Economic Theory

- Normal market
  - Two parties – buyers and sellers
  - Insurance – add regulators
- Reports of the market having problems occur regularly
  - Inability to afford or find coverage
  - Healthcare costs and insurance
  - Attorney Generals’ suit against Insurance Industry
  - Attack on McCarran Ferguson Act
Further Consideration of The Law of Supply and Demand

Conditions for Competitive Insurance Markets

- Large Number of Buyers and Sellers
- Low Exit and Entry Barriers
- Homogenous Products
- Well-Informed Market Parties

Insurance Industry Critics

- Critics of the Industry Charged
  - Collusion
  - Bad business practices
  - Inadequate rate regulation
  - Irresponsible investment practices
## Insurance Industry Response

Costs have gone up due to:
- Increased medical costs, automobile repair costs, and legal expenses
- More thefts, accidents, and insurance fraud
- Courts imposing more frequent and higher punitive awards
- Social inflation – due to liberal legal conclusions
- Investment rates of return are historically low

## FAIR

### Fair Access to Insurance Requirements
- Implemented in 1968
- In place in most states
- Guarantees property owners an inspection of their property if they request it
- If the property is insurable, an appropriate rate is charged
- If not, owner must receive written notice of improvements that are needed

## The Insurance Consumer

- The insurance consumer is not well informed
  - Cost of obtaining information is high
  - Feel that the insurance product is a commodity
  - Legal complexity of the contract
- The more informed the consumer the more information producers will provide
- Consumers do not ask the right technical questions and understand the answers
### Consumer Choices

<table>
<thead>
<tr>
<th>The Company</th>
<th>The Policy</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Financial Strength</td>
<td>- Meets needs</td>
</tr>
<tr>
<td>- Service and loss</td>
<td>- Proper amount of coverage</td>
</tr>
<tr>
<td>settlement practices</td>
<td>- The right price</td>
</tr>
<tr>
<td>The Agent</td>
<td>- Lowest price not necessarily the best price</td>
</tr>
<tr>
<td>- Trust and understand</td>
<td></td>
</tr>
<tr>
<td>- Professional designations and education</td>
<td></td>
</tr>
</tbody>
</table>
Consumer Protection: The Insurance Code
- The Law (Insurance Code)
- Massive amount of consumer protection
  - Financial solvency
  - Fair claims practices
  - Standardized insurance policies
  - Approval of wording
  - Approves rates and forms
  - Disclosure requirements
  - Investment requirements

Consumer Protection: The Insurance Commissioner
- Chief Insurance Regulator
  - Interpretation of insurance code
  - Enforcement of the insurance code
  - Suggests legislation
  - Member of National Association of Insurance Commissioners (NAIC)

Supply of Insurance is Regulated and Limited: Some Concepts
- Loss Ratio
  - Losses and loss adjustment expenses / Earned Premium
- Expense Ratio
  - Other Expenses / Written Premium
- Combined Ratio
  - Loss ratio + Expense Ratio
Supply of Insurance is Regulated and Limited: P/S ratio

Example 1 (Target: 2 or 3 to 1)

<table>
<thead>
<tr>
<th>Surplus</th>
<th>$10,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>P/S Ratio</td>
<td>2:1</td>
</tr>
</tbody>
</table>

Premium Volume Company can Write $20,000

If premium per policy goes up, fewer policies can be sold.
If premium per policy goes down, rates could be inadequate.
I.e., Can't sell unlimited number of policies.

Example 2

If P/S is 3 to 1
Combined Ratio is 1.05
15% of Surplus is wiped out in one year.

<table>
<thead>
<tr>
<th>Surplus</th>
<th>$10,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Premium</td>
<td>$30,000</td>
</tr>
<tr>
<td>Combined Loss</td>
<td>$31,500</td>
</tr>
<tr>
<td>Out of Surplus</td>
<td>$1,500</td>
</tr>
<tr>
<td>Loss as % of Surplus</td>
<td>15%</td>
</tr>
</tbody>
</table>

At 10:1 & 1.05 combined, 50% of surplus gone in one year.
At 5:1 & 1.10 combined, 50% of surplus gone in one year.
At 10:1 & 1.10 combined, 100% gone in one year.
Surplus may also shrink due to investment results.
If premiums remain the same and surplus shrinks, P/S ratio increases.

\[ \text{FIGURE 9-1 The Law of Supply and Demand} \]
<table>
<thead>
<tr>
<th></th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Workers' Compensation</td>
<td>276.6</td>
<td>281.6</td>
<td>287.0</td>
<td>299.7</td>
<td>321.5</td>
<td>309.5</td>
<td>306.5</td>
</tr>
<tr>
<td>Earned Premium</td>
<td>271.5</td>
<td>277.5</td>
<td>283.0</td>
<td>284.8</td>
<td>301.5</td>
<td>304.5</td>
<td>306.5</td>
</tr>
<tr>
<td>Losses Incurred</td>
<td>183.8</td>
<td>173.3</td>
<td>201.9</td>
<td>207.8</td>
<td>251.5</td>
<td>250.6</td>
<td>258.7</td>
</tr>
<tr>
<td>Loss Adjustment Expense</td>
<td>34.9</td>
<td>36.5</td>
<td>37.7</td>
<td>37.8</td>
<td>41.9</td>
<td>41.8</td>
<td>40.0</td>
</tr>
<tr>
<td>Other Underwriting Expense</td>
<td>74.9</td>
<td>77.9</td>
<td>80.6</td>
<td>81.6</td>
<td>86.2</td>
<td>95.8</td>
<td>106.7</td>
</tr>
<tr>
<td>Policyholders' Dividends</td>
<td>4.7</td>
<td>4.7</td>
<td>3.3</td>
<td>3.9</td>
<td>2.4</td>
<td>1.9</td>
<td>1.6</td>
</tr>
<tr>
<td>Underwriting Gain (Loss)</td>
<td>2.3</td>
<td>2.4</td>
<td>3.0</td>
<td>3.1</td>
<td>3.2</td>
<td>1.9</td>
<td>1.6</td>
</tr>
<tr>
<td>Investment Income</td>
<td>16.5</td>
<td>30.9</td>
<td>36.6</td>
<td>40.7</td>
<td>37.7</td>
<td>37.2</td>
<td>38.6</td>
</tr>
<tr>
<td>Operating Income (Loss)</td>
<td>35.3</td>
<td>25.4</td>
<td>13.9</td>
<td>9.8</td>
<td>13.8</td>
<td>5.6</td>
<td>5.8</td>
</tr>
<tr>
<td>Reearned Capital Gains</td>
<td>5.8</td>
<td>10.0</td>
<td>13.7</td>
<td>16.2</td>
<td>16.6</td>
<td>17.2</td>
<td>16.6</td>
</tr>
<tr>
<td>Federal Income Tax</td>
<td>9.5</td>
<td>18.6</td>
<td>3.4</td>
<td>5.3</td>
<td>6.2</td>
<td>4.3</td>
<td>3.8</td>
</tr>
<tr>
<td>Net Income After Tax</td>
<td>54.6</td>
<td>30.8</td>
<td>22.2</td>
<td>20.5</td>
<td>6.8</td>
<td>5.0</td>
<td>4.6</td>
</tr>
<tr>
<td>Loss Ratio (%)</td>
<td>72.8</td>
<td>76.5</td>
<td>78.3</td>
<td>81.2</td>
<td>86.4</td>
<td>81.4</td>
<td>74.7</td>
</tr>
<tr>
<td>Expense Ratio (ex. %)</td>
<td>27.3</td>
<td>27.7</td>
<td>21.1</td>
<td>23.8</td>
<td>25.6</td>
<td>25.6</td>
<td>25.6</td>
</tr>
<tr>
<td>Combined Ratio (at %)</td>
<td>101.6</td>
<td>101.4</td>
<td>107.9</td>
<td>130.1</td>
<td>111.9</td>
<td>106.7</td>
<td>99.6</td>
</tr>
</tbody>
</table>

*Excess losses include sums already paid and estimates of amounts to be paid.
*Loss ratio includes adjustment expenses.

Based on Insurance Services Office, Best's Review, Best's Aggregates and Averages, Interstate Information Institute, Business Insurance and author's calculations,

For further information, contact the current Insurance Services Office, Inc., or the author for details.