Ins 321 risk management ii

Business, Risk Management

INS 321 Risk Management II Course Tutor: AdesolaOgunlade Module Aims: 1) Function aspect of insurance - Introduction to the significant functional areas of insurance; examine each function in order to provide a precise understanding of each of these functions. 2) principles of insurance buying 3) history of insurance legislation in Nigeria Lecture 1: Underwriting function Rate making theory and application The marketing function Recommended Texts Diacon, S. R and Carter, R. L. (1992). Success in Insurance 3rd ed. Athenaeum Press Ltd, Gateshead, Tyne & Wear. Isimoya, O. A. (2000). Risks Management and Insurance Application. Malthouse Press Ltd. Ikeja, Lagos McOliver, Franklin (1993). Principles of Risk Management and Insurance. IdodoUmeh Publishers Ltd, Nigeria. Underwriting What is underwriting? Insurance is unlike almost any other industry, because product prices are fixed long before insurers know what the claims costs will be. It is the probability of a risk occurring which may result in a loss that is being insured against. Underwriting is the procedure by which an insurer evaluates the risk of a proposal and decides whether or not to enter into a contract and if so on what terms i. e. it is the evaluation of risk. (Diacon& Carter, 1992 p. 193) As this is done way before the claims costs are established, selecting and pricing risks have to be effectively done in order to ensure that the insurance company can maintain a profitable account of customers in a constantly changing business environment. What risks to insure? a)Pure Risk: can result only in loss e. g. damage by fire b) Speculative Risk: can result in loss or gain e. g. a business venture c) Particular Risk: localised to an individual or a business i. e. risks we can partially control e. g. the decision to own and drive a car d) Fundamental Risk: affects large numbers of individuals or businesses

— or whole societies e. g. unemployment, riot (a) and (c) tend to be more insurable Assessment: - An understanding of the risk in order to determine whether to accept or not and if accepted on what conditions. This is broadly categorised into; Moral Hazards — attitude and conduct of proposer — don't worry its insured Physical Hazards —tangible factors that arise out of the nature of the risk itself Other factors considered in risk assessment are; ïƒ˜ An evaluation of the major underwriting factors affecting claims experience for the particular type of insurance, e. g. age, sex, health and type of contract ïƒ˜ An assessment of the average claims experience of the group ïƒ˜ An assessment of the effect of the different underwriting factors on claims experience ïƒ˜ A comparison of the proposer's characteristics ïƒ˜ A comparison of the premium to be charged with the amount to be paid in the event of a claim Generally assessments may vary based on the type of insurance. Further reading: classes of insurance and the kind of assessments done in the underwriting function. Other sources of information in the underwriting function are; - Application Form - UberimmaeFidei - The Brokers - Survey - Centralised information sources for example mortality tables used in life insurance Rate Making Theory and Application Rate making is the process of establishing premium rates for an insurance company's service products. (Isimoya, 2000 p. 246) Pricing insurance refers to the setting of the insurance ' rate' for a particular unit of exposure. For example, a premium of N50, 000 to provide coverage against fire damage, to a total value of N10M, suggests a rate of N0. 50 for every N100 of fire insurance. The premium is the total price paid at a particular insurance rate. Insurance market is divided into life and non-life insurance, effective rate making is based on

these two categories. Factors to consider when fixing the premium 1) Equity among policyholders 2) Sufficiency 3) Profitability Components in rating - loading - target loss ratio Rates cannot be set to simply exceed claims costs. In setting rates the following should be put into consideration; - cost of expected claim payments - cost of services provided as part of the insurance process (admin) - payments to providers of capital placed at risk More sophisticated loadings might also take account of such factors as: level of uncertainty level of profit theneed to even out rates over the course of good and bad years the insurer’s ability to profit from investing the premium in stocks, bonds, etc. Adding the costs associated with all these factors establishes a ‘ loading fee’. Target Loss Ratio As insurers accumulate claims data and enjoy increasing volume, they can experiment to find the optimal resource expenditure upon loss control and adjustment, and they can exploit economies of scale in the provision of administrative services. Hence the ratio of claim costs to total premium may be expected to fluctuate. ‘ Target loss ratio’ is a fixed ratio of claims costs to total premium. Insurers set themselves the objective of working towards a ‘ target loss ratio’ where there is an optimal ratio between claims costs and efforts made by the insurer to reduce these costs. This in turn means that claims costs will come to equal a fixed ratio of the total premium. In setting rates for the year ahead, insurers may divide the incurred lost ratio (known from past experience) by the target loss ratio (which the insurer will work towards over the course of that year). Insurance Rating Procedures Whereas a general rate may be set for a particular unit of exposure, rates may be set for specific risk exposures, which means they will vary between insureds, even

for similar exposure units. Ratings procedures are required, which take an even handed approach to considering individual insurance proposals, and for varying individual premiums either above or below the general rates which exist for particular units of exposure. Principal rating procedures * individual or judgment rating — here, individual judgement is used to produce a unique rating for each insured. * class / manual rating — here, insurance rates for particular insurance classes are printed in a manual. Individual judgement may be exercised in deciding which class a particular insurance proposal should be assigned to. * modification/merit rating — here, insurance rates are varied for individual insureds within the same rating class, based upon past or anticipated losses for individual insureds. - schedule rating occurs where a schedule is drawn up which records ways in which a specific insured is better or worse than what is ‘ standard’ for insureds within their class. This information is used to modify premiums above or below what is standard for that class. - premium discount plans may apply for large premium insureds, in recognition of the economies of scale associated with administering larger clients. -experience rating is a claim sensitive method which modifies premium levels in accordance with actual claims experience - retrospective rating is a claim sensitive method which specifies how the premium for the year ahead will be based on actual claims experience. Factors affecting rates are; ï‚§ Marketing influence ï‚§ Long term agreement ï‚§ Good features e. g. proper fire safety procedures in a building ï‚§ Short period premium scales ï‚§ Exposure