FUNCTIONS OF INSURERS

RATE-MAKING FUNCTION:

- An Insurance Rate is the “price per unit of insurance”.
- Insurance pricing is distinct from product pricing in the following respects:
  - Price for insurance must be based on prediction.
  - Insurance rates are subject to Government regulations.
- State laws require insurance rates – not excessive, be adequate, and not unfairly discriminatory.
- Insurance rates must be relatively stable over time.
- Rates should be sufficiently responsive to changing conditions.
- Rates should provide an incentive for the insured to prevent loss.

- RATE: Rate is the price charged for each “unit of protection” or exposure.
- PREMIUM: Premium is determined by multiplying the rate by the number of units of protection purchased.
- For example, in life insurance, rates are computed for each 1000 Birr in protection, in fire insurance, the rate applies to each 100 Birr of coverage.
- GROSS PREMIUM is based on GROSS RATE.
- GROSS RATE is composed of two parts:
  - Provision for payment of losses, and
  - LOADING (Cover for the expenses of operation).
- PURE PREMIUM: Pure Premium is that part of the rate that is intended to cover losses (expressed in currency)
- EXPECTED LOSS RATIO: Expected Loss Ratio is the cover for losses expressed in percentage.
- The Loading takes into account:
  - Commission
  - Other acquisition expenses
  - General administrative expenses
  - Premium Taxes
  - Allowances for contingencies and Profit.

$$\text{Gross Rate} = \frac{\text{Pure Premium}}{1 - \text{Expenses Ratio}}$$

Supposing expenses are of 40% and the cover for losses (pure premium) is 300 Birr,

$$\text{Gross Rate} = \frac{\text{Pure Premium}}{1 - \text{Expenses Ratio}} = \frac{300 \text{ Br}}{1 - 0.40} = \frac{300}{0.60} = 500 \text{ Birr}$$

RATE-MAKING METHODS:

- INDIVIDUAL RATING
    - Each insured is charged a unique premium based on the judgment of the person setting the rate
    - Not widely in use
    - Followed in Ocean Marine Insurance
- CLASS RATING

  (also known as “Manual Rating” as the rates are printed in a Manual)
    - Insureds are classified into a few important and easily identified characteristics, and the insureds in each class are charged the same rate
    - Most widely used method
    - Two Approaches in Class Rating:
        - Loss-Ratio Approach (used in Fire and Marine Insurances): In this approach, the actual loss ratio during some representative period in the past is compared with a permissible or expected loss ratio.
        - Pure Premium Approach (used in Automobile, Workers’ Compensation, and Life Insurances): In this approach, changes in the average rate level for all classes combined are usually calculated using a loss-ratio formula.
- MODIFICATION RATING (or) MERIT RATING
    - The rate maker distinguishes among insureds in the same rating class on the basis of differences in expected losses or expenses per exposure unit
    - Four principal Merit Rating methods are: Schedule Rating, Experience Rating, Retrospective Rating, and Premium-Discount Plans.
    - SCHEDULE RATING: In this method, the modification is based on a comparison between some specified characteristics of a standard

insured and the corresponding characteristics of the insured who is being rated.

- EXPERIENCE RATING (also known as PROSPECTIVE EXPERIENCE RATING): Under this method, the modification is based on the relative loss experience of the individual insured during some representative period in the past.
- RETROSPECTIVE RATING (also known as RETROSPECTIVE EXPERIENCE RATING): In this, the modification depends upon the insured's experience during the policy period and a premium discount for expense savings attributable to the size of the insured.
- SIZE-DISCOUNT PLANS (or PREMIUM-DISCOUNT PLANS): These plans produce relatively lower premiums for large-premium insureds on the ground that they will probably experience more favorable expense ratios, loss ratios, or both merely because they are large.

PRODUCTION FUNCTION:

- The Production Department of an Insurance company is its sales or marketing division, and is known as the Agency Department.
- This department supervises the external portion of the sales effort – conducted by the agents or salaried representatives of the company.
- The internal portion of the production function is carried on by the production (or agency) department – by selecting and appointing agents and assisting them in sales of insurance products.
- Special Agents: Special agent is a technician who calls on agents, acting as an intermediary between the production department and the agent. This special agent renders assistance when needed on rating and programming insurance coverage.

UNDERWRITING FUNCTION:

- Underwriting is the process of selecting and classifying exposures.
- It is an essential element in the operation of any insurance program.
- There must be the same proportion of good and bad risks in the group insured as there were in the one from which the basic statistics were taken.
- The goal of underwriting is "to avoid a disproportionate number of bad risks, thereby equalizing the actual losses with the expected ones".

- The underwriter must secure an adequate volume of exposures in each class.
- He must guard against concentration of exposures that might result in a catastrophe.
- The process of underwriting involves collection of as much information about the subject of the insurance as possible. This collection of information is done through the following four sources:
    - Application containing the insured's statements
    - Information from the agent or broker
    - Information from external agencies
    - Physical examination or Inspection

LOSS / CLAIM SETTLEMENT FUNCTION:

- One of the basic purposes of insurance is to provide for the indemnification of those members of the group who suffer losses.
- This is attained in the loss-settlement (or Claim-Settlement) process.
- It is important that the insurance company pay its claims fairly and promptly.
- It is equally important that the company resists unjust claims and avoid overpayments.
- Claims department of an insurance company is supported / assisted by ADJUSTERS.
- An Adjuster is an individual who investigate losses. He determines the liability and the amount of payment to be made.
- Adjusters are generally granted 'Draft Authority' – which means that they are authorized to issue company checks in payment of losses up to some stipulated amount.
- The claim settlement process (that is followed by Adjusters) involves the four main steps:
    - Notice of Loss (issued by the insured to the company that a loss has occurred)
    - Investigation (designed to determine if there was actually a loss covered by the policy, and the amount of the loss)
    - Proof of Loss (is required to be submitted by the insured within a specified time after giving Notice of Loss)
    - Payment or Denial of the Claim (if all goes well, draft for claim settlement will be issued, otherwise disallowed – if there was no loss

at all, the policy did not cover the loss, or the adjuster feels that the claim amount is unreasonable).

INVESTMENT FUNCTION:

- Insurance companies accumulate large amounts of money for payment of claims in the future – which cannot be permitted to remain idle.
- It is the responsibility of the finance department of the insurance company to see that these funds are properly invested.
- Safety of the principal is the primary requisite in investing the funds of insurance company.
- Normally a major portion of the investments is in bonds (corporate and government) and a sizeable portion invested in mortgages, real estates and policy loans, and a small proportion of investment in corporate stocks.