Chapter 7

Insurable Perils and Insuring Organizations

Insurable Loss Exposures

Not all exposures to loss are insurable - Which ones are?
• What criteria is used to produce a financially viable and sustainable result?

Characteristics of Ideal Insurable Loss Exposures

• Point of view of the insurance company
  • Large number of homogeneous units
  • Accidental and unintentional losses (from the point of view of the insured)
  • Definite in time and in place, measurable and of sufficient severity to cause economic hardship
  • Non-catastrophic
Characteristics of Ideal Insurable Loss Exposures

- Point of view of the insured
  - Does the exposure warrant protection?
  - Is the probability of loss low? (How much is the premium for low probability exposures?)

Insurance Works Well When.....

The industry adheres to the above guidelines resulting in:

A balance that is maintained between the number of insured exposures and the number and severity of the losses in the pool.

Insurance Doesn't Work Well When....

- More and more people collect
  - Frequency and/or severity increases
  - Price must rise
  - Fewer people buy
  - Risk premiums increase
  - Pool shrinks in size and cycle starts again!
- Results in small pools, many collecting and unaffordable premiums
Principles of Risk Classification

Used to:
- Minimize subsidization
- Minimize adverse selection
- Goal is to have all pay a "fair" share
- Provide a structure for the evaluation of classification schemes

Adverse Selection and Subsidies

- Adverse selection - undisclosed information caused people to pay less than their "fair" share
- Causes subsidization - because included with people paying more than their "fair" share
- Self-selection

When Subsidies Are Caused By Government

- Setting or eliminating classification schemes prevents competition
- Called mandated subsidization
- Example:
  - Males vs. females
  - Annuity
  - Life insurance
  - Group employee pension benefits
Principles of Risk Classification

1) Separation and Class Homogeneity
   • Each classification will have a significantly different chance of loss
   • Each member (in a classification) will have approximately the same chance of loss

Principles of Risk Classification

2) Reliability
   • Information is easily obtained and not subject to manipulation
   • Information is verifiable

Principles of Risk Classification

3) Incentive Value
   • Provides incentive to act in socially and economically positive ways
Principles of Risk Classification

4) Social Acceptability
   • Mathematically fair outcome conflicts with social goals
   • Some rating criteria is socially or legally unacceptable
     because it is beyond the insured's control

Social Issues and Subsidization

• Acquired Immune Deficiency Syndrome (AIDS)
• Automobile Insurance
• Pension Benefits
• Catastrophes

Financial Services Modernization

• Insurance marketing channels will definitely change in the next 10 years.
• Financial Services Reform Act of 1999 – known as Gramm-Leach-Bliley (GLB) Act
### Many Legal Types Sell Insurance

- Stock companies
- Mutual companies
- Reciprocal exchanges
- Fraternal life insurers
- Blue Cross & Blue Shield
- Lloyds’ of London

### Mutual Insurers

- Incorporated, nonprofit organizations
- Advanced premium mutual
  - Initial premium followed by dividends
- Assessment (farm) mutuals
Mutual Insurers

<table>
<thead>
<tr>
<th>Objective</th>
<th>Non-profit; minimum cost (not charitable)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Management</td>
<td>Incorporated; Policyowners own; Board of Directors</td>
</tr>
<tr>
<td>Assessment</td>
<td>Can be; Larger mutuals give up the right to assess.</td>
</tr>
<tr>
<td>Participating Dividends</td>
<td>Yes, return of excess premium when declared; not taxable</td>
</tr>
</tbody>
</table>

Demutualization - 2000

- In 2000 several of the largest mutual companies demutualized and this trend continues
- More flexible capital structure
  - Capital contraints
  - Mergers and acquisition possibilities
  - How to value the “ownership” interest
  - How to compensate owners/policyholders a hard question
  - Need for “stock” to perform will be new experience for managers

Stock Insurers

- Shares of stock exist and can be traded on an organized exchange such as the NYSE or NASDQ
- For profit companies
  - Examples: Allstate, Lincoln national, Equitable life
- Typically, lower initial premium, but no participating dividends; dividends can be paid to stockholders
- Choosing the “best” type of insurer
Stock Insurers

<table>
<thead>
<tr>
<th>Objective</th>
<th>Profit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Management</td>
<td>Incorporated; Stockholders own; Board of Directors</td>
</tr>
<tr>
<td>Assessment</td>
<td>Never</td>
</tr>
<tr>
<td>Participating Dividends</td>
<td>No, taxable stockholder dividends paid</td>
</tr>
</tbody>
</table>

Reciprocal Exchange

- Unincorporated
- Non-profit, association
  - Not a mutual insurance company
- Third largest auto insurer (Farmers Exchange)

<table>
<thead>
<tr>
<th>Objective</th>
<th>Minimum Cost</th>
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</thead>
<tbody>
<tr>
<td>Management</td>
<td>Attorney-in-fact; no capital; unincorporated</td>
</tr>
<tr>
<td>Assessment</td>
<td>Yes</td>
</tr>
<tr>
<td>Participating Dividends</td>
<td>Yes</td>
</tr>
</tbody>
</table>
Lloyds’ of London

- Insurance “marketplace”
  - Collection of underwriting syndicates that write insurance

- Future has been in doubt
- Huge losses ($15.5 billion from 1986 - 1992); Profitable for 1994 accounting cycle
  - U.S. Names (3,000 in 1988) (750 in 1995)
  - Corporate names now participate
- www.lloyds.com

Lloyd's Type

<table>
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<tr>
<th>Objective</th>
<th>Profit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Management</td>
<td>Association of individual underwriters (names)</td>
</tr>
<tr>
<td>Assessment</td>
<td>No</td>
</tr>
<tr>
<td>Participating Dividends</td>
<td>No</td>
</tr>
</tbody>
</table>

The Insurance Industry

- Large numbers of buyers and sellers
  - About 1,200 life insurance companies; 900 property insurers
  - Collusion is unlikely
  - Little product differentiation
    - Standard policy forms in use but service may be variable
  - Employs over 2 million people (1.5 million administration, 750,000 marketing and service)
The Insurance Industry

- Few barriers to entry into the industry
- Cost structure requires law of large numbers to work to generate accurate predictions – large number of buyers
- Declining cost industry
  - Possibly, even a natural monopoly

**FIGURE 7-1** Net Premiums Written (in $ billions) by Type of Life-Health (L-H) Insurer

- [Graph showing data for 1986 and 2006]

Based on Premium data obtained from Best’s Aggregates and Averages, Property Liability Editions, 1999 and 2000.

**FIGURE 7-2** Net Premiums Written (in $ billions) by Type of Property-Liability (P-L) Insurer

- [Graph showing data for 1998 and 2008]

Based on Premium data obtained from Best’s Aggregates and Averages, Property Liability Editions, 1999 and 2000.