

Overview of Insurance Operations

Two Major Segments of the Insurance Industry

Type of Insurer	Covered Contingencies
Property Casualty Insurance	Physical Damage, Liability, Health, Disability
Life Insurance	Life, Annuities, Health, Disability

Differences:

Casualty Insurance --- Relatively short premium payment period 1 to 2 years
Coverage maybe short in duration – year or two, however
Claims may occur many years after insurance period ends
Asset investments tend to be short term in nature –
More in equities than bonds, emphasis on corporate
Securities

Life Insurance -----Relatively long premium paying periods 30 years or longer for
Life insurance, although group coverages for individuals can be
5 or 10 years in length
Claims generally occur after many years while the insurance
Contract is in-force
Asset investment allocation tends to be long term – with emphasis on
US Government Bonds, High Grade Corporate Bonds, Securitized
Mortgage Obligation backed by the Federal Government [Fannie
Mae, Freddy Mac, Ginnie Mae].

Insurance Mechanism --- Focus is on the service provided through the definition of insurance:

Definition: Insurance is a financial arrangement whereby an individual entity [insured] pays a small certain payment [premium] to an organization [insurer] in order to be indemnified against large, uncertain losses [contingency to be covered].

Characteristics: Financial Arrangement, insurer provides service of indemnification, insured
Makes a certain payment in the form of a premium which is collected and invested to pay
Large, uncertain losses sometime in the future if they occur.

Question: If a person buys insurance coverage, makes a premium for many years, but has no losses and receives no payments from the insurer, does this mean that the insured has made a poor financial decision and should discontinue coverage?

E.G. Financial Hedging for S&Ls and some Commercial Banks in the 1980's and 1990's
Insurance allows the insured to transfer risk onto a organization that pools the premiums and has the statistical basis and investment savvy to adequately cover the risk. Note: the risk transfer process does not ELIMINATE the possibility that a risk will be realized, it only handles the consequences of an insured risk when it is realized.

Risk Management Process

It is a total quality management process, designed to identify, handle, review and upgrade the treatment of risks faced by an organization or individual. The steps to the risk management process are quite similar to the Deming process to incorporate all levels of an organization in the process of reducing the consequences of risk.

Steps to the Deming Process: [PDSA Cycle]

1. Plan – plan ahead for change, predict the results of any alteration of the current system
2. Do – Execute the plan, taking small steps in controlled circumstances
3. Study – Check the results, record and analyze outcomes identifying the lessons learned
4. Act – Takes steps to utilize the new information to improve the process and incorporate enhancements to the plan [informational feedback loop]

Steps to the Risk Management Plan

1. Define what constitutes a significant risk to the organization
2. Identify all relevant risks to the organization
3. Determine what methods might be effectively employed to deal with each particular risk
4. Implement the risk technique that effectively addresses each identified risk [i.e., implement risk technique determined in (3) to the risks found in (2)]
5. Evaluate the risk management process, collect information on the treated risks, identify areas for improvement and then update the risk management plan beginning with step 1 [feedback loop back to step 1]

Reference: A. Frank Thompson, "Using the Deming Management Method to Develop Risk Management Plans on College Campuses," [Proceedings of the 14th Annual International Deming Research Seminar](#), Fordham University, February 2008.

Classifications and Types of Insurers

Classification	Type	Insurer
Legal Form of Ownership	==> Proprietary	Stock Insurer Lloyd's of London Insurance Exchange
	> Cooperative	Mutual Insurer Reciprocal Exchange Fraternal Organization
	=> Other	State Insurance Pools Federal Insurance Programs
Place of Incorporation	===> Domestic- incorporated in a specific state or under law of a particular state	
	===> Foreign- US insurer licensed to do business in states other than do state it is domiciled in	
	===> Alien - incorporated outside the US	
Licensing Status	===> Admitted	
	===> Nonadmitted	
Marketing System	====> Independent Agency	
	====> Direct Writing	
	====> Exclusive Agency [Hybrid Independent/Direct Writing Agency]	

The authority to write coverages varies with the type of incorporation, licensing status, and marketing system. The breadth of coverage may depend upon the form of ownership [e.g., the Lloyd's organization imposes greater personal and corporate liability to the risks assumed under the insuring agreements and therefore the coverages tend to be broader in scope --- the corporate form of ownership with its limited liability, but greater degree of state regulation results in more standardized, less expansive insuring agreements.

Insurer Goals

1. Maintain the adequacy of premiums and reserves to meet all future insurer obligations.
2. Generate a satisfactory level of return on invested reserves to allow for the shareholders [if the insurer is a stock company] or the policyholders [if the insurer is a mutual organization] to receive a fair level of compensation for funds left with the firm. [risk/return relationship with the emphasis on an adverse risk profile of the policyholders]
3. Provide fast, fair, and helpful claim service to all policyholders [addressing the conflicting goals of paying for all claims covered under the insured contract, but denying others that are clearly not insured under the insuring agreement].
4. Comply with legal requirements - filing adequate notice of all premium changes, accurate and timely statutory statements, SEC financials [if the insurer is a stock company], adhering to mandatory state and federal requirements with respect to underwriting, paying for claims that are covered within a reasonable length of time.
5. Fulfill the insurer's duty to society ---- i.e., take the premiums entrusted to the company and invest the funds wisely as opposed to using premium reserves as a piggy bank to gamble or speculate in derivatives or the purchase of other companies such as MGIC.

Constraints on Achieving Goals

Internal Constraints:

1. Efficiency --- imposed by market forces, if the insurer does not use capital wisely, premiums will go up and policyholders are likely to move to other companies
2. Expertise – a barrier to entry, insurers need to have the actuaries, underwriters, attorneys, accountants and claim settlement specialists to be able to deliver the service of indemnity
3. Size ----one of the reasons why the insurance industry may be more oligopolistic than perfectly competitive, the larger the insurer the better the ability to take on more policyholders and spread claim experience out thereby driving down the cost of coverage [through economies of scale and risk diversification].
4. Financial Resources --- in order to pay for future claims and insurer needs to maintain adequate reserves in the form of invested assets that can be tapped when losses occur. Up until a couple of years ago, an insurer's only source of financing was either through policyholder surplus [in the case of a mutual company] or the capital markets [in the instance of a stock company] ---- however, with the \$180 Billion bailout of AIG another convenient source of large insurers may be the federal government under the "Too Big to Fail" philosophy promulgated by the Federal Reserve going back to the 1980's bailouts of Continental Bank, FCA and Lincoln Savings. [see: http://www.fdic.gov/bank/historical/history/235_258.pdf]

One explanation of why the federal government continues to bailout, large failing institutions under the “Too Big to Fail” doctrine.

Both banks and insurers by their very nature are vested in the public trust. Depositors place money in banks on the basis of earning a safe return and not having to worry about loss of principal. By the same token, policyholders that pay for coverage are entrusting their premium dollars to an insurer, as a financial intermediary, to invest those dollars and have the money available for paying claims should insured losses occur. The federal government has failed and continues to fail to recognize the over-riding importance of safety and soundness of banks and insurers above a free market rate of return on bank deposits or premium reserves. By allowing both banks and insurers to develop investment strategies without public oversight and appropriate regulation to control financial risk, financial institutions using financial leverage have been able to inflate their scale of operations, take enormous risks with other people’s money, and then go to the federal government for bailouts when massive losses occur [which they inevitably occur]. Financial managers at these institutions are rewarded for taking large risks with money they don’t own but nevertheless control. If their speculation generates a high return, those managers will ask for significant compensation claiming it was their “expertise” that brought the largess. The reality is that these managers were not the risk takers and in fact were operating in a manner that was reckless to policyholders and depositors and the whole of society. Once catastrophic financial loss occurs, those same financial managers generally claim ignorance of the risks that are being realized and request “financial assistance” from the federal government. At this point, the federal government has the unenviable position of either allowing the financial institution to fail in which case the capital markets are likely to collapse [bank runs, panic, people in the streets asking for their money] or acquiescing to the demands of the financial reprobates who contrived the problems to begin with. The supreme irony is that the federal government has recently continued to hire and pay enormous salaries to these very same people. Or if not continue to hire them, at least provide a golden parachute for leaving their companies destitute.

Note: Current federal regulation is quite passive as opposed to being active. The federal government becomes involved in these failed institutions after it is a foregone conclusion that a bailout will occur. It’s like closing the barn door once the horses have left. In the meantime, every American citizen will eventually have to pay for these abuses ---- through higher taxes due to a big deficit. Active federal regulation would emphasize the underwriting responsibilities in trying to protect the interests of the American taxpayer from massive bailouts, high unemployment, and the destruction of retirement accounts imposed by the reckless behavior of financial managers in banks and insurance companies.

From an underwriting standpoint --- the federal government would seek to limit the use of those financial instruments or practices that expand the degree of risk and the amount of loss on a failed institution --- i.e., derivatives, direct investment, investment underwriting, and/or mortgage participations.

Current Regulation of Insurance in the US

Primarily through State Law

Federal Law --- limited to taxation of some investment return, and
Fair access to Insurance to prevent illegal discrimination

The AIG bailout should give most who are knowledgeable about insurance pause to consider a revision of federal regulation and the repeal of Public Law 15. Unlike banks that were covered under FDIC insurance and regulated through the Federal Reserve --- insurance firm's like AIG had no such federal oversight or any coverage under any federal insurance program. Therefore, if the American taxpayer is going to have to pay \$180 billion to bailout one insurer [an amount larger by several levels of magnitude than the largest bank rehabilitation], then shouldn't the federal government be actively monitoring and managing this significant, taxpayer risk?

Note also, well run banks and insurers should welcome this type of oversight --- Why? Because in the end, if there are large, taxpayer bailouts, it will not be the failed institutions and their highly compensated financial executives that are going to be asked to pay for a part of the losses through higher taxes on bank or insurance operations --- no, those taxes will go to the healthy insurance companies and banks that survive --- those same institutions that had nothing to do with the creation of the problems to begin with.