4 – The Underwriting Function

**1 – Underwriting Activities**

**Objective**: *Distinguish among the underwriting activities typically performed by line and staff underwriters*

Insurers assume billions of dollars in financial risk through coverage decisions based on underwriters’ analysis of data drawn from both traditional sources and the increasingly significant universe of technology-driven big data. An insurer’s underwriting activities – the coordinated efforts of line underwriters and staff underwriters – can therefore influence its profitability more than any other single factor.

Line underwriter is an underwriter who is primarily responsible for implementing the steps in the underwriting process. They evaluate new submissions and perform renewal underwriting, usually by working directly with insurance producers and applicants.

Staff underwriter is an underwriter who assists underwriting management with making and implementing underwriting policy. Staff underwriters manage risk selection by working with line underwriters and coordinating decisions about products, pricing, and guidelines.

*Collectively, these activities enable the insurer to avoid adverse selection, maintain adequate policyholder’s surplus, and enforce underwriting guidelines, all of which contribute to the primary underwriting goal of sustaining profitable growth.*

**Line Underwriting Activities**

Line underwriters evaluate accounts for acceptability and make their decisions according to underwriting guidelines outlined by staff underwriters.

* **Selecting insureds** – *Select new and renewal accounts (and evaluate existing ones) by identifying suitable applicants and charging appropriate premiums that accurately reflect the loss exposures covered*. Techniques driven by customer-generated data, such as predictive analysis, generalized linear models, and credit-scoring models, often help line underwriters also look for unusual patterns of policy growth or loss and monitor real time data, such as vehicle based telematic devises, wearable sensors, and devices connected to the internet of things. *Optimized insured selection helps line underwriters fulfill one of underwriting’s chief purposes – to avoid adverse selection, which can significantly undermine profitability*.
* **Classifying and Pricing Accounts** – ***Account classification entails grouping similar accounts so that they can be priced competitively while still allowing the insurer to make a profit and maintain an adequate policyholders’ surplus (insurer’s assets minus its liabilities, which represents its net worth)****.* This activity is often reinforced with data-driven decision making.
* **Recommending or providing coverage** – *line underwriters may make sure the existing accounts are adequately protected through non-insurance risk management techniques, such as retention or risk control, so that any coverage gaps are addressed***.** They might also collaborate with producers to ensure that applicants obtain the coverage they request**. They may also respond to questions from producers and applicants about how coverage will respond to a particular type of loss by explaining the types of losses covered and the endorsements that can be added to provide coverage not included in standard policies**.
* **Managing a book of business** – some insurer’s line underwriters are responsible for the profitability of a book of business accepted from a producer or written in a territory or line of business. In such cases**, the line underwriter works to ensure that each book of business achieves established goals, such as product mix, loss ratio, and written premium**
* **Supporting producers and customers** – **because customer service activities and underwriting are often interwoven, line underwriters have a vested interest in ensuring that producers’ and insureds’ needs are met. Line underwriter usually work directly with producers to prepare policy quotations.**
* **Coordinating with marketing efforts** – insurer’s marketing and underwriting policy should be compatible.

**Staff Underwriting Activities**

Staff underwriters work closely with underwriting management to perform activities essential to profitable risk selection, such as these:

* **Performing market research** – *may entail evaluating the effect of adding or deleting entire lines of business, or expanding into additional states, or of retiring from states and insurer operates in; determining optimal product mix for a book of business; and examining premium-volume goal*s. Market research can also be refined using data fueled predictive analysis methods.
* **Formulating underwriting policy** – underwriting policy (underwriting philosophy) translates an insurer’s mission and goals into specific strategies that, in turn, determine the composition of the insurer’s book of business. *Insurer’s often develop their underwriting policy within the market(s) they serve – standard, non-standard, or specialty market. The goals for an insurer’s book of business and resulting underwriting policy may be established according to types of insurance and classes of business to be written, territories to be developed; or forms, insurance rates (such as filed and surplus lines pricing) and rating plans to be used*
* **Revising underwriting guidelines to reflect changes in underwriting policy** – Some guidelines include systematic instructions for handling particular classes of commercial accounts, including instructions. Such guidelines may identify specific hazards to evaluate, alternatives to consider, criteria to use when making the final decision, ways to implement the decision, and methods to monitor the decision.
* **Evaluating loss experience** – products with greater than anticipated losses are usually targeted for analysis. *Staff underwriters research loss data to determine the specific source of the excess losses. Part of this research includes analyzing – often augmented with big data – the insurance industry’s loss experience, which may reveal trends affecting the insurer’s products*. Based on the evaluation, staff underwriters, usually with agreement of other key departments, adjust the insurer’s underwriting guidelines.
* **Researching and developing coverage forms** – collaborate with the insurer’s actuarial and legal departments to meet changing consumer needs and competitive pressures. Insurers modify existing coverage forms so that the coverage provided will respond as anticipated.
* **Reviewing and revising pricing plans** – staff underwriters review and update rates and rating plans continually, subject to regulatory constraints, to respond to changes in loss experience, competition, and inflation. *Insurers and advisory organizations gather historical loss data to develop prospective loss costs (loss date that are modified by loss development, trending and credibility processes, but without considerations for profit and expenses). Each insurer then examines its own operations profit and expense requirements. Staff underwriters combine prospective loss costs with an insurer-developed profit and expense loading to create a final rate used in policy pricing.* Insurers must develop their own rates for any coverage for which advisory organizations do not develop loss costs*. In such situations, reviewing and revising rating plans become even more crucial to ensuring that the loss costs adequately reflect loss development and trending.* (loss development – the increase or decrease of incurred losses over time) (trending – a statistical technique for analyzing environmental changes and projecting such changes into the future)
* Assisting others with complex accounts – staff underwriters often serve as consultants to other underwriters. Generally, staff underwriters have significant first-hand experience in line underwriting. They regularly see complex and atypical accounts, unlike most line underwriters. They also function as referral underwriters, reviewing and approving the risk when an application exceeds a line underwriter’s authority.
* **Conducting underwriting audits – Staff underwriters are often responsible for monitoring line underwriter’s activities and their adherence to underwriting authority, which can be evaluated by conducting underwriting audits. These audits focus on proper documentation; adherence to procedure, classification, and rating practices; and conformity of selection decisions to the underwriting guidelines.** They also monitor underwriting activity by analyzing statistical results by type of insurance, class of business, size of loss exposure, and territory. This statistical data shows the extent to which underwriting goals are met, but it does not conclusively demonstrate whether the results are a product of the insurer’s guidelines.

**2 – Underwriting Authority**

**Objective** *– Explain why it is important to comply with underwriting authority in individual account selection*

The level of underwriting authority granted to underwriters reflect their experience and knowledge in risk selection decisions. Authority may also be granted to producers and managing general agencies. Compliance with levels of authority is crucial to maintaining the appropriate controls over risk selection.

**Underwriters have different levels of authority. As their levels of underwriting authority increases, the responsibility for accurately applying experience and judgment also increases. Compliance with levels of authority ensures that the insurer accepts applicants within its underwriting policy**.

**Underwriting authority requirements are usually communicated to an underwriter through the insurer’s underwriting guidelines. A notation next to a specific classification in the underwriting guide, might indicate that a senior underwriter must review and approve an application from that classification before it is processed further. Another approach might be to specify certain policy limits at which the accounts must be submitted to higher authority**.

Some rating plans, such as composite rating, might require higher underwriting authority to review the merits of the account. Similarly, certain endorsement for coverage forms named in the underwriting guidelines might require specific levels of authority for approval.

Compliance with levels of underwriting authority ensures that the individuals making application-selection decisions have the experience necessary to evaluate which risks are acceptable and the unique knowledge required to judge risk for specialized lines of insurance.

To place controls on levels of underwriting authority, insurers generally grant authority in these ways:

* Underwriters gain underwriting authority with experience and positive results
* Producers may gain authority based on experience, profitability, and contractual arrangements. Authority, if granted, may be only for certain types of insurance, within specific limits
* Managing general agents (MGA), when appointed, assume decentralized underwriting authority, which capitalizes on an MGA’s familiarity with local conditions.

Insurers with conservative internal underwriting philosophies may not grant underwriting authority to any entities beyond their own internal underwriters. Specialty insurers, such as those offering surety bonds, aviation insurance, and livestock mortality insurance, also usually centralize underwriting authority.

**3 – Constraints in Establishing Underwriting Policy**

**Objective:** *Describe the constraining factors considered in the establishment of underwriting policy*

An insurer’s underwriting policy promotes the type of insurance anticipated to produce a growing and profitable book of business. However, various factors constrain what an underwriting policy can accomplish.

An insurer’s senior management formulates an underwriting policy that guides individual and aggregate underwriting decisions. Underwriting policy determines the composition of the insurer’s book of business, including all the lines and classes of business that the insurer will offer, the amount of business the insurer is willing to write, the rating philosophy and forms the insurer will apply, and the territories to be developed.

Lines of Business – the NAIC annual statement, which is prescribed for financial reporting in all states, divides property and liability coverages into 33 separate lines of business. Example; fire, allied lines, workers compensation, commercial multiperil, and ocean marine. A complete listing appears in the NAIC annual statement, insurers must report premiums, losses, and expenses by the lines of business, but related lines of business are combined to create insurance products. Example, and insurer who markets commercial auto insurance will have to offer the following NAIC annual statement lines of business: commercial auto not-fault (PIP), other commercial auto liability, and commercial auto physical damage. When they use the term “line of business”, underwriters are mentally combining several related NAIC annual statement lines into a single reference, such as “commercial auto”.

All insurers would like to obtain profitable results, and most insurers would like to expand premium writing or increase market share. However, when these changes involve the insurer’s underwriting policy, major constraining factors must be considered.

**Financial Capacity**

**An insurer’s financial capacity refers to the relationship between premiums written and the size of policyholders’ surplus, which is an insurers net worth.** That relationship is crucial in evaluating insurer solvency. THE NAIC developed a series of financial ratios that it uses in conjunction with analytical evaluations to identify insurers that should receive additional solvency surveillance from regulators. The premium to surplus ratios is one of those key ratios, and is considered to high when it exceeds 300%, or 3 to 1. Premium to surplus (or capacity ratio) is net written premiums to policyholders’ surplus

**Insurers may exceed the premiums to surplus ratio through rapid growth of premiums written. Because of conservative Statutory Accounting Principles (SAP) used in insurance, rapid growth results in a reduction in policyholder’s surplus to pay for expenses generated by that growth. This constraint often precludes premium expansion unless the insurer purchases reinsurance or obtains more capital**.

Statutory Accounting Rules

Since the beginning of state oversight of insurance, insurance regulators have been primarily concerned with insurer insolvency. The NAIC was formed in 1871 to reduce the inconsistencies and confusion caused by multiple state financial reporting requirements. The accounting system evolved to satisfy insurance regulations is called **statutory accounting principles (SAP). SAP are conservative accounting rules designed to determine whether an insurer can meet its obligations to policyholders**. Most other businesses use generally accepted accounting principles **(GAAP), which focuses on the organizations as an ongoing enterprise, for financial reporting**.

Insurers recognize the limitations of their capacity and seek to write those lines of business or accounts that maximize return on equity. (a profitability ratio expressed as a percentage by dividing a company’s net income by its net worth (book value). Sometimes called shareholders equity, owners’ equity, or policyholders’ surplus). These activities help realize maximization:

* Setting return thresholds – establish return on equity threshold against which capacity allocation proposals are evaluated. If, for example and insurer wants a 10% return on equity and the sale of WC insurance in a specific state is expected to generate a 12% return on equity, then the insurer should expand into this territory and line of business if no better opportunity is present.
* Redirecting focus on target business classes – an insurer may decide to stop pursuing one class of business and, instead, use capacity elsewhere
* Adjusting underwriting policy based on jurisdiction – jurisdiction can be relevant in this process. Example, inadequate rate levels and rising benefit levels for claimants in many states led some insurers to develop restrictive acceptance criteria for workers compensation submissions

Effective account selection allows insurers to be commercially viable by rationing their available capacity to obtain an optimum spread of loss exposures by territory, business class, size of risk, and line of business

**Return on Equity** – is not only a benchmark for employing capacity but also a fundamental measure of insurer profitability. This financial ratio relates net operating gain (after taxes) as a percentage of prior year capital and surplus.

**SAP Basis – Return on Equity = Net income *divided by* Average Policyholders’ Surplus**

GAAP Basis – Return on Equity = Net income *divided by* Average Owners’ Equity

Stock insurers calculate both ratios since they report their financial performance using both SAP and GAAP bases. Mutual insurers calculate return on equity using only the SAP basis.

Return on equity is also a key financial ratio used by insurance regulators for solvency surveillance. Acceptable values fall between 5 and 15%.

**Regulation**

**States promulgate insurance regulations that take the form of statutes enacted by state legislature and regulations adopted by the state insurance department. Insurance is highly regulated, and regulations directly and indirectly affect most insurer activities. Regulation affects underwriting in several ways:**

* **Insurers must be licensed to write in each state in which they write insurance**
* **Rates, rules and forms must be filed with state regulators**
* **Some states specifically require underwriting guidelines to be filed**
* **If consumer groups believe that the insurance industry has not adequately served certain geographical areas, regulatory focus on insurance availability can lead to requirements to extend coverage to loss exposure that an insurer may not want to write**

State regulators perform market conduct examinations to ensure that insurers adhere to the classification and rating plans they have filed. If the insurer has deviated from filed forms and rates or improper conduct, the insurer is subject to penalties.

Regulation is not applied uniformly across states. In some jurisdictions, insurers may be unable to get rate filings approved, or approval may be granted so slowly that the rate levels are inadequate relative to rising claim costs. Some insurers have chosen to withdraw from states that impose regulations they consider to restrictive.

**Personnel**

Insurers require the talent of specialist to market their products effectively, underwrite specific lines of business, service their account, and pay claims for losses that occur. An insurer must have sufficient number of properly trained underwriters to implement its underwriting policy.

In addition to having personnel with the necessary skills, the insurer must have the personnel where they are needed. An Insurer should obtain premiums from a broad range of insureds to create the widest possible distribution of loss exposures. However, regulatory expenses and policyholder service requirements make it difficult for small insurers to efficiently handle a small volume of business in many widespread territories. Insurers must have sufficient volume of premium to operate efficiently in an area. Information systems are especially important; many growth plans have been abandoned because computer support was not available.

**Reinsurance**

The availability and cost of adequate reinsurance can influence underwriting policy. Reinsurance treaties may exclude certain types of insurance or classes of business, or the cost of reinsurance is prohibitive.

**Reinsurers are also concerned about the underlying policy forms offered by the insurer. A reinsurer may not have any reservation about an insurer’s use of forms developed by advisory organizations. However, it may expressly exclude coverage for loss exposures covered by manuscript forms developed for a particular insurer or covered by forms developed independently of an advisory organization**.

**4 – Implementing Underwriting Policy**

**Objective***: Explain why insurers implement underwriting guidelines and conduct underwriting audits*

Staff underwriters develop underwriting guidelines, which distill underwriting policies into directions for line underwriters’ policy selection. Underwriting audit ensure that established underwriting standards are reasonably consistent.

**Purpose of Underwriting Guidelines**

**An insurer’s underwriting policy is communicated to underwriters through underwriting guidelines, which are continually updated to reflect changes in policy. Underwriting guidelines identify the major elements that underwriters should evaluate for each type of insurance, as well as boundaries, such as maximum coverage limits, for application selection**.

Some underwriting guides include step-by-step instructions for handling particular classes of insureds. Such guide might identify specific hazards to evaluate, alternatives to consider, criteria to use when making the final decision, ways to implement the decisions, and methods to monitor the decision. Some may provide pricing instructions and reinsurance-related information. Others may be less comprehensive.

Because underwriting guidelines usually specify the attributes of accounts that insurers are willing to insure, insurers consider them trade secrets. Disclosure of this proprietary information might cause an insurer to lose its competitive advantage over others.

Underwriting guidelines serve these purposes: provide for structured decisions; ensure uniformity and consistency; synthesize insights and experience; distinguish between routine and non-routine decisions; avoid duplication of effort; ensure adherence to reinsurance treaties and planned rate levels; support policy preparation and compliance; provide a basis for predictive models.

**Provide for Structured Decisions**

*Underwriting guidelines provide a structure for underwriting decisions by identifying the major considerations underwriters should evaluate for each type of insurance the insurer writes*. For example, the section of an insurers underwriting guidelines addressing contractor’s equipment might indicate that equipment use is of paramount importance in determining acceptability and pricing. Contractors’ equipment used in mountainous areas is more likely to be subject to upset and overturn and therefore requires more scrutiny and premium than contractor’s equipment used on flat terrain. *By identifying the principal hazards associated with a particular class of business, underwriting guidelines ensure that underwriters consider the primary hazard traits of the exposures they evaluate*.

**Ensure Uniformity and Consistency**

Underwriting guidelines help ensure that selection decisions are made uniformly and consistently by all of the insurer’s underwriters. Ideally, identical submissions should elicit the same response from different underwriters. Guidelines facilitate uniformity because they include acceptable approaches to evaluating applicant and the overall desirability of a particular type of risk or class of business.

**Synthesize insights and Experience**

Underwriting guidelines synthesize the insights and experience of seasoned underwriters. Staff underwriters who assists with the insurers’ unique or challenging accounts on a referral basis, often are able to include the approaches they have taken in underwriting particular classifications and lines of business. Underwriting guidelines serve as a repository for an insurer’s cumulative expertise.

**Distinguish between Routine and Non-Routine Decisions**

* **Routine decisions are those for which the line underwriter clearly has decision making authority according to guidelines**
* **Non-routine decisions involve submissions that fall outside underwriting guidelines**

Underwriting guidelines usually indicate that the classification and lines of business must be either declined or submitted to a higher level of authority for approval.

**Avoid Duplication of Effort**

Many underwriting situations recur. If the problems inherent in a particular situation have been identified and solved, the solution should apply to all similar situations that might arise in the future. Underwriting guidelines contain the information necessary to avoid costly duplication of effort.

**Ensure Adherence to Reinsurance Treaties and Planned Rate Levels**

**Compliance with underwriting guidelines ensures that coverage limits and accepted loss exposures will not exceed the insurers’ treaty reinsurance, because staff underwriters reflect those treaty limitations in the guidelines**.

*Compliance with underwriting guidelines also ensures selection of loss exposures in an overall book of business commensurate with the planned rate levels for those policies*. The importance of compliance with underwriting guidelines as it affects the profitability of a book of business is illustrated by an example of the outcome when compliance with guidelines fails. Many homeowners’ policy underwriting guidelines require property to be insured to within a percentage of the replacement cost of the dwelling. Because most property losses are partial, rates are developed with the expectations that losses will be rare*. If property insured in a portfolio is significantly undervalued, average losses will equal a larger percentage of the average dwelling coverage limits. The portfolio might also experience a greater number of losses equal to the total dwelling coverage limit. Overall the profitability of the book of business will decline as losses exceed expectations.*

*In resolving this profitability problem, one alternative is to increase the rates charged. However, that does not resolve the underlying problem of undervaluing the property insured, and the increased rates might not be competitive in the market. A better alternative is to enforce compliance with underwriting guidelines, ensure adequate coverage to replacement cost at the time of the initial application, and implement a program to increase dwelling coverage to keep pace with inflation and building costs increases*.

**Support Policy Preparation and Compliance**

Underwriting guides provide information to assist underwriters and support staff in policy preparation. Rules and eligibility requirements for various rating plans are also included. Specialized information, such as eligibility for experience and retrospective rating together with appropriate rating formulas, often appears in the underwriting guide. Underwriting guidelines also support compliance with state regulatory requirements, as staff underwriters incorporate applicable regulations in the guidelines.

**Provide a Basis For Predictive Models**

Underwriters use predictive modeling to identify applications that present lower underwriting risk. Predictive modeling incorporates underwriting thought process with underwriting guidelines by assigning a rank or score to all of the variables presented by an account and its loss exposures. Predictive models function in this way:

* Multiple data variables of individual risks are developed to rank the relative likelihood of insurance losses
* Data variables are based on underwriting guidelines along with the insurer’s loss experience, loss data collected from external sources, and underwriting expertise
* The ranking score developed from the data variables is a predictive measure of future profit potential based upon the account’s characteristics

**Predictive modeling can provide a consistent way to review individual applications that improves the overall profitability of a book of business. It can also help in managing a large book of business for which conducting an in-depth underwriting review on every account would be too costly**.

**Purposes of Underwriting Audits**

Staff underwriters conduct periodic audits to monitor line underwriter’s adherence to the practice and procedures outlined in the underwriting guidelines. Audits are a management tool used to achieve uniformity and consistency in the application of underwriting standards.

The accounts selected may be random or that had notable claims. These accounts are scrutinized to determine whether the prescribed procedures were followed and whether the underwriter acted in accord with the underwriting policy. Feedback from the audit provides individual line underwriters with strategies to improve future underwriting decisions.

Underwriting audits can also be used to monitor statistics for books of business. This can provide indications of applications written in excess of underwriting guidelines. For example, an excessive number of workers compensation applications accepted with hazardous classification codes in one territory could indicate an imbalance of product mix. It can also indicate inconsistent adherence to underwriting guidelines.

**An underwriting audit provides staff underwriters with the information on the effectiveness of the underwriting guidelines. Underwriting guidelines that are not being followed may be either outdated or considered unrealistic. This could indicate that a critical review for updates is required.** If compliance with underwriting guidelines is not leading to the desired results, such information is valuable in the ongoing effort of developing or revising effective underwriting guidelines.

**5 – Steps in the Underwriting Process**

**Objective**: Summarize the steps in the underwriting process and the purpose of each

Whether relying on independent judgement or the guidance of automated underwriting systems, underwriters engage in a series of steps and tasks designed to ensure that insurers are ultimately able to reach their business goals.

After a producer submits and application for insurance to an insurer, the application must be qualified for acceptance. Underwriters qualify an application by following steps in the underwriting process. The Underwriting process is also applied to renewal policies and certain policy changes, such as requests to add new locations to the property policy. Applications, renewals, and policy changes are referred to as underwriting submission.

The underwriting process is a series of steps to determine which submission will be accepted, for what amount of insurance, at what price, and under what conditions. In addition to considering the merits of an individual submission, underwriters consider how a submission fits into the insurer’s business portfolio mix and whether it provides an opportunity for profitability.

**There are 6 general steps of the underwriting process:**

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

**Evaluate the Submission**

**The fist step in the underwriting process is evaluating a submission’s loss exposures and associated hazards. Underwriters must understand the activities, operations, and character of each applicant. To do so, they determine the information needed to make decisions regarding acceptance, coverage amounts, conditions and price. However, trade-offs are necessary to control underwriting expenses and to handle a reasonable number of submissions**.

**Before gathering the information necessary to evaluate a submission, underwriters must determine what information is essential and what information may be desirable or available, but not essential**. **Underwriter seek to achieve information efficiency by weighting the need for information against the cost to obtain it.** Example, an underwriter is likely to investigate a chemical manufacturer extensively but not as much information is needed for a gift shop.

**Underwriters can use various sources to obtain the information needed to evaluate a submission. These are the principal sources of underwriting information**:

* **Producers** – **usually prequalifies applicants and often have 1st hand knowledge of operations and reputation**
* **Applications** – provide general information required to process, rate and underwrite. In addition, insurers often use supplemental applications or questionnaires for certain coverages or classes of business to obtain more information
* **Inspection reports** – or risk control reports provide useful information about the property’s physical condition, safety record and management
* **Government records** **– MVRs, Criminal records, civil court records, mortgages, liens, business licenses, property tax records, securities and exchange commission filings, bankruptcy filings**
* **Financial rating services** – **Dun & Bradstreet, Standard & Poors, and Experian**
* **Loss data** – **loss history provides frequency and severity as well as types of losses and trends**
* **Premium audit reports** – can provide useful information about the insured’s operations that may have underwriting implications
* **Claims files** – to obtain insights into renewal policies by reviewing insured’s claim files. Claims representative typically accumulate and document a significant amount of underwriting information

*Choosing the right tools requires a holistic understanding of the information available and the usefulness of the information in predicting which submissions are likely to provide an underwriting profit*.

**Develop Underwriting Alternatives**

The second step in the underwriting process is developing underwriting alternatives. Such alternatives include accepting a submission as is, rejecting the submission or making a counteroffer to accept the submission subject to certain modifications. These are the types of modifications the underwriter typically makes to accept a submission:

* **Require risk control measures** – such as install automatic fire-extinguishing equipment, improving housekeeping and maintenance; if the applicant accepts the counteroffer, the insurer generally establishes controls to verify that the required risk control measures have been implemented
* **Change insurance rates, rating plans, or policy** limits – rate modification can either increase or decrease the premium. Using a different rating plan can provide pricing flexibility; the underwriter can properly price a submission based on its loss exposures. **Experience rating** is a plan that adjusts the premium for the current policy period to recognize the loss experience of the organization during past policy periods**; Schedule rating** is a plan that award debits and credits based on specific categories such as the care and condition of the premises, training of employees and to modify the final premium to reflect factors that the class rate does not include; **Retrospective rating** the technique that adjusters the insured’s premium for the current policy period based on the insured’ loss experience during the current period. If high policy limits are requested, the underwriter may suggest lower limits or use **facultative reinsurance** in which primary insurer chooses which loss exposures to submit to the reinsure, and the reinsurer can accept, or reject any exposures submitted.
* **Amend policy terms and conditions** – by modifying the policy to exclude certain causes of loss, add or increase a deductible, or make another coverage change
* **Use facultative reinsurance** – If an applicant is in a class of business or has atypical loss exposures that are excluded from the insurer’s treaty reinsurance agreement – a reinsurance agreement that covers an entire class or portfolio of loss exposures and provides that the primary insurer’s individual loss exposures that fall within the treaty are automatically reinsured – or if the amount of insurance needed exceeds the limit of the treaty reinsurance agreement, the underwriter may be able to transfer a portion of the liability for the applicants loss to a facultative reinsurer.

**Selecting an Underwriting Alternative**

The underwriter must evaluate each underwriting alternative carefully and select the optimal one under the circumstances. In some cases, the underwriter has no choice but to reject a submission; however, rejections produce neither premium or commission, only expense. Therefore, underwriters try to make submission acceptable whenever possible.

**Selecting an alternative involves weighting a submission’s positive and negative features, including the loss exposures contemplated in the insurance rate, risk control measures, and management’s commitment to loss prevention. These factor also should be considered before selecting an underwriting alternative**:

* **Underwriting authority – the underwriter must determine whether he or she has the necessary authority, if not, if must be referred to an individual with higher authority**
* **Supporting business – a submission that is marginal by itself might be acceptable if the applicant has desirable supporting business. The account underwriting approach evaluates all lines together**
* **Mix of business – the underwriter might consider whether accepting the submission supports the insurer’s goal for mix of business**
* **Producer relationships – the relationship between underwriters and producers should be based on mutual trust and respect. Underwriters should consider the opinions and recommendations of the producer before determining alternatives.**
* **Regulatory restrictions – state regulations restrict underwriter’s ability to accept or renew business. Many states also establish time frames within which a submission must be declined or a policy non-renewed, with notice of refusal to renew provided. Underwriters must know these restrictions and make timely decisions to avoid mandatory acceptance of renewal of an otherwise unacceptable submission**.

**Determining an Appropriate premium**

**Underwriters must ensure that each loss exposure is accurately classified so that it is property rated, with the appropriate premium charged. Insurance loss costs (portion of the rate that covers projected claim payments and loss adjusting expenses, the insurer can develop an adequate premium to pay losses and operating expenses and produce a profit) are typically based on a classification system that combines similar loss exposures into the same rating classification.**

**Accurate classification ensures a pool of loss exposures with similar expected loss frequencies and loss severity. Misclassification can produce adverse results, including insufficient premium to cover losses and expenses and the inability to sell policies because prices are higher than competitors’ prices**.

**Implement the Underwriting Decision**

Once an underwriter has evaluated a submission, selected an applied any appropriate modifications, and determined the premium, the next step is to implement the underwriting decision.

**Implementing underwriting decisions generally involves 3 steps:**

* **The underwriting decision is communicated to the producer. If the decision is to accept the submission with modifications, the reasons must be clearly communicated to the producer and applicant, and the applicant must agree to accept or implement any modifications made as a counteroffer. If the submission is rejected, the underwriter must provide a clear explanation of why that applicant does not meet the insurer’s underwriting requirements. Effective communication of both positive and negative decisions clarifies the insurer’s standards and helps the producer understand what kinds of business the insurer wants to write.**
* **The second task is issuing any required documentation. Accepting a submission, the underwriter may need to issue a binder or prepare certificates of insurance.**
* **The third task is to record data about the applicant and the policy for policy issuance, accounting, statistical, and monitoring purposes. Data may include location, limits, coverages, price modifications, and class of business**. This data is coded so that the insurer and the industry can accumulate and aggregate information on all accounts for ratemaking, statutory reporting, financial accounting, and book-of-business evaluations. Such information is also used to monitor the account, trigger renewal, and flag situations requiring special attention.

**Monitor Underwriting Decisions**

The final step, an ongoing one, in the underwriting process is monitoring underwriting decisions. After the underwriting decision has been made on a new-business submission or renewal, the underwriter is tasked with monitoring both individual policies and books of business to ensure that satisfactory results are achieved.

Underwriters must be alert to changes in insured’s loss exposures. Changes in the nature of an insured’s business operation, for example, could significantly raise of lower the insured’s loss potential. Because underwriters do not have the resources necessary to constantly monitor all individual policies, they are usually monitored in response to one or more of these triggering events that may indicate a change in the account:

* Substantive policy change request
* Significant and unique loss occurrences
* Risk control and safety inspection reports
* Premium audit results

Policy monitoring also frequently occurs on renewal. As a policy’s expiration date approaches, the underwriter may need to repeat the underwriting process before agreeing to renew the policy for another term. Renewal underwriting however, can generally be accomplished more quickly than new-business because the insured is already known to the insurers and more information might be available if claim reports or risk control report have been added to the file.

In addition to monitoring individual policies, underwriters must monitor books of business. Monitoring a book of business means evaluating the quality and profitability of all the business written for any group of policies. The evaluation should identify specific problems fore each type of insurance, which can be subdivided into class of business, territory, producer, and other policy subgroups. Monitoring a book of business is also necessary to ensure that premium volume covers the fixed cost and overhead expenses of each book of business.

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

**6 -Measuring Underwriting Results**

**Objective**: *Explain how an insurer’s underwriting results are measured and how financial measures can be distorted.*

An insurer’s underwriting results are a key indicator of its profitability. Without a clear understanding of their underwriting performance, insurers may not be able to respond to conditions that adversely affect them or recognize opportunities to improve their performance.

Insurers typically track their underwriting results through the use of financial and non-financial methods. The most common financial measure of underwriting results over a specific time period – usually one year – is the insurer’s combined ratio. Proper underwriting should produce an underwriting profit or perhaps a small underwriting loss that is more than offset by investment profits. However financial ratios are not always reliable indicators of underwriting success in the short term.

Nonfinancial measures can be used to evaluate the actions of individual underwriters and underwriting departments, rather than their results.

**Financial Measures**

Many insurers use the combined ratio (or combine loss and expense ratio) to measure the success of underwriting activities.

**Combined Ratio – you want less than 100% to show a profit**

**Combined Ratio = Incurred Losses and Adjustment Expenses + Underwriting Expenses Incurred**

**(or trade basis) Premiums earned Premiums written**

***When the combined ratio is***:

**Exactly 100% Every premium dollar is being used to pay claims and cover operating costs, with nothing remaining for insurer profit**

**Grater than 100% An underwriting loss occurs: more dollars are being paid out than are being taken in as premiums**

**Less than 100% An underwriting profit occurs because not all premium dollars taken in are being used for claims and expenses**

*From an insurer’s perspective, the lower the combined ratio, the better. For example, a combined ratio of 95% means that the insurer has an out flow of $0.95 for every premium dollar, while a combined ration of 115% means that the insurer has an out flow of $1.15 for every premium dollar. Therefore, a lower combined ratio reflects higher profitability*.

Although a combined ratio is the most commonly cited measure of underwriting success, the results it produces are generally subject to an additional analysis of its components. Example, individual categories of insurers expenses may be compared with those of other insurers or industry norms, or the specific lines of business that exceeded anticipated losses may be examined. *An in depth analysis enables an insurer to make changes to its underwriting guidelines that yield desired results in the future*.

Changes in premium volume, major catastrophic losses, and delays in loss reporting can distort the combined ratio making it difficult to evaluate the effectiveness of underwriting. Additionally, any discussion of insurer underwriting profitability needs to be considered within the context of the underwriting cycle.

**Distortions Created by Changes in Premium Volume**

An insurer’s combined ratio must be evaluated, taking into consideration fluctuations in premium volume distortions they can create*. Premium volume and underwriting policy are related. Restrictive underwriting policy usually reduces premium volume, while a less restrictive underwriting policy generally increases premium volume.*

**Changes in underwriting policy, however, often do not have the immediate effect desired. Example, an insurer that becomes more restrictive in its underwriting criteria will usually see a reduction in premiums written. Because incurred loses remain outstanding from the prior period that had a less restrictive underwriting policy, the loss ratio component of the combined ratio will likely deteriorate. With this reduction in premiums written, the expense ratio will increase, even though the insurer’s underwriting expenses might have remained relatively unchanged. Similarly, a significant relaxation of underwriting standards, at least in the short term, can make an insurer appear profitable and even cost conscious** **when its book of business is underpriced**.

**Distortions Created by Major Catastrophic Losses**

Hurricanes, earthquakes and other natural catastrophes occur to irregularly to be predicted annually. Catastrophes such as an industrial explosion airplane crashes, nuclear reactor breakdowns, or terrorist activities likewise occur with too little regularity to create a predictable pattern. Ideally, insurance rates allow for unpredicted losses. *Still a major catastrophe is likely to cause an underwriting loss for that year for most, if not all affected insurers. Failure to predict the unpredictable does not necessarily indicate inadequate underwriting*.

**Distortions Created by Delays in Loss Reporting and Loss Development**

Delays in loss reporting reduce the value of the information provided by the combined ratio. *If premiums and loses could be readily matched, an insurer could determine whether its book of business was underpriced and then make correction in its pricing structure. This information is valuable to insurance regulators as well, because an inadequately priced book of business is a significant threat to an insurer’s solvency*.

Insurers establish a loss reserve when a claim is reported. Reserved losses are included in the incurred losses and reflected in the combined ratio. The type of loss usually determines how quickly the insurer is notified of a claim and how quickly the reserve is placed with the amount of final payment. With certain types of insurance, particularly liability, a considerable amount of time can elapse between when a loss is reported and when a claim is settled*. Reserves are established as soon as the loss is reported, but significant inaccuracy exists in estimating ultimate loss costs that will be paid at some future date. The longer between the estimate and the ultimate claim settlement, the greater the inaccuracy is likely to be*.

These delays in loss reporting and loss settlement can result in understatement of losses in one year and an overstatement in another year that appear in the combined ratio. These misstatements do not reflect changes in actual underwriting results.

**Distortions Created by Underwriting Cycle**

Insurance industry underwriting cycles have consisted of a period of underwriting profit followed by a period of underwriting losses, as measured by the combined ratio. When insurers earn underwriting profits, they may use those profits to reduce their premium rates an offer broader coverage to increase their market share.

At times of underwriting losses, insurers may need to increase premium rates and restrict the availability of coverage to increase underwriting profits. These tactics may be necessary for the insurer to maintain the policyholder’s surplus it need to support it level of business. Policyholders’ surplus is an insurer’s total admitted assets minus its total liabilities.

**Because premium levels, capital-allocation strategies, investment strategies, and insurer profitability are affected by this market phenomenon insurers have tried to better understand what factors cause the underwriting cycle to shift to a different phase. Insurers want to be able to maintain their competitive advantage and market share regardless of the cycle phase**

*Regulators* are concerned about the effects of the underwriting cycle on insurance availability and affordability. *Most of the factors affecting the underwriting cycles have been identified through examination of past cycles, changes in the insurance marketplace have reduced the predictive value of these factors. This increases the difficulty in determining when the next cycle will begin.*

Individual insurers cannot change the underwriting cycle. However effective underwriting and financial management can enable an insurer to periodically reposition itself through changes in its underwriting guidelines and allocation of capital to underwriting. This allows the insurer to maximize profits and market share growth during the cycle phases.

Your Combined ratio will be higher when competition / low prices / Soft market this leads to re-underwriting which brings on the Hard market with higher pricing giving you a lower (better combined ratio).

**Non-financial Measures**

The success of an insurer depends on the ability of every underwriter to attain an maintain profitable results over the long term. This profitability goal is accomplished in part by non-financial measures to assess performance.

Non-financial measures link an organization’s business strategy and its outputs to its performance. These measures evaluate individual underwriters and underwriting departments based on their actions rather than their results. If underwriters adhere strictly to underwriting guidelines, underwriting should produce favorable financial results over the long term, barring uncontrollable variables.

**Selection**

Insurers often establish selection goals for underwriters in order to ensure that the quality of the underwriter’s book of business does not deteriorate. Examples, an underwriter might be required to have specific percentages of it book of business to be considered “highly desirable”, “average”, and “below average”. For this type of performance standard to be effective, the insurer’s underwriting guidelines need to clearly delineate among account categories. Selection standards usually support overall underwriting goals and are evaluated during an underwriting audit.

**Product or Line of Business Mix**

Building a proper mix in a book of business requires that underwriters have a thorough knowledge of the insurer’s business goals, including the types of products it prefers to write and the insurer’s appetite for certain risks. If one class of business is not doing well shift to other classes of business.

This performance measure requires a statemen in the insurer’s underwriting guidelines of the desired product or line of business mix for new and renewal business. Underwriters are often held accountable for supporting product or line-of-business mix goals, provided those goals are clearly stated in the insurer’s underwriting guidelines.

**Pricing**

Insurers generally establish pricing standards as a non-financial measure***. Pricing standards enable insurers to determine levels of premium adequacy by comparing premiums charged with the established pricing standards. Underwriters typically modify rates for each account being underwritten to reflect specific features of that account****. Pricing standards indicate the extent to which theses modifications depart from the insurer’s regular, or standard, pricing*. If one underwriter continually apply excessive premium credits to account to obtain new business or to retain it on renewal, *an underwriting audit might reveal that profitability is being sacrificed in return for short term growth.*

**Insurers use information systems to track the extent to which their underwriters deviate from the insurer’s established pricing for specific classifications. *This information might be useful in determining the extent to which the underwriter’s book of business is underpriced or overpriced and where pricing adjustments might be made should market conditions change*.**

**Accommodated Accounts**

Making an underwriting accommodation usually means accepting substandard exposures in return for other, more profitable accounts. Some insurers require that underwriters note accommodation in the file for the account along with reasons for the accommodations. Evaluating the accommodation notes in the files or the log as part of underwriting audits and reviews can reveal whether the underwriter is making excessive accommodations and can ensure that the producer has increased volume or has fulfilled some other promise in exchange for the accommodation.

**Retention Ratio**

The retention ratio is the percentage of expiring policies and insurer renews. Retention can be measured by policy count, premium volume, or both. Because most, is not all, of the underwriting investigation work has been completed for existing policies, retaining these policies offers more profit potential than acquiring new business, which involves acquisition costs.

Low retention rate might indicate serious deficiencies in the way insurers do business, including poor service to producers, noncompetitive pricing, or unfavorable claims service. This requires careful monitoring of the renewal rate and evaluation of any trends detected.

**Hit Ratio**

Increasingly underwriters have dual responsibilities: *they are responsible not only for underwriting a profitable book of business, but also for meeting any new business sales goals the insurer makes applicable to a book of business, which is often referred to a production underwriting (performing underwriting but also traveling to visit and maintain rapport with agents and sometimes clients)*. The hit ratio, sometimes called the success ratio, is nonfinancial measure used to determine how well underwriters (or the insurer as a whole) are meeting their sales goals (the ratio of insurance policies written to those that have been quoted).

High hit ratio may indicate: Competition is easing; rates are inadequate or lower than other insurer’s rates; Coverage is broader than other insurers; The underwriter has the skill set for production underwriting; underwriting-selection criteria are deteriorating; An extremely good relationship exists between the insurer and the producer.

A low hit ratio may indicate: Competition is increasing; rates are higher than other insurers; coverage forms are too restrictive; the underwriter does not have the skill set for production underwriting; Selection criteria are too stringent; service is poor; a poor relationship exists between the insurer and the producer.

**Service to Producers**

Producers work most frequently with insurers who work most cooperatively with them. Because producers usually rank insurers on the basis of service received, an insurer must be able to evaluate its own performance. This standard requires establishing a set of minimum acceptable standards for certain types of service to producers. The actual performance of each underwriter, branch, or region being evaluated is then compared with the targeted level of performance.

**Premium to Underwriter**

The volume of premium an underwriter is able to handle is often-used measure of performance. Underwriting management uses this measure to determine whether individuals underwriters are assuming their share of work compared with other underwriters in the same company handling similar accounts.