Insurance Functions

Chapter 8

AGENCY LAW

• An agent is a person authorized to act on behalf of another person who is the principal
• Duties of the agent:
  • Loyalty
  • Not to be negligent
  • To obey instructions
• Duties of the principal:
  • Pay the agent for services rendered
  • Meet other contractual obligations (training, expense reimbursement, etc.)

INSURANCE OCCUPATIONS

• Insurance Agent and Broker
• Loss Adjuster
• Underwriter
• Actuary
• Lawyer
• Other Occupations
INSURANCE AGENT

• Usual link between the consumer and the insurance company for personal lines.
• Commercial insurance often involves brokers.
• The agency relationship is controlled by agency law

Agent's Authority

• Agents receive authority from principals in several ways
  • Agency agreement (contract)
  • Ratification – through a series of unauthorized and accepted repeated acts
  • Apparent authority – principal leads the public to believe the agency relationship exists
• Scope of authority is established in the agency agreement - contract between agent and the insurance company
• Agency agreement spells out extent of authority as well as all the contract specifics

Types of Insurance Agents

• In Property and Liability
  • When limited to soliciting business - called a "special" or "soliciting" agent
  • When agent able to bind principal then called a "general agent"
• In Life Insurance
  • Insurance agents are soliciting agents because they do not have the power to bind
  • General agents (branch managers) are hired to develop a geographic territory
Insurance Brokers

- Brokers also market insurance in both life and health and property and liability insurance
- Brokers do not have the power to bind
- Broker is agent of the consumer - not the company

Comparison of Agents and Brokers

- AGENCY RELATIONSHIP
  - Consumer - agent - company
- BROKERAGE RELATIONSHIP
  - Consumer - broker - company

Questions: Who does the agent work for? What was the agent doing at the time of the incident?

DISTRIBUTION OF INSURANCE
Property and Liability

<table>
<thead>
<tr>
<th>Direct Writers</th>
<th>Independent Agents</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employee / Agent usually paid by salary + commission</td>
<td>Represents several companies</td>
</tr>
<tr>
<td>Lower Price</td>
<td>Own the business</td>
</tr>
<tr>
<td>Standard Contracts</td>
<td>Paid commissions</td>
</tr>
<tr>
<td></td>
<td>More service</td>
</tr>
<tr>
<td></td>
<td>Local help</td>
</tr>
<tr>
<td></td>
<td>Select company</td>
</tr>
</tbody>
</table>
**DISTRIBUTION OF INSURANCE**

Life Insurance

- Branch manager has control of territory and recruits and trains soliciting or special agents.
- Life insurance agents can never bind coverage; authority limited to the home office.

**LOSS ADJUSTERS**

or Claims Investigator

- Loss adjusters make the product perform - pays the claim.
- Steps in adjusting a claim:
  - Investigate
  - Determine if policy covers
  - Determine amount of the loss
  - Pay the claim
- Independent Adjusters vs. Company Adjusters vs. Public Adjusters

**LOSS ADJUSTERS**

- QUESTION: Why do insurance agents and loss adjusters have to be very careful about what they tell insureds when they process a loss or adjust a claim?
- Waiver - voluntary relinquishment of a known right.
- Estoppel - legal order to create consistent behavior.
UNDERWRITER

- Job is to accept exposures at appropriate rate
- Reject application if underwriting rules do not allow acceptance (too few exposures or lack of data to determine credibility of the class)
- Must be a skillful judge of people
- Goal is to produce a group of insureds by categories whose actual experience will approximate or approach expected.
- Goal is not to reject people going to have losses.

ACTUARY

- Develops statistics and classifications for insurance rates
- Reviews past and projected future results
- Involved in product development
- Regulatory compliance issues
- Calculation of participating dividends

Accountant

- Insurance company accounting is significantly different than manufacturing
  - Assets are mainly financial
  - Liabilities are mainly reserves for loss payments
  - Costs can have long durations
  - Early expensing of selling expenses
Accounting Standards

• Generally Accepted Accounting Principles (GAAP) for insurance companies – publicly traded
• Statutory Accounting Principles (SAP) for regulatory reporting
• International Accounting Standards Board (IASB) produced International Financial Reporting Standards (IFRS)

LAWYER

• Lawsuits
• Wording of insurance contracts
• Deal with regulatory agencies
• General advice and counsel

Other Occupations

• Financial administrators
• Accountants, Financiers, Managers, Statisticians, Economists
• Architects, Engineers
• Doctors, Health Care Professionals
• Marketing, Advertising
• Personnel Administrators, Law Enforcement
• Computer System Operators and Software Authors
• . . .
Reinsurance

- The purchase of an insurance contract on an insurance contract
- Consumers generally do not know their insurance policy is reinsured
- Primary company is responsible for claims
- Small as well as large insurance companies reinsure

Players in the Reinsurance Transaction

- Primary Company
  - Cedes
  - Reinsurer
- Process is called:
  - Cession
- Reinsurer
  - Cedes
  - Retrocession

FIGURE 8-1 Reinsurance Arrangement
Reasons for the Reinsurance Transaction

- Make exposures similar in dollar size
- Enhances the law of large numbers
- Purchase services from reinsurer
- Eases entry into and exit out of the insurance business

Types of Reinsurance

- Facultative - individually negotiated contracts
- Automatic treaty

Reinsurance Loss Splitting

- Prorata – each company takes a percentage of each loss
- Excess of loss – payment occurs after the primary pays up to a limit.
Reinsurance Prorata Loss Splitting

$500,000 LOSS

<table>
<thead>
<tr>
<th>$1 million exposure, 3 companies</th>
<th>Coverage</th>
<th>Primary</th>
<th>Loss</th>
<th>Payment</th>
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</thead>
<tbody>
<tr>
<td>Primary</td>
<td>250,000</td>
<td>20%</td>
<td>600,000</td>
<td>100,000</td>
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<tr>
<td>Reinsurer 1</td>
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<td>30%</td>
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<tr>
<td></td>
<td>1,000,000</td>
<td>100%</td>
<td>600,000</td>
<td>500,000</td>
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Reinsurance Excess-of-Loss Loss Splitting

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<td>0</td>
</tr>
<tr>
<td></td>
<td>1,000,000</td>
<td>600,000</td>
</tr>
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Reinsurance and Risk Management

- Use fronting arrangements for direct access to reinsurance markets
- Tax, solvency, and regulatory issues surrounding fronting arrangements
- The NAIC Model Act on Reinsurance Intermediaries, Managing General Agents and Credit for Reinsurance (1991)
Reinsurance Providers

- Professional reinsurance companies
- Primary companies
- Wholly-owned subsidiaries of non-insurance companies
- International reinsurance firms