

Underwriting

UNDERWRITING ACTIVITIES

Underwriting is the process by which insurers evaluate applicants for insurance and those currently insured in order to maintain a profitable book of business.

To a large extent, an insurer's success in achieving its goals depends on the effectiveness of its **underwriting**. Insurers themselves, rather than their employees, are sometimes called underwriters. However, the term **underwriter** is usually reserved for an insurer employee who evaluates applicants for insurance, selects those that are acceptable to the insurer, prices coverage, and determines policy terms and conditions.

Underwriting consists of four activities:

- Selecting insureds
- Pricing coverage
- Determining policy terms and conditions
- Monitoring underwriting decisions

The first three activities are not performed in sequence but occur simultaneously. The last activity, monitoring underwriting decisions, is ongoing. Underwriters try to select insureds to whom the insurer can offer insurance coverage under reasonable conditions. Of course, the price charged for coverage must be high enough to enable the insurer to pay claims and to provide the insurer with a reasonable profit.

Selecting Insureds

Insurers must carefully screen applicants to determine which ones to insure. If insurers do not properly select policyholders and price coverages, some insureds might be able to purchase insurance at prices that do not adequately reflect their loss exposures. Underwriters, producers, and underwriting managers all participate in selecting policyholders.

Underwriting

The process of selecting insureds, pricing coverage, determining insurance policy terms and conditions, and then monitoring the underwriting decisions made.

Underwriter

An insurer employee who evaluates applicants for insurance, selects those that are acceptable to the insurer, prices coverage, and determines policy terms and conditions.

Most insurers receive more insurance applications than they accept. An insurer cannot accept all applicants for two basic reasons:

1. The insurer can succeed only if it selects applicants who, as a group, present loss exposures that are proportionate to the premiums that will be collected. In other words, insurers try to avoid adverse selection.
2. An insurer's ability to provide insurance is limited by its capacity to write new policies.

Adverse Selection Considerations

Insurers expect to pay claims. Without claims, insurance would be unnecessary. However, insurers try to select applicants who are not likely to have covered losses greater than the insurer anticipated in its insurance rates. On the other hand, people with the greatest probability of loss are often more likely to purchase insurance, a situation called **adverse selection**.

Poor underwriting results might occur if too many of the applicants accepted for insurance are those most likely to incur serious losses. Underwriters minimize adverse selection by screening applicants to avoid those who present loss potentials not adequately reflected in the insurance rates.

An extreme example of adverse selection involves a burning building. No insurer would knowingly write fire insurance to cover a building that is already burning, but the owner of an uninsured building that is on fire would probably be glad to purchase fire insurance on the building.

Adverse selection is particularly prevalent with some kinds of insurance. For example, owners of property next to a river are more likely to purchase flood insurance than are those who own property on a hilltop with no flood exposure.

Pricing Coverage

The underwriting pricing goal is to charge a premium that is commensurate with the loss exposure. In other words, each insured's premium should be set at a level that is adequate to enable the total premiums paid by a large group of similar insureds to pay the losses and expenses of that group and to allow the insurer to achieve a reasonable profit.

Basically, pricing insurance involves classifying the applicant by category of loss exposure and then determining a premium by applying an appropriate rate to the applicant's exposure units. The rate is the price of insurance charged per exposure unit, and an exposure unit is a unit measure of loss potential used in rating insurance. The exposure unit used depends on the type of insurance:

Adverse selection
In general, the tendency for people with the greatest probability of loss to be the ones most likely to purchase insurance.



Type of Insurance	Exposure Unit
Workers compensation	Each \$100 of payroll
Property insurance	Each \$100 of insurance
Auto liability insurance	Each car month insured (one car insured for one year would be 12 exposure units)

The premium is determined by multiplying the rate by the number of exposure units. For example, the premium for property insurance with a limit of \$250,000 at a rate of \$0.40 per \$100 of insurance is \$1,000.

$$\text{Premium} = \frac{\$250,000}{\$100} = 2,500 \text{ units} \times \$0.40 \text{ per unit} = \$1,000.$$

The premium is the total amount of money an insured pays the insurer for a particular policy or coverage for a stated period. For example, an insurer may charge a premium of \$750 to provide a one-year property insurance policy with a \$500 deductible for a \$200,000 brick home located in Anytown, U.S.A. The same insurer may charge \$750 to provide identical coverage on a \$160,000 brick home located five miles outside Anytown. While the total premium would be the same in both cases, the rate per \$100 of insurance is different, probably reflecting a difference in fire protection in the two locations.

Of course, accurately predicting what losses a particular insured will have during a given policy period is difficult. An excellent driver may have several auto accidents in a year because of a streak of bad luck. A careless driver may get through the same year without any accidents. However, according to the law of large numbers, prediction becomes more accurate as the number of similar insureds increases.

Although one excellent driver may have a worse year than one careless driver, it is highly unlikely that a group of one hundred cautious drivers will have more insured losses than a group of one hundred careless drivers. Each group of drivers should be charged a premium commensurate with their loss exposure. Therefore, drivers with good driving records are generally charged less than those with poor driving records.

Determining Policy Terms and Conditions

Selection and pricing are intertwined with a third underwriting activity—determining policy terms and conditions. The insurer must decide exactly what types of coverage it will provide to each applicant and then charge a premium appropriate to that coverage.

