



# advocate

THE VOICE OF THE PROPERTY-CASUALTY INSURANCE INDUSTRY

## INSURANCE 101

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PROPERTY-CASUALTY BASICS

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A photograph of a red apple, a yellow pencil, and a stack of books on a wooden desk. The apple is on top of a silver laptop, which is on top of a stack of books. The pencil is lying on the laptop. The books are stacked on a wooden desk.

**E**very day, individuals and businesses face a variety of potentially catastrophic risks. By creating tools to manage uncertainty and loss, property-casualty insurers are able to provide vital personal and professional protection. In addition, property-casualty insurance helps provide and maintain a reliable foundation for our economy. Despite these fundamental roles property-casualty insurance plays in the lives of virtually every American, relatively few people outside of the insurance industry understand how it works. This issue of the **AIA Advocate** looks at the basic concepts of property-casualty insurance, providing a plain-English primer on several key topics.



# LIFE CAN

## INSURANCE HELPS PEOPLE MANAGE

Risk is inevitable in society; insurance helps address that reality. Insurance allows individuals or organizations to exchange the risk of a large loss for the certainty of smaller periodic payments, known as premiums. The exchange (or transfer) of risk is laid out in a legal contract called the insurance policy, which spells out the coverage, compensation, and/or other benefits.

Insurance takes on (or assumes) “pure” risk—the possibility of suffering harm or loss. (Insurance is not for “speculative” risks, like gambling, where financial gain is possible.) If a loss occurs, the policyholder simply is restored to the same condition as before the loss. Examples of risk covered by insurance include fire, theft, tornadoes, motor vehicle crashes, and being sued for causing harm to another person.

Risk has two key dimensions—frequency and severity—and both help determine insurability. Frequency relates to how often a loss occurs, i.e., whether the risk/event is common or relatively rare. Severity relates to how costly losses resulting from that risk could be, i.e., whether they could be relatively inexpensive or truly catastrophic in nature.

In the table at right, insurance can be an appropriate method of risk transfer for low-frequency, high-severity losses (e.g., house fires or tornadoes), as well as for high-frequency, low-severity losses (e.g., motor vehicle crashes).

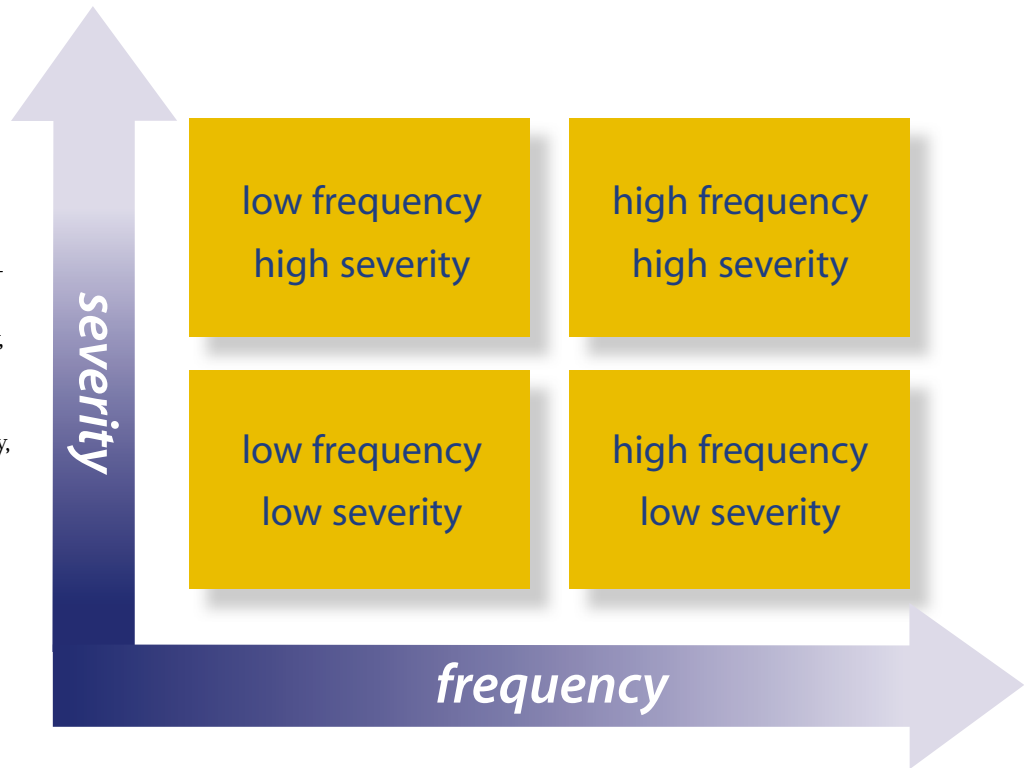
# BE RISKY

## RISK

However, insurance may not be the most appropriate method for treating all risks facing individuals and businesses. For example, insurance could be too expensive for certain risks (low-frequency, low-severity) or unavailable for other risks (such as high-frequency, high-severity risks, or risks whose frequency and/or severity is difficult to predict, such as terrorism). Additionally, insurance may be unable to fully compensate for a loss (e.g., the destruction of family photos, which have great emotional value but little financial value).

In taking on massive amounts of societal risk, the insurance industry relies on two fundamental tools: pooling and the Law of Large Numbers. An insurer can cover the risk of losses from a few policyholders by combining (pooling) together the premiums from a much larger group of policyholders. This also improves predictability, thanks to a statistical principle known as the Law of Large Numbers, which states that the accuracy of loss prediction increases with the number of policyholders in the pool.

Insurance also handles risk by working to prevent losses to lives and property. Loss prevention (also known as loss control or mitigation) is a core function of the insurance business and has benefited society immeasurably. See the “Two Functions of Property-



Casualty Insurance” section on page 7 for some examples of how the property-casualty industry created and continues to support many important public safety systems and world-class safety organizations.

# A HISTORY LESSON

## PROPERTY-CASUALTY INSURANCE: ORIGINS AND TYPES

Property-casualty insurance traces its modern history back to marine insurance in the late Middle Ages. With an increase in maritime trading, merchants and bankers became concerned about the safety of shipments due to piracy,

Fire insurance, and what became the modern insurance industry, developed primarily in England after the Great London Fire in 1666. The U.S. property-casualty insurance market evolved from British practices; the first U.S. fire insurer was started by Benjamin Franklin in 1752. By the early 1900s, many major types (or “lines”) of insurance we know today had developed.



Fire insurance, and what became **THE MODERN INSURANCE INDUSTRY, DEVELOPED PRIMARILY IN ENGLAND** after the Great London Fire in 1666.

Today, this segment of the insurance industry provides protection from risk in two basic areas: protection for physical items, such as houses, personal possessions, cars, commercial buildings, and inventory (property), and protection against legal liability (casualty).

storms, and other perils. The bankers provided guarantees against loss; in return, merchants paid the bankers a fee for this protection.

Property insurance is a “first-party” coverage for losses related to a policyholder’s own person/property. Casualty (or liability) insurance is a “third-party” coverage for a policyholder’s legal obligations against losses the policyholder may cause to others.

### PROPERTY-CASUALTY INSURANCE: AN ESSENTIAL DUALITY

#### Property

- First-party coverage
- Provides coverage for physical items such as houses, personal possessions, cars, commercial buildings, and inventory

#### Casualty

- Third-party coverage
- Provides coverage for a policyholder’s legal obligations against losses the policyholder may cause to others

# How Insurance Benefits Society and the Economy

These two basic types of coverage are written for both individuals or families (“personal lines” policies) and businesses (“commercial lines” policies).

Personal lines policies include homeowners insurance, renters insurance, and vehicle coverage. For example, homeowners policies cover both fire damage to a house and/or contents, plus legal defense costs and liabilities should a person be injured on the policyholder’s property.

Commercial lines products are written for businesses and other organizations (churches, schools, cities, non-profits), and include packages such as “Business Owners Policies” as well as commercial general liability, workers’ compensation, commercial property, and product liability insurance.

Commercial property policies cover buildings and the organization’s property, and include a type of coverage known as “business interruption” designed to help a company continue operating if it is put out of its office/physical plant by a covered risk.

Commercial liability policies protect policyholders against financial responsibility for injury or property damage resulting from a policyholder’s premises, products, services, or other operations. One example of commercial casualty coverage is workers’ compensation, which deals with lost earnings and medical expenses of employees injured on the job.

The specific scope and limits of coverage in all of these examples are spelled out by an individual insurance policy. The section beginning on page 6 examines this essential contract.



**Improving consumer and worker safety** Insurance makes businesses and individuals more aware of the risks they face and provides motivation to prevent losses. For example, insurers provide premium discounts to safe drivers and to businesses that implement effective worker safety programs.

**Protecting consumer transactions** Most consumers have to borrow money to buy homes and cars; lenders require insurance in order to secure the loans they make for these purchases. Without insurance, few people could obtain an auto loan or home mortgage.

**Protecting business transactions** Without insurance, most businesses would find that they could not operate. Insurance enables businesses of all sizes and types to manage the risks that are an inherent part of any business operation (e.g., signing contracts, financing and expanding operations, manufacturing and distributing products, providing services, hiring employees).

**Providing recovery from catastrophes** Hurricanes, winter storms, fires, and other disasters can cause tremendous, sudden loss to many people all at once. Insurance coverage enables businesses to replace inventories and rebuild buildings, and allows homeowners to repair and rebuild homes and replace property.

## Providing trillions of dollars to the U.S. economy each year

- The property-casualty insurance industry pays out more than \$300 billion annually in policy benefits.
- Property-casualty insurers doing business in the United States have more than \$1 trillion invested in the economy, through stock, corporate and government bonds, and real estate mortgages. These investments finance building construction and provide other crucial support to economic development projects all across the country.
- Property-casualty insurers are a major source of capital for state and local government in the United States. Insurers held a total of over \$368.1 billion in state municipal bonds in 2007. Insurers invest in a variety of public projects, such as airport, hospital, and highway construction.
- There are approximately 3,000 companies providing property-casualty insurance coverage in the United States. About 100 of these companies provide the majority of the property-casualty coverage.
- About 1.3 million people are employed by the property-casualty industry, including insurance companies, agencies, and brokerages.

# THE TRANSACTION

## INSURANCE POLICY FUNDAMENTALS



An insurance policy is a binding legal contract with very specific terms, conditions, and promises by both insurance company and policyholder. The policy describes in detail what is—and what is not—covered. The diagram above details the insurance policy lifespan. Using the example of a typical homeowners insurance product, here is how the process works:

**Application** The customer contacts an insurance agent or insurance company directly to inquire about the types of coverage available and costs related to coverage for a specific need (such as a new house). The customer fills out an application, which is then sent to an insurance company underwriter.

**Underwriting** Through the underwriting process, the insurance company determines which customers to insure and what coverages to offer. The insurer considers the insurance agent's recommendation (if an agent is involved), the amount of coverage requested, the policyholder's loss

and insurance history, as well as several other objective, actuarially derived factors. The insurance company will accept the application, reject the application, or accept the application with modifications. Except as limited by state law, these modifications can include higher deductibles, changes to the coverage limits or premium, or changes to the coverage by the use of "endorsements" (specific policy revisions that provide greater or lesser coverage than allowed under the standard/base policy form).

**Issuing the Policy** The policy is then sent to the policyholder (also known as an "insured"). The policy includes the following: a "declarations page" (important information about the policyholder, exposures, and coverage to be provided); an insuring agreement (the insurer's promise to pay for covered losses); modifications ("exclusions" eliminate coverage for certain property or situations, while "conditions" specify what is required of the policyholder and insurer to ensure that losses

are covered); and endorsements. It is the policyholder's responsibility to read the policy and make sure the coverage provided is what was requested. At this time, the policyholder also is required to submit the premium payment.

**Claims** Fortunately, most policyholders do not suffer losses that lead them to submit claims under their insurance policies. When a claim is made, how it is handled depends on the type of loss involved.

- **Property claim** In the event of loss, the policyholder calls their agent or company claims department to report the loss/file a claim. The claims representative (known as an "adjuster") will investigate the loss, including verifying coverage for the particular risk; they also will determine whether a policy is in force, and prepare a repair estimate.

- **Liability claim** If a third party makes a claim alleging that the policyholder is responsible for damage to/losses by the claimant (e.g., a guest falls down

the policyholder's stairs and injures their back), the insurance company claims representative would assess the claim, verify insurance coverage, and interview the policyholder, claimant, and the claimant's medical doctor to determine the extent of injuries and negligence.

Liability claim costs generally are broken down into two categories:

1) special damages, which include the claimant's out-of-pocket expenses and lost wages; and, 2) general damages, which cover compensation for pain and suffering (often called non-economic damages).

The claim representative/adjuster has the responsibility to offer a fair settlement to the injured party (whether first- or third-party), but can offer only up to the dollar limits of the policy. Once the claimant and company agree on the amount of loss, the company pays that amount (less the amount of a deductible in first-party claims). If there is disagreement over the claim, the matter may go to arbitration, mediation, or court for resolution.

### Renewal

Most policies (especially personal lines) run for either six months or 12 months and are renewed at the end of that period. However, policies also can be cancelled or non-renewed by either the policyholder or the insurer. The policyholder can choose to cancel the policy during the policy period or move to another insurer at the end of the policy period (non-renew). The insurer can decide to non-renew a policy if the insured has had an unacceptable number of claims, and can cancel a policy during the policy period for non-payment of premium or other specific reasons. State laws place restrictions on the ability of insurance companies to cancel or non-renew. Advance notice to the policyholder is required in both instances.

## TWO FUNCTIONS OF PROPERTY-CASUALTY INSURANCE

### Preventing Losses

Property-casualty insurance is about preventing losses (injuries, deaths, and/or property damage) from occurring in the first place; through their everyday business practices, insurers are dedicated to reducing injuries, deaths, and property damage; in this way, the interests of insurers, their customers, and the general public are exactly in line.

Listed below are a few of the many public safety organizations that insurers have started throughout their history.



Insurance companies were the first firefighters. They started the fire service, and supported, improved, and standardized it. Fire brigades in the early days were run by insurance companies, and even after fire fighting was undertaken by local governments, the industry still played an active role through the National Board of Fire Underwriters (NBFU), which was created in 1866. (AIA is descended from the NBFU).



Insurance companies created the National Fire Protection Association (NFPA) in 1896. The NFPA remains the world's leading advocate of fire prevention and public safety. The organization was the driving force behind building and electrical codes; and now NFPA codes influence every building, design, and installation in the United States as well as many across the world.



Insurers started the Underwriters Laboratories over a hundred years ago. The UL mark is among the most universally recognized and sought consumer product safety certifications.

**INSURANCE INSTITUTE FOR HIGHWAY SAFETY** The Insurance Institute for Highway Safety (IIHS) was founded in

1969 for the specific purpose of conducting high-quality, independent research looking at motor vehicle technology and design, driver and occupant safety systems and behavior, and roadway engineering. IIHS research has led to safety innovations that have saved thousands of lives; its work has spread worldwide.



Individual homes and commercial buildings are made safer through the work of the Institute for Business & Home Safety (IBHS). IBHS was established by the insurance industry to reduce the social and economic effects of natural disasters and other property losses by conducting research and advocating improved construction, maintenance, and preparation practices.

### Helping Recover from Loss

Property-casualty insurance is about facilitating recovery from losses suffered by individuals or businesses—whether those losses are relatively small (such as a fender bender) or truly catastrophic (such as a hurricane).

Insurance helps individuals, businesses, and entire communities stay financially stable and recover from unanticipated—and potentially ruinous—losses. As a result, jobs are protected, taxes continue to be paid, and goods and services continue to be produced and provided.

Insurance policies (contracts) provide protection against financial losses that occur as the result of certain specified causes. For example, if you are involved in an automobile crash, health insurance or auto insurance would pay your medical bills and those of your passengers; auto insurance would pay for repairs to your vehicle, and for losses your driving causes to other people or property.



# THE CHALLENGE

## DETERMINING PREMIUMS IS A COMPLEX PROCESS

The lifespan of the insurance policy outlined above illustrates one of the fundamental differences between insurance products and other products. Issuing the policy (and thus collecting premiums) comes before paying out the claims, sometimes years or even decades before.

price and the customer purchases the product/service. However, for insurance products, the actual cost of providing coverage is unknown to the insurer for some time. Nonetheless, the insurer remains obligated to pay claims in the face of this uncertainty, even if the premium it received turns out to be wholly inadequate.

in the future—sometimes the distant future—for a particular pool of risks. The accuracy of the estimate depends on the type of risk, policyholder characteristics, and the size of the pool.

The bottom line is that as the cost of the things insurance pays for rises or falls, the price policyholders pay for coverage typically rises or falls as well. This also means that when regulators, public policy makers, the courts, and/or the public want insurance companies to increase benefits under an insurance policy, the purchasers of that policy must pay more for coverage.

A more expansive discussion of how premiums are determined and where premium dollars are spent begins on page 11.

Premiums are fundamentally derived from projected cost of claims (losses) and other expenses. While each insurance entity's operational expenses vary, they are relatively predictable. Claims costs, on the other hand, are not always predictable.

Insurers use statistics and historical loss information to forecast an accurate estimate of the amount of losses to be paid

For most economic goods, the cost of the product to the business is known at the time the customer is given a

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The bottom line is that

**AS THE COST OF THE THINGS  
INSURANCE PAYS FOR RISES OR FALLS,  
THE PRICE POLICYHOLDERS PAY FOR  
COVERAGE TYPICALLY RISES OR FALLS  
as well.**

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# CHECKS AND BALANCES

## AN INSURANCE REGULATION OVERVIEW

Property-casualty insurance is heavily regulated at the state level; this is particularly true for personal lines and for workers' compensation. Generally speaking, state regulators have oversight of market conduct; insurance company and agent licensing; insurance rates; policy language; financial condition (solvency) of insurance companies; and, consumer protection in insurance transactions.

Ideally, regulators focus their resources on making sure that insurance rates are adequate to cover losses, so that claims can be paid in full. They also are responsible for making sure that rates are neither unreasonably high nor unfairly discriminatory. Another key regulatory duty is to make sure that insurers remain solvent, i.e., that they maintain enough capital to pay policyholder losses as they come due.

States also have laws in place to protect insurance consumers, such as Unfair Trade Practices Acts (which prohibit coercion of consumers during the sales process) and Unfair Claims Practices Acts (which prohibit insurers from settling a claim for less than should be paid).

Regulators (whose titles range from commissioner to superintendent to director) in every state and in the District of Columbia administer insurance laws for their jurisdictions. The vast majority of insurance regulators are appointed; in about a dozen states, insurance regulators are elected to office.

All states provide mechanisms for relatively high-risk individuals who seek insurance from the private market, but are unable to find it; these individuals are known as the "residual market." For example, high-risk drivers who are required to carry liability insurance by state law, but cannot obtain auto insurance in the regular or "voluntary" market because of the high likelihood of costly losses (which insurers may not be able to reflect in rates due to government price controls) can go to their state's residual market mechanisms for coverage. All insurers licensed in the

state must participate in these mechanisms for their particular lines of coverage, whether that is auto insurance, property insurance, or workers' compensation.

A few federal insurance programs either directly provide or enable private sector provision of property-casualty coverage. These include the National Flood Insurance Program (private insurers sell coverage and adjust claims; but coverage is underwritten and claims are paid wholly by the government); the Overseas Private Investment Corporation (provides political risk coverage for U.S. businesses with operations overseas); the Terrorism Risk Insurance Act program (a public-private risk-sharing mechanism for catastrophic terrorist attacks); and the Federal Crop Insurance Corporation (federally reinsured coverage against adverse weather, plant diseases, and insect infestations).



# INSURANCE 201

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PROPERTY-CASUALTY FINANCE

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**E**very day, individuals and businesses face a variety of potentially catastrophic risks. This portion of our primer looks at insurance finance by discussing how premiums are determined and tracing the path of the premium dollar as it flows through a hypothetical company.

# THE PREMIUM QUESTION

## ASSIGNING COST TO REAL-WORLD RISK

Insurance is fundamentally different from other products and services, because the price of the insurance policy is determined before the actual, final cost of that policy has been determined. Because of this cost uncertainty, insurer pricing is based largely on informed estimates of what potential claims from policyholders will cost at some point in the future.

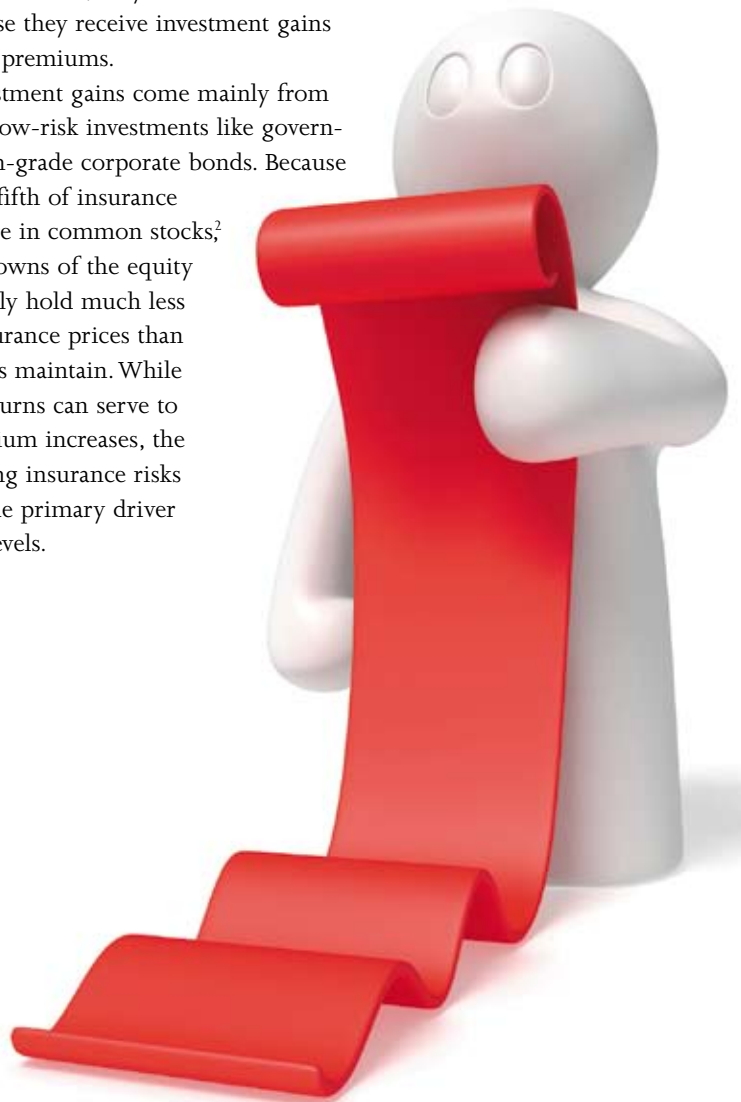
As a result, generally speaking, premium rates are driven up and down by the anticipated cost of claims losses. When real-world risks (e.g., fire, windstorm, litigation, or personal injury) and their attendant costs (e.g., labor, construction materials, health care, and judicial verdicts) are rising, insurers are forced to factor these increasing costs into future policyholder premiums. Or, insurers may significantly limit their participation in the marketplace. Failure to take one or the other action can lead to insolvency. This same dynamic comes into play when there is tremendous uncertainty about real risks and associated costs.

To estimate future losses, insurers use historical loss information and other statistics about the risks presented by a particular group of policyholders. This estimate is based on a type of predictive mathematics known as actuarial science; its accuracy depends on the type of risk (also known as a “peril”) involved, policyholder characteristics, and the size of the data pool. Larger data pools are more predictive, due to another mathematical concept called the “law of large numbers.”

As with any business, insurers must earn a profit to stay in business. Thus, another factor in the premium charged is a rate of profit. This amount is heavily dictated by competitive market forces and regulatory restrictions. On one hand, insurance company profit must be adequate for the company to attract future capital and to remain viable financially in the long-term; on the other hand, profit cannot be excessive, or the company will not be able to compete with other insurers in the marketplace.

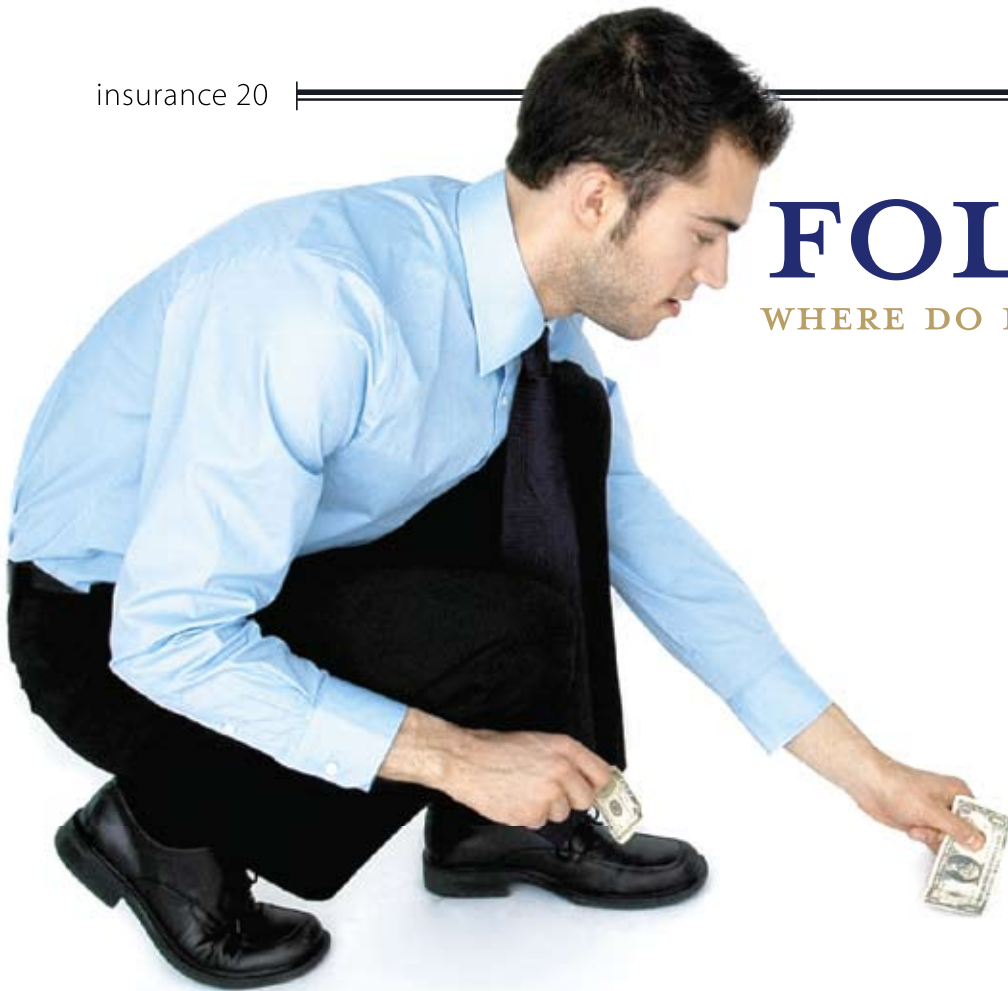
Generally speaking, because insurance markets are competitive, when insurers seek profits higher than the marketplace average for the same type of product and service, customers will go elsewhere to take advantage of a lower price. As a result, insurers charge policyholders almost exactly what they believe the claims/losses will cost them. Even if there is very little or no profit on this, the underwriting<sup>1</sup> side of insurers’ operations, they can continue to operate because they receive investment gains from invested premiums.

These investment gains come mainly from conservative, low-risk investments like government and high-grade corporate bonds. Because less than one-fifth of insurance investments are in common stocks,<sup>2</sup> the ups and downs of the equity markets actually hold much less sway over insurance prices than industry critics maintain. While investment returns can serve to cushion premium increases, the cost of covering insurance risks is—by far—the primary driver of premium levels.



# FOLLOWING

## WHERE DO PREMIUM DOLLARS GO?



Premium dollars generally follow the diagram on the next page. In viewing this diagram, it is important to remember that it is purely representational and that each line of insurance in each state must be viewed separately.

The premiums enter the diagram at the top left, where they split into investments (or invested assets), claims payments (flowing from invested assets), and other expenses. The bulk of premium dollar allocation goes to claims payments, i.e., to compensate policyholders for insured losses.

The following section gives a quick overview of these three categories:

### INVESTED ASSETS

During the time interval between the collection of premiums and the payment of policyholder claims, insurers invest premium dollars. Investment gains often are a key source of profitability for insurers.

However, all investments are always “on the hook”—meaning that if needed, they must be used to pay policyholder claims. As a result, the rules governing property-casualty insurer investments are highly restrictive (e.g., in New York, insurers can invest no more than 10 percent of their assets in common stocks<sup>3</sup>). Property-casualty insurers limit their exposure to stock market risk by allocating invested assets among a mixture of low-risk, conservative investment vehicles.

Approximately two-thirds of the industry’s portfolio is held in the form of bonds (primarily high-grade corporate and government bonds). In fact, property-casualty insurers are among the largest institutional purchasers of state and municipal government bonds that go directly to the financing of public projects. As noted above, less than 20 percent of insurers’ investments are in common stocks. Most of the

remainder is held as cash and short-term securities.<sup>4</sup>

### EXPENSES

Like all businesses, insurers have general operating expenses, such as paying the costs of maintaining offices and staff. Insurers also pay commissions to agents, brokers, and others who market and distribute their products; these commissions typically are withheld from premiums before being remitted to insurers. Insurers pay taxes (e.g., state premium taxes and federal income tax), as well as license fees to do business in each state. In addition, they support each state’s guaranty fund, which provides protection to policyholders in the event of an insurance company insolvency.

As noted in the first section, these operating costs generally are predictable and stable, and relative to claims losses, can be considered a known quantity.

# THE MONEY

## CLAIMS PAYMENTS/LOSSES

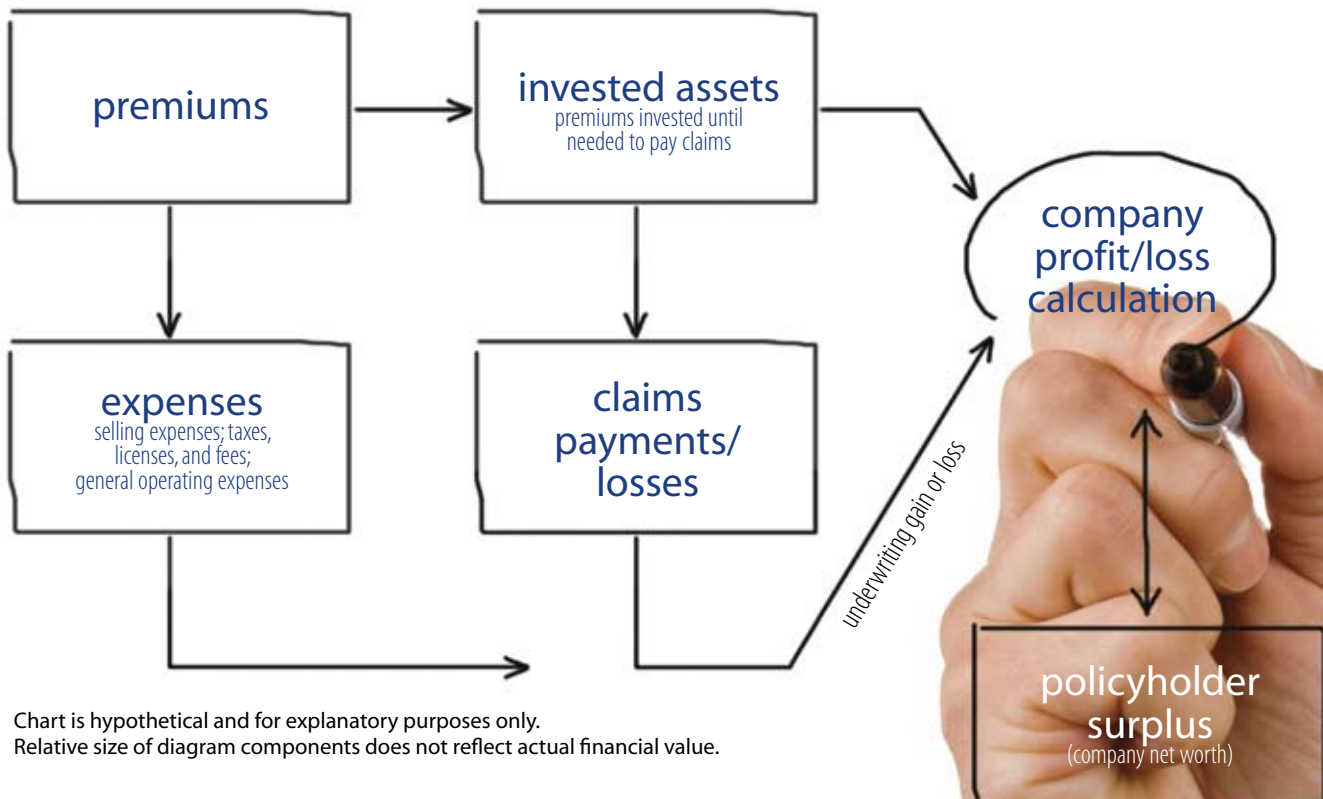
Claims costs, on the other hand, are an unknown quantity. Despite the skill of insurance actuaries, actual losses can differ significantly from projected claims costs.

Claims costs are affected not only by events that occur during a particular calendar year. They also can be affected if funds (called “reserves”) set aside to pay claims that occurred in the past turn out to be inadequate (e.g., because of higher-than-expected legal or medical costs). Overall claims-related costs also include expenses derived from “loss adjustment”; these are items such as claim investigation costs and legal costs of defending policyholders when

claims are brought against them.

Claims costs can fluctuate significantly because insurance involves uncertainty. Although an insurer might insure the value of 100 homes, it does not collect premiums for an amount equal to the cost of replacing 100 homes. Instead, it bases premiums on the number of homes—usually a very small percentage—that complex statistical models determine are likely to suffer losses. Nonetheless, the insurer remains “on the hook” for all 100 homes during the policy period. Should a highly unpredictable and severe catastrophe strike, all of the insurer’s capital (surplus assets) could potentially be used to pay these claims.

Should an insurer become insolvent, there are additional costs for the remaining solvent insurers in that same market. The state insurance guaranty fund system—which is unique to insurance—requires that financially healthy insurers assume responsibility for the claims of failed companies’ policyholders. Unlike other sectors of the economy, the price of an insurer’s failure is borne by market competitors (and their policyholders), who must honor the failed insurer’s obligations to its own policyholders. Assessments by each fund to pay for outstanding claims typically apply to insurers doing business in a state in the same line of insurance as the insolvent insurer.





# TURNING A PROFIT?

## CALCULATING PROFITABILITY

Insurer profitability is determined by two main components: underwriting profit/loss and investment gains/losses. These components are shown in the middle section of the diagram on page 13. Combining the underwriting gain/loss and the investment gain/loss yields an insurer's overall profit or loss. In turn, this loss or profit affects the net worth (or "policyholder surplus") of the company.

The following section gives a quick overview of these three categories.

### UNDERWRITING GAIN/LOSS

If premium income exceeds both expenses and claims losses, there is an underwriting gain. If it is insufficient, there is an underwriting loss. In most years, insurers actually pay more in claims and associated expenses than they earn in premiums, resulting in underwriting losses. The underwriting process itself is rarely profitable—in fact, the U.S. property-casualty industry as a whole has had only four underwriting gains at year's end during the past 30 years.<sup>5</sup>

Insurance rates in each state must reflect the actual and expected loss experience within that one state. Consequently, each line of insurance must stand on its own in terms of profitability. For instance, profits in workers' compensation insurance cannot be used to subsidize losses in personal auto insurance. This compartmentalized profitability extends across state lines, as well. Hurricane-related losses to homes in one state, for example, should not be subsidized by profits generated by homeowners insurers in another state.<sup>6</sup>

### INVESTMENT GAIN/LOSS

As noted previously, the vast majority of property-casualty insurance investments are placed in relatively conservative assets, such as U.S. Treasury and municipal bonds. Even when the rates of return are low for such investments, they still are positive.

The major source of investment earnings for insurers is interest from bonds. Investment earnings also come from capital gains and dividends paid

on stocks. Capital losses also can and do occur; such losses reduce overall investment performance. The sum of what an insurer earns in interest from its bond portfolio, plus capital gains (less capital losses) and dividends, is known as its "investment gain."

### POLICYHOLDER SURPLUS OR NET WORTH

An insurance company's net worth<sup>7</sup> is also known as "policyholder surplus," since it is used as the ultimate backstop for policyholder claims. Looking at the diagram on page 13, an insurer's net worth (or total capital available) is affected by its overall profitability. Making a profit generally adds to net worth, while taking a loss generally erodes net worth.

An insurer must operate profitably over the long-term to have enough capital to pay claims. When an insurer fails to make a profit, financial rating agencies may downgrade the company. Downgrades increase the cost of new capital to the company, and limit its



ability to underwrite new business. A continued lack of profitability can lead to company insolvency and seizure by state regulators. In fact, a fundamental role of insurance regulation is to make sure that companies do not overextend themselves by taking on more risk exposure than they can back-up with surplus.

Net worth also is the capital that belongs to company owners (whether they are shareholders in a stock insurance company or policyholders in a mutual insurance company). These owners rightly expect an insurer to provide an appropriate return on their investment of capital.

Despite receiving income from invested premiums and the company's overall asset portfolio, insurer profitability is relatively modest compared to most other industries, including other financial services sectors. From 1997-2006, the property-casualty insurance industry (as measured by return on equity) underperformed the Fortune 500 by an average of 6.3 percentage

points.<sup>8</sup> Furthermore, in a longer-term view from 1985-2007, property-casualty insurers lagged similarly behind their financial services counterparts, commercial banks (by 5.9 percentage points) and diversified financial services providers (by 7.5 percentage points).<sup>9</sup>

This disparity in return on equity can be explained by several factors. First, property-casualty insurer investments tend to be in low-risk assets, preventing large short-term investment gains. Second, insurance is heavily regulated by a state-based system that, in most jurisdictions, uses price controls to prevent insurers from charging an appropriate, market-based rate for their products. Third, despite this antiquated system, property-casualty insurance is still highly competitive in many states and lines. Fourth, insurance intrinsically is about managing risk, and there can be tremendous volatility in claims costs/losses.

Although the last point was made earlier, it is so essential to proper understanding of insurance financial

dynamics, that it warrants repetition.

As the cost of things that insurance pays for rises or falls, the price policyholders pay for coverage typically rises or falls as well. The bottom line of insurance finance is that the price of coverage is directly related to the risk underlying that coverage and its anticipated cost.

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<sup>1</sup> Underwriting refers to the process that a company uses to determine which customers to insure and what coverages to offer.

<sup>2</sup> "Computing Profitability in the P/C Insurance Industry," Insurance Information Institute.

<sup>3</sup> New York Insurance Law §1404 (8)(B)

<sup>4</sup> "Computing Profitability in the P/C Insurance Industry," Insurance Information Institute.

<sup>5</sup> Special Report: U.S. Property/Casualty — 2007 Financial Review, A.M. Best Company, Oldwick, NJ (April 2008)

<sup>6</sup> "Computing Profitability in the P/C Insurance Industry," Insurance Information Institute.

<sup>7</sup> Net worth is the amount by which the value of a company's assets exceeds the value of its liabilities.

<sup>8</sup> NAIC Report on Profitability By Line By State in 2006, most recent all-industry figures available.

<sup>9</sup> Understanding Property-Casualty Insurance Profits: The Importance of Financial Strength," Martin Grace and Robert Klein, Georgia State University, October 2008.

## KEY PROPERTY-CASUALTY INSURANCE TERMS

**Assigned Risk Plans**

**(Automobile Insurance Plans)** A mechanism used in some states to insure people who cannot obtain insurance in the voluntary market. There is one rate level and the individual policies are assigned to specific companies according to the percentage of the market they insure.

**Combined (Loss/Expense)**

**Ratio** An important measure of underwriting and profitability, this figure represents the percentage of each premium dollar that an insurer spends on claims and expenses (i.e., a combination of the "loss ratio" and "expense ratio"). A combined ratio of less than 100 percent indicates a profit; anything over 100 represents a loss.

**Exclusion** A provision in an insurance policy that denies coverage for certain perils, persons, property, or location.

**Expense Ratio** This figure represents the insurer's operating expenses divided by net premiums written (expenses include commissions, salaries, administrative expenses, etc.).

**FAIR (Fair Access to Insurance Requirements)**

**Plan** A facility, operating under a government-insurance industry cooperative program, to make fire insurance and other forms of property insurance readily available to people who have difficulty obtaining such coverage.

**Loss Control** Methods to reduce the cost and/or frequency of risk through prevention and mitigation.

Simple, common examples of risk management/loss control include wearing a seat belt, installing dead bolt locks or security systems, making factory workers wear safety goggles, and installing fire suppression systems.

**Loss Ratio** Percentage of each premium dollar that an insurer spends on claims. Example: A loss ratio of 94 means that the insurer spends 94 percent of each \$1 of premiums on claims.

**Pool** An organization of insurers or reinsurers through which particular types of risks are underwritten with premiums, losses, and expenses shared in agreed ratios.

**Reinsurance** Just as individuals purchase insurance to spread the risk of possible losses, primary insurers need a way to transfer some of these losses too, so they turn to "reinsurers." Reinsurance is an agreement between two property-casualty insurers to share financial consequences of a loss. The primary insurer buys reinsurance (essentially, insurance for insurance companies) in order to diversify and transfer risks, and to share potentially devastating losses.

**Reserve** This term can apply to: 1) an amount representing actual or potential liabilities kept by an insurer to cover obligations to policyholders and third-party claimants; or, 2) an amount allocated for a special purpose. Note: A reserve is usually a liability and not an extra fund. On occasion, a reserve may be an asset, such as a reserve for taxes not yet due.

**Residual Market** A general term describing the total of all consumers who have had difficulty purchasing insurance through normal channels. Automobile Insurance Plans, FAIR Plans, reinsurance facilities, and Joint Underwriting Associations all service this market.

**Risk Retention** A term meaning that the policyholder pays for part or all of the losses associated with a particular risk. Retention can be deliberate or unintentional. Deliberate risk retention includes such things as: 1) agreeing to a particular level of "deductible" as part of purchasing an insurance policy; or 2) a business or individual covering the cost of low frequency-low severity events, or high frequency-low severity events (such as flat tires on cars, shoplifting at grocery stores, or damage to household possessions). Unintentional risk retention may result because an individual or business simply did not realize that some type of risk was not covered by their insurance policy.

**Statutory Accounting**

**Principles (SAP)** State legal requirements that insurers must follow when submitting financial statements to the various state insurance departments. Such principles differ from Generally Accepted Accounting Principles (GAAP) in some important respects. For example, SAP requires that expenses must be recorded immediately and cannot be deferred to track with premiums as they are earned and taken into revenue.

**Surplus Lines** Any risk or part thereof for which insurance is not available through a company licensed in the policyholder's state (licensed insurers are also known as "admitted" insurers). The business, therefore, is placed with "non-admitted" insurers (insurers not licensed in the state) in accordance with surplus or excess lines provisions of state insurance laws.

## TYPES OF INSURERS

**Stock Companies** Formed to make money for shareholders, who actually own the company. Also known as "public" companies, because their shares are publicly traded.

**Mutual Companies** Owned by the policyholders; like shareholders at stock companies, policyholders of mutual companies receive dividends if operations are profitable.

**Captives** Wholly owned subsidiary of a business organization or group of affiliated organizations that exists for a limited purpose: to provide the parent organization's insurance coverage.

**Risk Retention Groups** Limited by law to providing product liability and other commercial liability insurance coverage for collections of similar entities with similar risk exposures.

**Reciprocal** Unincorporated associations that provide insurance services only to their members, known as "subscribers."



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