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LECTURE 5. ROLE OF INSURANCE MARKET



- ▶ In this section we elaborate on:
 - ▶ The marketing activities within different segments of the insurance industry.
 - ▶ The various types of agency relationships.
 - ▶ How agents and brokers differ.
 - ▶ The major features of underwriting.
 - ▶ The role of actuarial analysis in insurance operations.

LEARNING OBJECTIVES

- ▶ In this section we elaborate on:
 - ▶ The tools actuaries utilize to perform their work.
 - ▶ The investments of insurers, or investment income—the other side of insurance operation.
 - ▶ The fact that insurers are holders of large asset portfolios.
 - ▶ How reinsurance works and the protection it provides.
 - ▶ Contract arrangements in reinsurance transactions and methods of coverage.

LEARNING OBJECTIVES

- ▶ In this section we elaborate on:
 - ▶ The benefits of reinsurance.
 - ▶ The general legal aspects of insurance.
 - ▶ The claims adjustment process and the role of the claims adjuster.
 - ▶ The management function.

LEARNING OBJECTIVES

- ▶ Insurance may be bought through agents, brokers, or directly from the insurer.
- ▶ An agent legally represents the company.
- ▶ A broker represents the buyer and, in half of the states, also represents the insurer because of state regulations.
- ▶ Both agents and brokers are compensated by the insurer.
- ▶ In many states, **producer** is another name for both agents and brokers.

MARKETING

- ▶ Life/Health Insurance Marketing
 - ▶ General Agency System
 - ▶ A **general agent** is an independent businessperson rather than an employee of the insurance company and is authorized by contract with the insurer to sell insurance in a specified territory.
 - ▶ Subagents usually are given the title of agent or special agent.
 - ▶ A **personal producing general agent** sells for one or more insurers, often with a higher-than-normal agent's commission and seldom hires other agents.

MARKETING

- ▶ Managerial (Branch Office) System
 - ▶ The **branch manager** is a company employee who is compensated by a combination of salary, bonus, and commissions related to the productivity of the office to which he or she is assigned.

MARKETING

- ▶ Property/Casualty Insurance Marketing
 - ▶ Independent (American) Agency System
 - ▶ The **independent agent** usually represents several companies, pays all agency expenses, is compensated on a commission plus bonus basis, and makes all decisions concerning how the agency operates.
 - ▶ An independent agent **owns the x-date**; that is, he or she has the right to contact the customer when a policy is due for renewal.

MARKETING

- ▶ Direct Writers and Exclusive Agents
 - ▶ **Direct writers:** Companies that market insurance through exclusive agents.
 - ▶ **Exclusive agents** are permitted to represent only their company or a company in an affiliated group of insurance companies.
 - ▶ Some direct writers place business through **salaried representatives**, who are employees of the company.
- ▶ Brokers
 - ▶ **Broker** is an individual who solicits business from the insured and also acts as the insured's legal agent when the business is placed with an insurer.

MARKETING

- ▶ Group and Supplemental Insurance Marketing
- ▶ Internet Marketing
- ▶ **Mass Merchandising:** The selling of insurance by mail, telephone, television, or e-mail.
- ▶ **Financial Planners:** Individuals who facilitate some insurance sales by serving as a consultant on financial matters, primarily to high-income clients.

MARKETING

- ▶ **Underwriting** is the process of classifying the potential insureds into the appropriate risk classification in order to charge the appropriate rate.
- ▶ An **underwriter** decides whether or not to insure exposures on which applications for insurance are submitted.
- ▶ There are separate procedures for group underwriting and individual underwriting.

UNDERWRITING

- ▶ Once the underwriter determines that insurance can be issued, the next decision is to apply the proper premium rate.
- ▶ Over the years, insurers have used a variety of factors in their underwriting decisions.

UNDERWRITING

- ▶ Administration is defined broadly to include accounting, information systems, office administration, customer service, and personnel management.
- ▶ **Service** is the ultimate indicator on which the quality of the product provided by insurance depends.
- ▶ **Engineering and loss control:** Service concerned with methods of prevention and reduction of loss whenever the efforts required are economically feasible.

ADMINISTRATION

▶ Actuarial Analysis

- ▶ Is a highly specialized mathematic analysis that deals with the financial and risk aspects of insurance.
- ▶ An **actuary** determines proper rates and reserves, certifies financial statements, participates in product development, and assists in overall management planning.
- ▶ The rates or premiums for insurance are based first and foremost on the past experience of losses.
- ▶ The loss reserves estimation is based on data of past claim payments.

INSURANCE OPERATIONS: ACTUARIAL AND INVESTMENT

- ▶ **Loss development** is the calculation of how amounts paid for losses increase (or mature) over time for the purpose of future projection.
- ▶ **Incurred losses** are both paid losses plus known but not yet paid losses.
- ▶ **Incurred but not reported (IBNR)** losses are estimated losses that insureds did not claim yet, but they are expected to materialize in the future.
- ▶ **Rate calculations** are the computations of how much to charge for insurance coverage once the ultimate level of loss is estimated, plus factors for taxes, expenses, and returns on investments.

INSURANCE OPERATIONS: ACTUARIAL AND INVESTMENT

▶ Catastrophe (Cat) Modeling

- ▶ The use of computer technology to synthesize loss data, assess historical disaster statistics, incorporate risk features, and run event simulations as an aid in predicting future losses.
- ▶ Development of catastrophe models is complex, requiring the input of subject matter experts such as meteorologists, engineers, mathematicians, and actuaries.
- ▶ Cat modeling can be extremely useful from an underwriting standpoint.
- ▶ Cat models are capable of estimating losses for a portfolio of insured properties.

INSURANCE OPERATIONS:
ACTUARIAL AND INVESTMENT

- ▶ Life and Annuity Lines
 - ▶ For life insurance, actuaries use **mortality tables**, which predict the percentage of people in each age group who are expected to die each year.
 - ▶ Life insurance involves the group sharing of individual losses.
 - ▶ The adjustments for various factors in life insurance premiums are known as **premium elements**.
 - ▶ **Investment income** refers to returns from all the assets held by the insurers from both capital investment and from premiums.
 - ▶ **Mortality curve** illustrates the relationship between age and the probability of death.

INSURANCE OPERATIONS: ACTUARIAL AND INVESTMENT

Mortality cost

- Investment income
- + Expense charge
- + Taxes
- + Risk change
- + Profit
- = Gross premium charge

TABLE 7.6 TERM PREMIUM ELEMENTS

▶ Investments

- ▶ Investment income is a significant part of total income in most insurance companies.
- ▶ For the life insurance industry, the largest component of liabilities is reserves for pensions.

INSURANCE OPERATIONS:
ACTUARIAL AND INVESTMENT

- ▶ **Reinsurance** is an arrangement by which an insurance company transfers all or a portion of its risk under a contract (or contracts) of insurance to another company.
- ▶ The company transferring risk in a reinsurance arrangement is called the **ceding insurer**.
- ▶ The company taking over the risk in a reinsurance arrangement is the **assuming reinsurer**.

INSURANCE OPERATIONS: REINSURANCE, LEGAL AND REGULATORY ISSUES, CLAIMS, AND MANAGEMENT

▶ How Reinsurance Works

- ▶ Reinsurance may be divided into three types: treaty, facultative, and a combination of these two.
- ▶ Each of these types may be further classified as proportional or nonproportional.
- ▶ Under a **treaty arrangement**, the original insurer is obligated to automatically reinsure any new underlying insurance contract that meets the terms of a prearranged treaty, and the reinsurer is obligated to accept certain responsibilities for the specified insurance.

INSURANCE OPERATIONS:
REINSURANCE, LEGAL AND
REGULATORY ISSUES, CLAIMS, AND
MANAGEMENT

- ▶ In a **facultative arrangement**, both the primary insurer and the reinsurer retain full decision-making powers with respect to each insurance contract.
- ▶ The combination approach may require the primary insurer to offer to reinsure specified contracts while leaving the reinsurer free to decide whether to accept or reject reinsurance on each contract.
- ▶ Alternatively, the combination approach can give the option to the primary insurer and automatically require acceptance by the reinsurer on all contracts offered for reinsurance.

INSURANCE OPERATIONS: REINSURANCE, LEGAL AND REGULATORY ISSUES, CLAIMS, AND MANAGEMENT

- ▶ When the reinsurance agreement calls for **proportional (pro rata) reinsurance**, the reinsurer assumes a prespecified percentage of both premiums and losses.
- ▶ **Nonproportional reinsurance** obligates the reinsurer to pay losses when they exceed a designated threshold.
- ▶ **Excess-loss reinsurance** requires the reinsurer to accept amounts of insurance that exceed the ceding insurer's retention limit.
- ▶ **Ceding commission** is a fee paid by the reinsurer to the original insurer.

INSURANCE OPERATIONS: REINSURANCE, LEGAL AND REGULATORY ISSUES, CLAIMS, AND MANAGEMENT

▶ Benefits of Reinsurance

- ▶ Increases the financial stability of insurers by spreading risk.
- ▶ Facilitates placing large or unusual exposures with one company, thus reducing the time spent seeking insurance and eliminating the need for numerous policies to cover one exposure.
- ▶ Helps small insurance companies stay in business, thus increasing competition in the industry.

INSURANCE OPERATIONS:
REINSURANCE, LEGAL AND
REGULATORY ISSUES, CLAIMS, AND
MANAGEMENT

- ▶ Legal and Regulatory Issues
 - ▶ Lawyers help draft insurance contracts, interpret contract provisions, defend the insurer in lawsuits, communicate with legislators and regulators, and help with various other aspects of operating an insurance business.

INSURANCE OPERATIONS:
REINSURANCE, LEGAL AND
REGULATORY ISSUES, CLAIMS, AND
MANAGEMENT

▶ Claims Adjusting

- ▶ **Claims adjusting** is the process of paying insureds after they sustain losses.
- ▶ The **claims adjuster** is the person who represents the insurer when the policyholder presents a claim for payment.
- ▶ **Company adjuster:** An employee of the insurer who handles claims.
- ▶ **Independent adjuster:** An employee of an adjusting firm that works for several different insurers and receives a fee for each claim handled.

INSURANCE OPERATIONS:
REINSURANCE, LEGAL AND
REGULATORY ISSUES, CLAIMS, AND
MANAGEMENT

- ▶ A claims adjuster's job includes:
 - ▶ Investigating the circumstances surrounding a loss.
 - ▶ Determining whether the loss is covered or excluded under the terms of the contract.
 - ▶ Deciding how much should be paid if the loss is covered.
 - ▶ Paying valid claims promptly.
 - ▶ Resisting invalid claims.

INSURANCE OPERATIONS:
REINSURANCE, LEGAL AND
REGULATORY ISSUES, CLAIMS, AND
MANAGEMENT

- ▶ It is advisable to avoid a company that makes a practice of resisting reasonable claims.
- ▶ An insurer needs competent managers to plan, organize, direct, control, and lead.
- ▶ The insurance management team functions best when it knows the nature of insurance and the environment in which insurers conduct business.

INSURANCE OPERATIONS: REINSURANCE, LEGAL AND REGULATORY ISSUES, CLAIMS, AND MANAGEMENT

- ▶ The marketing function of insurance companies differs for life/health and property/casualty segments.
- ▶ Underwriting classifies insureds into risk categories to determine the appropriate rate.
- ▶ Actuarial analysis is used to project past losses into the future to predict reserve needs and appropriate rates to charge.

SUMMARY

- ▶ Reinsurance acts as insurance for insurance companies, assuming responsibility for part of the losses of a ceding insurer by contract.
- ▶ The nature of insurance is very legal and requires specialists with a great deal of knowledge about the insurance industry.

SUMMARY