Insurance Output

Two different approaches:

Pooling of Risk

Transfer or Assumption of Risk

Pooling of Risk

- Insurer is an intermediary between various policyholders
- Insurer collects premiums and disburses them to claimants
- Insurer assumes no risk
- Policyholders retain risk

Transfer of Risk

- Insurer provides protection from casualties and liabilities
- Insurer collects premiums and invests a portion of the premiums
- Insurer assumes risk
- Policyholders do not retain risk

Pooling of Risk
Pricing Methodology

- Value Added
- Premiums less claims

Transfer of Risk
Pricing Methodology

- Risk protection plus financial intermediation
- Premiums plus return on the invested portion of the premium

Risk Protection

- Protects against economic losses resulting from casualties and liabilities related to the property of the insured

Defining and Classifying Risk

- Actuaries set rates for general classes of risk
- Underwriters ascertain which class of risk is appropriate for a policy
- Finance department determines the amount of investment income through its investment strategy

Financial Intermediation

- Financial intermediation is taking someone else's money and investing it with the goal of increasing it's value
- Premiums are paid a year in advance so the insurer invests a portion of the premium
- Return on the invested portion of the premium is used to offset the premium payment

Pricing Procedures

- Price is the premium plus the rate of return
- Any dividends are subtracted
- Each policy is priced once a year in the anniversary or renewal month for that policy
- Policy’s price is held unchanged for the year

Pricing Procedures

- Policy characteristics not affected by inflation are fixed or frozen
- Policy characteristics affected by inflation are adjusted (escalated)
- After initiation, actual policy becomes hypothetical policy

Pricing Characteristics

- Coverage amounts/limits
- Deductible/Coinsurance
- Specific risks or perils covered
- Past loss experience
- Valuation of property insured or risk

Adjusting for inflation sensitive characteristics:

- Not adjusted:
  - liability coverages/limits
  - deductibles/coinsurance

Adjusting for inflation sensitive characteristics:

- Updated:
  - physical damage coverages/limits
  - past loss experience
  - valuation of property insured or risk (business assets, receipts, gross sales, payroll, etc.)