the types of decisions an underwriter can make without receiving approval from someone at a higher level. The amount of authority given to each underwriter usually reflects the underwriter's experience, job title and responsibilities, and the types of insurance handled. Each underwriter's authority is clearly explained in the underwriting guidelines or in the underwriter's job description.

With some insurers, underwriting authority is highly **decentralized**; that is, underwriting management delegates extensive underwriting authority to personnel in the field offices. Other insurers are highly **centralized** with many or all final underwriting decisions being made in the home office. For centralized insurers, field offices serve as a point of contact where insurance company 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 line underwriters in field offices and the underwriting authority reserved for home office underwriters.

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

Making and Enforcing Underwriting Guidelines

Underwriting management develops the guidelines that line underwriters use in the underwriting process. Companywide rules guide underwriters toward consistent decisions that enable the insurance company to meet its overall underwriting objectives.

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 insurance company'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 activity does not end with the development of underwriting guidelines. The guidelines must be clearly communicated to all underwriters, which might require training programs. In addition, underwriting management must prepare and distribute bulletins or guideline revisions whenever changes are made.

Monitoring the Results of Underwriting Guidelines

Underwriting management must also monitor the results of underwriting guidelines to see whether they have had the desired effect. Monitoring includes taking steps to ensure that underwriters are following underwriting guidelines and that underwriting objectives are being met. If the guidelines are not followed, there is no evidence as to whether they will work. Periodically, underwriting management sends underwriting audit teams to visit field offices to examine underwriting files. **Underwriting audits** attempt to determine whether underwriters are following the guidelines. Second, if guidelines are being followed, it is necessary to determine whether they are having the desired results. For example, suppose 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 the revenues from the increased sales more than offset the costs of claims.

An **underwriting audit** is a process in which members of the home office underwriting department examine files to see whether underwriters are following underwriting guidelines.

Many factors affect the success of an insurance company. Constant monitoring of underwriting results enables underwriting management to adjust underwriting guidelines to accommodate changing conditions, objectives, and results.

Educational Objective 5

Identify and describe the steps in the underwriting process that an underwriter follows in making an underwriting decision.

The Underwriting Process

An underwriting decision must be made on every new insurance application, as well as on renewal policies and many policy changes. The underwriting process comprises the following steps:

1. Gathering the necessary information
2. Making the underwriting decision
3. Implementing that decision
4. Monitoring the decision

Traditionally, underwriting has been largely a nonautomated process that depends on human judgment. Increasingly, however, portions of the underwriting process, particularly in personal lines, are computerized. Computerized underwriting processes use software that emulates the steps an underwriter would take. Computerized underwriting is most common with high-volume types of insurance such as personal auto or homeowners insurance. In a common approach, the computer screens applications and accepts those that clearly meet all criteria and rejects those that clearly do not. Questionable applications are referred to an underwriter for evaluation.

Expert systems (also known as **knowledge-based systems**) are computer software programs that supplement the underwriting decision-making process. The system asks for the information necessary to make an underwriting decision, ensuring that no necessary information is overlooked.

Some insurers now use **expert systems** (also known as **knowledge-based systems**) to assist underwriters in the underwriting process. These computerized systems are programmed to emulate the underwriting decision-making process as it would be performed by "expert" (usually senior) underwriters. The expert system asks for the information necessary to make an underwriting decision, thereby ensuring that no necessary information is overlooked. Although expert underwriting systems are capable of "making" an underwriting decision (usually by assigning a grade on a scale of one to ten or one to one hundred), most are used to supplement an underwriter's decision making, not to replace the underwriter.

New underwriters can "ask" the expert system why a certain question was asked or why a certain grade was assigned. The ability of the expert system to interact with the underwriter makes the system an excellent training tool in addition to an underwriting tool.

Educational Objective 6

Identify and describe sources that underwriters use in making underwriting decisions.

Gathering Underwriting Information

Underwriters base their decisions about individual applications on a combination of information and judgment. To make a decision, underwriters need adequate information in order to analyze the potential losses each applicant represents. Underwriters derive information from several sources:

- *Producers*. In addition to completing and submitting applications, producers might supply additional information not included on applications, such as a personal evaluation of the applicant.
- *Consumer investigation reports*. Several independent reporting services investigate and provide background information on prospective insureds. Insurance applications generally inform the applicant that he or she might be investigated.
- *Government records*. Motor vehicle records (MVRs) are commonly used in underwriting auto insurance. Underwriters can also seek underwriting information in court records and public information relating to property ownership.
- *Financial rating services*. Firms such as Dun & Bradstreet (D&B) and Standard & Poor's provide data on the credit rating and financial stability of specific businesses.
- *Inspection reports*. Many insurance companies employ loss control representatives whose duties include inspecting the premises and operations of insurance applicants and preparing reports for underwriters.
- *Field marketing personnel*. Many insurers have marketing representatives or other employees who spend much of their time in the field working with producers. These field personnel can often provide additional insights regarding an applicant based on personal observations.
- *Claim files*. After a policy has been issued, the insured might have claims. Significant information about the insured might thus appear in the insurance company's claim files, and additional information might be available from the claim representatives who handled the claims.
- *Production records*. In evaluating applications, underwriters generally consider the track record of the producer who submits the application. If the producer has consistently generated profitable business, the underwriter might be willing to accept an applicant that might not meet all of the underwriting standards.
- *Premium audit reports*. Rates for some kinds of commercial insurance are applied to estimated payroll, sales, or some other exposure unit whose final measure is not determined until the end of the policy year. Insurance companies employ premium auditors to obtain the final figures from insureds' accounting records in order to compute the final premium on such policies. In addition to providing this exact information, a premium auditor can provide other information about an insured, especially since the premium auditor has probably visited the insured's premises and seen the operations.
- *Applicant's or insured's records*. Underwriters can sometimes obtain information from the applicant's or insured's records,

including copies of appraisals of jewelry (for valuation purposes) and bills of sale. For businesses, the annual report, which describes the firm's operations and future plans and includes its financial statements (balance sheet and income statement), provides much useful underwriting information. Many businesses now have Web sites that could also be a source of valuable information to an underwriter.

Making the Underwriting Decision

Hazards are conditions that increase the chance of a loss occurring.

Once the underwriter has gathered the necessary information, he or she must analyze the information to determine what **hazards** the applicant presents. To make an underwriting decision, the underwriter must then evaluate underwriting options and choose the best option.

Educational Objective 7

Identify and describe four categories of hazards that underwriters must evaluate.

Analyzing Hazards

An applicant with hazards that are greater than normal might not be acceptable as an insured, unless the increased hazards can be eliminated or controlled or unless they can be offset by a substantially increased premium. On the other hand, an applicant presenting normal or less-than-normal hazards is generally desirable from an underwriting standpoint. An underwriter must evaluate four categories of hazards:

- Physical hazards
- Moral hazards
- Morale (attitudinal) hazards
- Legal hazards

Physical Hazards

Physical hazards are tangible characteristics of property, persons, or operations that tend to increase the probable frequency or severity of loss.

In evaluating an application for property insurance on a building, the underwriter considers possible **physical hazards**, such as those inherent in the building's construction, occupancy, protection, and external exposures. An office building located next to a restaurant without adequate fire protection clearly represents a greater fire hazard than an office building located next to a retail store with excellent fire protection.

Moral Hazards

Moral hazards are dishonest tendencies in the character of the insured (or applicant) that increase the probability of a loss occurring.

Moral hazards are dishonest tendencies in the character of the insured (or applicant) that increase the probability of loss. The threat from a moral hazard is the possibility that the insured might intentionally cause a loss or file a false claim. For example, an insured might intentionally cause a fire or an auto accident to collect a claim payment on a hard-to-sell building or car and unjustly enrich himself or herself. A moral hazard might be indicated by a weak financial condition (which could be detected in a financial report) or questionable moral character (which could be indicated by a police record).

As stated in Chapter 1, one of the characteristics of an ideally insurable loss exposure is that losses be accidental. Insurance is intended to deal with losses that are unexpected from the standpoint of the insured; it is not feasible to insure against events within the insured's control. The prudent underwriter rejects applicants presenting a significant moral hazard.

Morale Hazards

Morale hazards (also known as **attitudinal hazards**) are more subtle, and thus more difficult to detect, than moral hazards. A particularly dangerous morale hazard is an insured's attitude that "I don't need to be careful because I have insurance." Evidence of a morale hazard might be found in personality traits (some people are naturally careless and therefore accident-prone regardless of insurance), poor management (tolerance of dangerous conditions and practices), or past loss experience (a history of losses caused by carelessness).

Morale hazards (also known as **attitudinal hazards**) involve carelessness about, or indifference to, potential loss on the part of an insured or applicant.

Moral hazards and morale hazards are often confused. Someone who represents a moral hazard might, for example, set a fire to collect an insurance settlement. Someone who represents a morale hazard might be careless in allowing smoking in hazardous areas or permit combustible supplies to be piled in a furnace room.

Legal Hazards

Legal hazards are characteristics of the legal or regulatory environment that affect an insurer's ability to provide insurance with appropriate premiums. Hazards in the legal environment might include court decisions that interpret policy language in a way unfavorable to insurers. For example, commercial liability policies at one time provided coverage for pollution losses that were sudden or accidental, but court decisions applied coverage in cases where insurers thought the pollution was clearly not sudden or accidental but gradual. Because of this legal hazard (courts mandating coverage broader than insurers intended), insurers ceased to provide pollution liability coverage in many cases or started charging an additional premium for pollution liability coverage.

Legal hazards are characteristics of the legal or regulatory environment that affect an insurer's ability to collect a premium commensurate with the exposure to loss.

The regulatory environment presents legal hazards when it forces underwriters to charge premiums that are too low for the exposures or to provide coverages that are too broad. Legal hazards are also presented when regulatory authorities unduly restrict insurers' ability to cancel or nonrenew policies.

Educational Objective 8

Identify and explain the underwriting options an underwriter has in evaluating an application for insurance.

Evaluating Underwriting Options

In evaluating each application, an underwriter faces three options:

- Accept the application without modification
- Reject the application
- Accept the application with modification

The third option requires the greatest amount of underwriting creativity. Often an applicant that is not acceptable for the insurance originally requested can become acceptable if some aspect of coverage is changed. Generally, the underwriter, producer, and applicant all desire that an insurance policy be issued. If the particular policy applied for cannot be issued, the underwriter might be able to offer an alternative that satisfies all parties.

Frequently, a policy can be issued if the applicant agrees to implement loss control measures. For example, an underwriter might agree to write property insurance for the owner of a particular bookstore, provided the store owner installs and maintains an appropriate fire alarm system.

Another possibility is to modify the rate charged for the coverage. A producer might have quoted auto insurance using the insurer's "preferred risk" rate, a rate offered to substantially better-than-average applicants that is lower than the standard class rate. The underwriter might determine that the applicant does not qualify as a preferred risk but would be acceptable for coverage at standard class rates.

Coverage might also be modified—that is, the underwriter might offer terms and conditions that are somewhat different from those that the applicant has requested. For example, an underwriter might be asked to provide an auto policy, including coverage with a $50 deductible for damage to the insured vehicle for an applicant who has had several claims for windshield damage. The applicant might be a preferred risk except for this one coverage. The underwriter could offer the desired coverage with a $250 or $500 deductible and thus avoid rejecting the applicant. This modification would turn a standard risk into a preferred risk. If the applicant agrees, the underwriter has found a way to make an application acceptable through coverage modification.

Reinsurance presents an underwriting alternative in cases where an otherwise acceptable application exceeds the limit in the underwriting guidelines. Suppose, for example, an insurer is asked to provide $10 million of property insurance on a building, but the insurer's acceptable limit on a single building is $500,000. After checking with underwriting management, an underwriter might determine that adequate reinsurance exists to handle the remaining $9.5 million of coverage. By arranging reinsurance in the amount of $9.5 million, the underwriter can accept the application for the limit of $10 million requested by the applicant.

Choosing the Best Option

After careful analysis of hazards and underwriting options, the best underwriting decision for a particular application usually becomes obvious. All alternatives, such as following loss control recommendations or accepting modified coverage, require the agreement of the applicant and might involve further negotiation. In such situations, the underwriter normally contacts the producer to negotiate the modified terms, price, or conditions with the applicant.

Implementing the Underwriting Decision

When asked to deal with an application for coverage exceeding his or her underwriting authority, an underwriter might need to seek a supervisor's or manager's approval. The supervisor or manager might simply approve or reject the underwriter's recommendation, or the entire application might be referred to a more specialized or experienced senior underwriter.

If the underwriting decision is within the underwriter's authority and consistent with underwriting guidelines, the underwriter can approve the policy and pass the file along to another department for processing and policy issuance. This approach is typical with routine applications for auto insurance, homeowners insurance, and small commercial accounts. In more complex cases, it is necessary to communicate the underwriter's decision to the producer, along with a quote showing the premium to be charged and the terms and conditions to be offered. After the producer discusses this information with the client, and possibly compares it with quotes from other insurance companies, the underwriter might be asked to issue the policy or might learn that the applicant has decided to do business with another insurer.

Monitoring the Underwriting Decision

The underwriter's job does not end when a policy is issued. The underwriter must monitor the results of the initial underwriting decision. Among other things, the underwriter needs to reevaluate his or her underwriting decisions by being aware of claims that develop from accounts that were accepted. The nature and number of losses in a given period might indicate that some other underwriting action is required.

The fact that an insured has a serious loss or several losses is not necessarily an indication that the underwriter made a bad decision. Conversely, a lack of serious losses on an account does not necessarily mean that the underwriter made a good decision in accepting the account; the lack of losses might have been a matter of chance. Despite these variations in the experience of individual accounts, the entire group of accounts handled by an underwriter is expected to earn a profit for the insurer. Each account contributes to the underwriter's record in the long term.

If serious problems develop with an account, the underwriter might need to take corrective action. Such action might include recommending additional loss control measures, modifying the terms of coverage, canceling coverage (if permitted), or marking the policy for nonrenewal at the end of the present policy term.

During the policy term, the underwriter might also receive one or more requests for coverage changes. Each request must be carefully considered and implemented as appropriate. Some changes present no increased hazard, while others might increase the potential for losses beyond those intended in the policy or by the price charged. For example, a change of vehicles on an automobile policy from a five-year-old sedan to a newer model does not necessarily represent an increased hazard, but it might if at the same time a young driver is added as an additional operator.

Finally, as the expiration date of a policy approaches, the underwriter might need to repeat the entire underwriting process before agreeing to renew the policy for another term. Renewal underwriting can generally be accomplished more quickly than new-business underwriting because the insured is already known, to some degree, and the amount of information might be increased as claim reports or loss control reports are added to the file. However, the underwriter must determine whether any changes in the exposures have occurred, and, if so, carefully go through the underwriting process again.

Many insurers do not reunderwrite existing personal lines policies such as auto and homeowners at every renewal. Instead, they continue to renew these policies until something triggers an underwriting review. Claims, requests for coverage changes, or the passage of a certain amount of time might cause reunderwriting.

Educational Objective 9

Describe ways in which states regulate underwriting activities.

Regulation of Underwriting Activity

In the interest of protecting the public, every state regulates insurers' underwriting activities and places some constraints on the terms and conditions that insurers offer. Two important examples of the regulation of underwriting activity are:

- 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, as discussed in Chapter 2 in regard to insurance rates, 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.

Reminder

Unfair discrimination involves applying different standards or methods of treatment to insureds who have the same basic characteristics and loss potential.

With the attention given to topics such as racial and sexual discrimination, it is easy to forget that "discrimination" itself can be a neutral word. Dictionary definitions of "discrimination" include the following:

- The quality or power of finely distinguishing
- The act or practice of discriminating categorically rather than individually

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 involves 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 the following:

- Refusing to issue, canceling, or nonrenewing coverage for an applicant or an insured solely on the basis of geographic location. (This prohibited practice is sometimes called *redlining*—suggesting a bright red line on a map surrounding a prohibited area.)

- Refusing to issue, canceling, or nonrenewing coverage for an applicant or an insured solely on the basis of that person's gender or marital status.
- Refusing to issue, canceling, or nonrenewing a policy solely because of the applicant's or the insured's race.

These examples of unfair discrimination all include 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 ethnic group are likely to have an unacceptable level of losses. Further information in each case might indicate that the applicant or insured does not meet the insurer's underwriting standards, without regard to his or her address, gender, marital status, or racial heritage. Therefore, if coverage is denied after objective underwriting criteria have been applied, it is not likely that unfair discrimination has occurred.

Restrictions on Cancellation and Nonrenewal

Most states require that insurers notify the insured a specified period (such as thirty days) before a policy is to be canceled or nonrenewed. 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.

During the mid-1980s, several widely publicized claims involving allegations of child abuse caused insurance companies to become concerned about the legal hazards associated with the operation of day-care centers. Some policies providing coverage to day-care 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 that prohibited 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 in order to avoid adverse reaction that could lead to further regulatory restrictions on underwriting activities.

Educational Objective 10

Define or describe each of the Key Words and Phrases for this assignment. (All Key Words and Phrases appear in bold print in the text and in boxes in the margins throughout this chapter.)

Summary

Underwriting is the process by which insurance companies evaluate applicants for insurance and those currently insured in order to maintain a profitable book of business. The underwriting process consists of the following activities:

- Selecting those applicants who meet the company's underwriting guidelines
- Pricing the coverage to charge a premium commensurate with the exposure
- Determining the proper policy terms and conditions
- Monitoring underwriting decisions

While line underwriters are responsible for day-to-day decisions, they must refer to the insurer's underwriting guidelines. Underwriting management sets the company's guidelines in order to make optimal use of the company's available capacity and avoid adverse selection. The role of underwriting management involves various responsibilities:

- Participating in the overall management of the insurance company 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 limits the types of decisions a underwriter can make without receiving approval from someone at a higher level
- Making and enforcing underwriting guidelines that reflect the company's overall underwriting objectives
- Monitoring the results of underwriting guidelines to see whether they have the desired effect

In making decisions, underwriters follow several steps in the underwriting process:

- Gathering the necessary information from various sources to evaluate applicants
- Making the underwriting decision, which includes analyzing hazards (which can be physical, moral, morale, or legal), evaluating underwriting options (accepting or rejecting the application or accepting it with modification), and choosing the best option
- Implementing the underwriting decision
- Monitoring the underwriting decision

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