

Fundamentals of Underwriting

PURPOSE OF UNDERWRITING

Insurance companies assume billions of dollars in financial risk annually, risk that is transferred to them from individuals and businesses via the insurance transaction. Insurance underwriters, using the underwriting process and various supporting underwriting tools, are employed by insurers to assess both their new and current business. An insurance company's overall profitability can depend significantly on the quality of its underwriting.

Underwriting has multiple purposes. The overarching purpose is to develop and maintain a profitable **book of business** for the insurer. Underwriting is crucial to an insurer's success; underwriting goals flow directly from the insurer's corporate strategies and objectives. Favorable underwriting results are necessary for an insurer's ability to sustain profitable growth.

To achieve profitability, the underwriting function serves additional purposes:

- Guarding against adverse selection
- Ensuring adequate policyholders' surplus
- Enforcing underwriting guidelines

Guarding Against Adverse Selection

Underwriters are an insurer's guard against **adverse selection**. These are examples of adverse selection:

- Some property owners in areas prone to coastal storms purchase wind-storm coverage or increase their limits only before a hurricane season, when they expect severe losses.
- A disproportionate percentage of property owners in an earthquake-prone zone purchase earthquake insurance, as compared to property owners in areas less prone to earthquakes.

Underwriters minimize the effects of adverse selection by carefully selecting the applicants whose loss exposures they are willing to insure, charging appropriate premiums for the applicants that they do accept with premiums that accurately reflect the loss exposures, and monitoring applications and books of business for unusual patterns of policy growth or loss.

Underwriting

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

Book of business

A group of policies with a common characteristic, such as territory or type of coverage, or all policies written by a particular insurer or agency.

Adverse selection

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



Policyholders' surplus

Under statutory accounting principles (SAP), an insurer's total admitted assets minus its total liabilities.

Capacity

The amount of business an insurer is able to write, usually based on a comparison of the insurer's written premiums to its policyholders' surplus.

Underwriting guidelines (underwriting guide)

A written manual that communicates an insurer's underwriting policy and that specifies the attributes of an account that an insurer is willing to insure.

Underwriting authority

The scope of decisions that an underwriter can make without receiving approval from someone at a higher level.

Line underwriter

Underwriter who is primarily responsible for implementing the steps in the underwriting process.

Staff underwriter

Underwriter who is usually located in the home office and who assists underwriting management with making and implementing underwriting policy.

Ensuring Adequate Policyholders' Surplus

An insurance company must have adequate **policyholders' surplus** if it wishes to increase its written premium volume. An insurer's **capacity** is limited by regulatory guidelines and often by its own voluntary constraints, which are frequently more conservative than those imposed by regulators. If an insurer's underwriting practices generate policy premiums that exceed losses and expenses, the policyholders' surplus will increase, thereby increasing capacity.

Underwriters ensure the adequacy of policyholders' surplus by adhering to underwriting guidelines, making certain that all loss exposures are correctly identified, and charging adequate premiums for the applications that are accepted.

Enforcing Underwriting Guidelines

Underwriting guidelines reflect the levels of **underwriting authority** that are granted to varying levels of underwriters, producers, and managing general agents (MGAs). Exactly who has what level of underwriting authority varies considerably by insurer and by type of insurance.

Underwriting ensures that applicants accepted adhere to underwriting guidelines. If loss exposures, risks, or policy limits on an application exceed an underwriter's authority, he or she will seek approval through supervisory and management ranks within the underwriting department.

UNDERWRITING ACTIVITIES

In insurance organizations, underwriting responsibilities are delegated by members of senior management to line and staff underwriters who coordinate the day-to-day risk selection decisions and the management-level underwriting activities. This coordinated effort is crucial to the achievement of the insurer's profitability goals.

There is no standard method to organize insurer underwriting activities. However, insurers commonly distinguish between **line underwriters** and **staff underwriters**. The focus of line underwriters is evaluating new submissions and renewal underwriting. Line underwriters work directly with insurance producers and applicants. The focus of staff underwriters is managing the risk selection process. Staff underwriters work with line underwriters and coordinate decisions with other departments to manage the insurance product, pricing, and guidelines. See the exhibit "Underwriting Activities Performed by Line and Staff Underwriters."

Line Underwriting Activities

Line underwriters evaluate individual accounts for acceptability and execute underwriting policy by following practices and procedures outlined by staff



Underwriting Activities Performed by Line and Staff Underwriters

Line underwriters

- Select insureds
- Classify and price accounts
- Recommend or provide coverage
- Manage a book of business
- Support producers and insureds
- Coordinate with marketing efforts

Staff underwriters

- Research the market
- Formulate underwriting policy
- Revise underwriting guidelines
- Evaluate loss experience
- Research and develop coverage forms
- Review and revise pricing plans
- Arrange treaty reinsurance
- Assist others with complex accounts
- Conduct underwriting audits
- Participate in industry associations
- Conduct education and training

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underwriters. The specific tasks line underwriters perform may vary by insurer; however, most line underwriters are responsible for these major activities.

Select Insureds

Line underwriters select new and renewal accounts that meet the criteria established in underwriting guidelines. Underwriters' effective account selection is essential to attaining these goals:

- Avoiding adverse selection
- Charging adequate premiums for accounts with a higher-than-average chance of loss
- Selecting better-than-average accounts for which the premium charged will be more than adequate
- Rationing an insurer's available capacity to obtain an optimum spread of loss exposures by location, class, size of risk, and line of business

Line underwriting selection activities are continuous. Line underwriters monitor accounts to ensure that they continue to be acceptable. A line underwriter may cancel or nonrenew an account if risk control recommendations made at the policy's inception are not implemented or if the insured fails to take corrective action to control loss frequency.

