# FUNCTIONS OF INSURERS

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***"You don't have to be an expert on every company, or even many. You only have to be able to evaluate companies within your circle of competence. The size of that circle is not very important; knowing its boundaries, however, is vital."***

*- Warren Buffett*

When learning a new topic, it is generally easier to gain a basic understanding from someone experienced on the matter rather than beginning from scratch. For example, if I wish to learn more about computers, I would talk to my brother who obtained a degree in information technology. Likewise, if my car is making a foreign noise, I would consult my father before the dealership quotes the repairs at the cost of the vehicle. With that being said, if you desire for your circle of competence to incorporate insurance companies, what better reference than Berkshire Hathaway's annual letters? After researching the fundamentals of insurance for many hours, an overview of basic insurance functions is condensed in this short paper. The information is not tailored to the operational differences among various providers, but rather to be utilized as a general framework for understanding primary insurance operations. In any instance where terminology may have been inadequately explained, please refer to the National Association of Insurance Commissioners.

There are all sorts of different insurance companies ranging from auto to life to property and casualty. Despite the differences, the primary functions focused on in this oversimplified crash course are categorized as follows:

1. Rate-making: Depending on the size and type of insurance company, rates may be computed by an actuarial department, an actuarial consulting firm, rating bureaus, or independent staff and underwriters. While all prices are "a function of the cost of production," an insurer's "cost of production is not known when the contract is sold" (Vaughan 126). Insurers attempt to forecast claims and expenses so that total premiums (rate x number of units) adequately cover these costs. Additionally, the standard dollar amount of each unit is dependent on the type of insurance coverage. A brief explanation as to how rates are calculated follows:

$$\textit{Pure Premium} = \frac{\textit{Expected Losses}}{\textit{Exposure Units}}$$

The pure premium is "designed to provide for the payment of losses" and is one of two components that form the gross rate (Vaughan 126).

$$\textit{Gross Rate} = \frac{\textit{Pure Premium}}{\textit{1-Expense Ratio}}$$

The expense ratio, "primarily a matter of cost accounting," typically includes:

- Commissions
- Other acquisition expenses
- General and administrative expenses

- Premium taxes
- Allowance for contingencies and profit

“Since several of the expenses” vary with the growth and shrinkage of premiums, “expenses are usually treated as a percentage of the final rate.” Consequently, the denominator represents the portion of premium “available to pay losses after provision for expenses” (Vaughan 127).

It is important to note the term “expected losses.” This term implies rates are not solely based upon historical loss experience. Instead, rates look forward and are computed with a degree of judgment. For example, higher gas prices could incentivize people to drive less frequently. Fewer cars on the road would decrease the probability of an accident, allowing an underwriter or agent to offer a lower rate. However, this change in driving habits would eventually manifest itself in decreasing loss trends provided by rating bureaus. Since this is public information and insurance companies offer “standardized policies which can be copied by anyone,” rates would likely experience an industry-wide drop. Where there is no product differentiation, there is no pricing power. As a result, when “markets loosen and rates become inadequate” due to competition for premiums, accepting reduced volume will require “unusual managerial discipline” as “it runs counter to normal institutional behavior to let the other fellow take away business” (BRK 1977 Letter). Since a significant portion of an insurer’s investments is devoted to bonds, this scenario occurs when interest rates encourage obtaining “business at underwriting loss levels” (BRK 1979 Letter).

Additionally, there are two types of rating systems. These systems are known as class rates and individual rates. Class rates apply “to all applicants possessing a given set of characteristics,” while individual rates are broken down into either judgment, schedule, or experience ratings (Vaughan 127). Since rating systems are predominately dependent on the line of insurance offered, an in-depth analysis is beyond the general scope of this paper.

2. <u>Production</u>: The production department consists of the sales and marketing division. Their primary responsibilities include appointing agents and supervising “the external portion of the sales effort” (Vaughan 130). Accordingly, a brief overview of the different marketing systems may be useful.

    a. The agent is “first and foremost the representative of the insurance company.” In some lines of insurance, their responsibilities are more limited than others. For example, property and liability agents are “authorized to create, terminate, and modify contracts,” while life insurance agents can only solicit and deliver contracts. Neither the life insurance agent nor the broker possesses the authority to bind an insurance company to a contract. However, take note that some agents can “act as brokers, placing coverage through the agents of companies they do not represent” (Vaughan 82).

    b. The broker “is a representative of the insured.” In exchange for a commission, the broker “solicits business from clients and then places the business with an insurer.” Since they do not represent an insurance company, “information provided to the broker is not imputed to the company” (Vaughan 83).
    This information may be important when determining an insureds overall risk profile.

    c. The direct response system promotes “the sale of insurance by mass media advertising and” direct mail (Vaughan 84). As the primary form of marketing, this distribution system is typically more common among national insurers possessing brand name recognition and large advertising budgets. As a result, some larger insurance companies successfully reduce agent commissions relative to total expenses while increasing premium volume.

3. <u>Underwriting</u>: A firm’s “underwriting policy establishes the framework within which the desk underwriter makes decisions.” It is usually formulated “by the officers in charge” and outlines geographical exposures, prohibited exposures, along with the “lines of insurance” and “amount of coverage to be permitted” (Vaughan 131).

The main objective "of underwriting is not the selection of risks that will not have losses," but rather "to avoid a disproportionate number of bad risks." In other words, the goal is for actual losses to equal expected losses. Real losses may exceed expected losses if the underwriter does not possess "thorough knowledge of the hazards associated with various types of coverage" (Vaughan 130). Information obtained by the underwriter "regarding the hazards inherent in an exposure" is derived from five sources (Vaughan 131). These sources include: (a) application, (b) information from the agent or broker, (c) investigations, (d) information bureaus, and (e) physical examinations or inspections.

a. "The questions on the application are designed to give the underwriter the information needed to decide if he or she will accept the exposure, reject it, or seek additional information" based on the company's underwriting policy.

b. The amount of weight placed "on the recommendations of the agent or broker" varies "with the experience the underwriter has had with the particular agent in question."

c. An underwriter may request an inspection company to generate a report of an applicant covering a wide range of personal characteristics. These characteristics may include, but are not limited to, "financial status, occupation, character, and the extent to which he or she uses alcoholic beverages."

d. An auto-industry supportive bureau may provide data regarding an "applicant's motor vehicle record with a list of violations from the state department of motor vehicles" at the underwriter's request.

e. Physical examinations may be conducted by physicians and reported to the underwriter in the life insurance field. An inspection of the premises "is performed by the agent" or company representative in the property and liability field (Vaughan 132).

It is the underwriter's responsibility to consider information provided by these sources since some exposures are "unacceptable at one rate" but "may be written" at another. The desk underwriter's job is further complicated by the need to "secure an adequate volume of exposures in each class" while guarding against concentration "that might result in catastrophe" (Vaughan 130). Buffett offers his thoughts regarding an insurance company's relative inability to protect against catastrophic events during this clip of **Berkshire's 2019 annual meeting**.

4. Loss adjustment: The claims department is charged with the responsibility of paying losses. "Prompt, courteous, and fair claim" services are viewed as "one of the most effective competitive tools available to a company." While efficient claim payments may provide a competitive edge, avoiding overpayment of losses remains a critical function of the department. As a result, insurance companies utilize "adjusters" who investigate losses. These adjusters may "include agents as well as staff, bureau, independent, and public adjusters."

   Depending on the line of insurance, agents may be "authorized to issue company checks in payment of losses up to some stipulated amount." However, "most insurers employ adjusters who are salaried representatives." If hiring a full-time adjuster is not economically feasible, "the company will contract for" alternative services from an adjustment bureau or independent adjuster (Vaughan 133). While the independent adjuster represents multiple firms, public adjusters are "employed by an insured who has suffered a loss and does not feel able to handle his or her own claim." Compensation is typically a "contingency fee basis under which the" public "adjuster collects a percentage of the settlement" (Vaughan 134).

   Insurance companies typically follow a set process when settling claims. These steps include: "(1) notice of loss, (2) investigation, (3) proof of loss, and (4) payment or denial of the claim." (Vaughan 134). However, arguably the most troubling part of the settlement process involves the fact that value is often "a matter of opinion" (Vaughan 135). Accordingly, the adjuster must ensure claims are reasonable while simultaneously attempting to satisfy the client.

5. Investment: Insurance companies receive large sums of cash for the payment of future claims. Consequently, an insurer's finance committee is responsible for investing the capital as "it would be a costly waste to permit these funds to remain idle." Since a portion of an insurer's invested funds are dedicated to satisfying future claims, safety of principal is a common theme (Vaughan 135). Of the investment products offered, insurers primarily utilize corporate stocks, bonds, mortgages, real estate, and policy loans. While an investment portfolio's structure varies with each line of insurance, the majority of funds are typically devoted to corporate and government bonds. This potentially enables "low tax rates because of significant amounts of tax-exempt interest and dividend income" (BRK 1978 Letter).

For further insight, Berkshire provides a concise break-down of the most important factors when evaluating an insurance company on page eight of the **1998 Chairman's letter**.

Vaughan, E. J., & Vaughan, T. M. (1996). *Fundamentals of risk and insurance*. Wiley.