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Foundations of Commercial Lines

Understanding Insurance Industry Financial Measures
Part 3 - Underwriting Profitability

How do insurance companies differ from other types of corporations?

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Product:
- Insurance companies do not sell a tangible product, like most other types of companies.
- Ratios that include inventory and cost of goods sold rarely apply.
- Insurance companies sell a promise to pay covered losses if they should occur.

Solvency:
- Although all companies have goals to remain in business, it is particularly important for an insurance company to remain solvent.
- If an insurance company goes bankrupt, they are unable to pay those promised loss payments, which could happen years or decades after the policy is sold in some cases.

Regulation:
- Insurance is governed by the state insurance department where the insurance company is domiciled. The state's primary concern is to ensure that insurance companies remain solvent.

Financials:
- In a typical business, products are sold, which generates revenue.
- In the insurance business, policies are sold, premium is collected, then losses are paid at a later time.
- The nature of these transactions causes insurance companies to assess their financials differently. SAP vs. GAAP.

Policyholder surplus

Policyholder surplus =
Insurance co. assets – Insurance co. liabilities

- Indicator of financial health
- Source of funds
- Premium to surplus ratio = Gross or net premium/PHS
- Metric used by rating agencies

Financial strength ratings

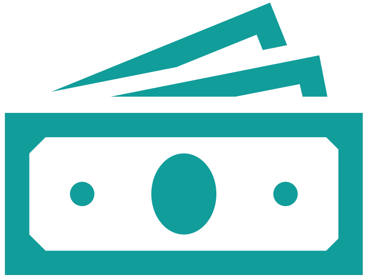
- **Rating agencies** – provide financial strength ratings for financial services organizations, like insurance companies.
- A.M. Best is the most well-known rating agency in the commercial insurance space.
  - Ratings range from A++ to D for operating insurers, with lower grades for those no longer operating.
  - While a B may sound like a fairly good score, for some types of business (particularly long tail business), an insured may not want to partner with a B insurer.
- Everest is an A+ rated company
- Companies with an A++ are very financially strong, but tend to hold onto a very large amount of surplus. Although this makes them safe from a financial mishap, they are not putting their surplus to use, which isn't always the best business decision.

AM BEST SINCE 1899

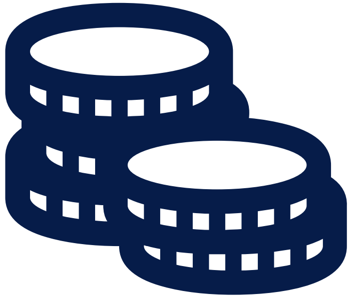
A+ to A++	Superior
A	Excellent
B+	Good
B	Fair
C+	Marginal
C	Weak
D	Poor

(+) or (-) reflect graduation of financial strength within a category

How do insurance companies make money?

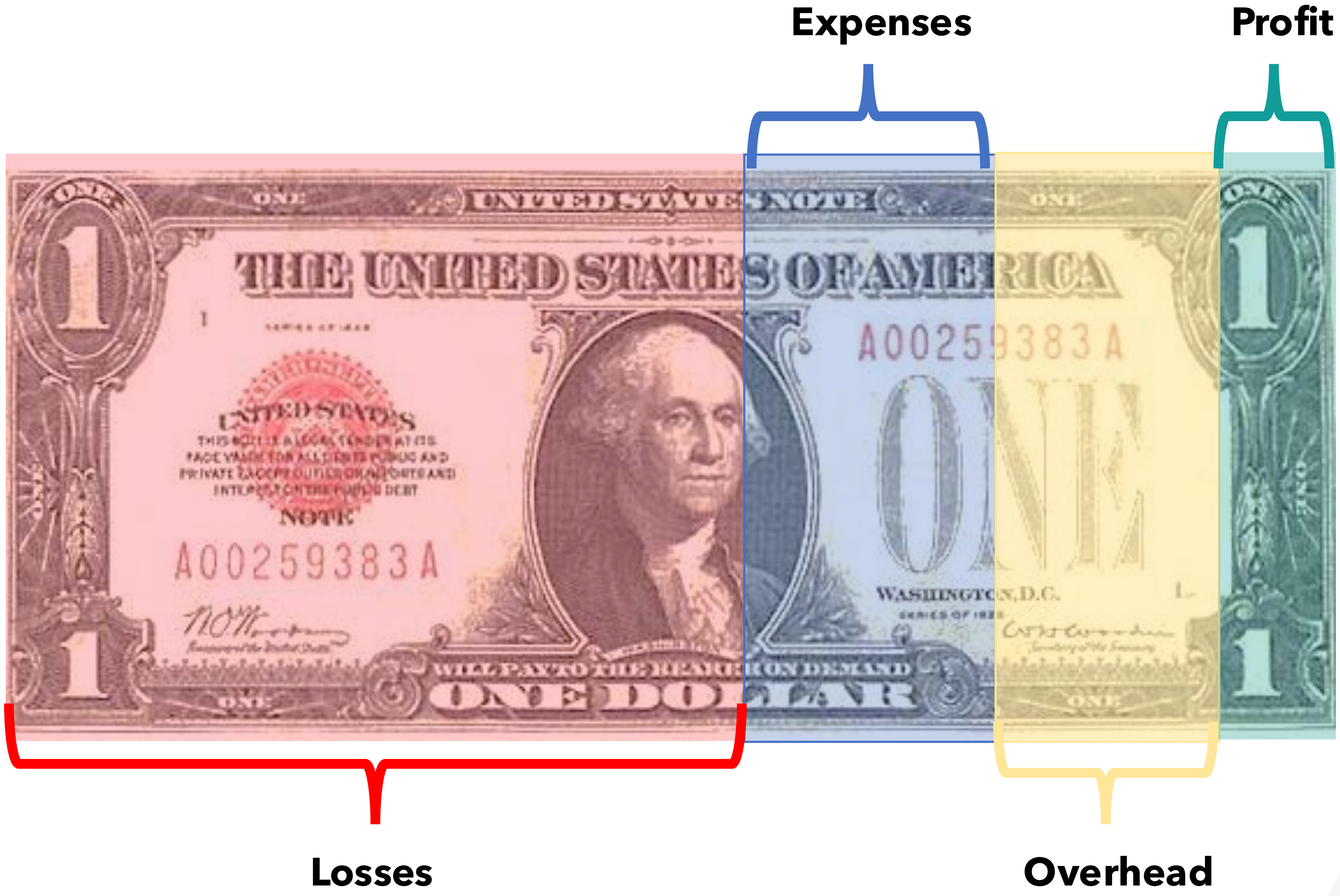


Investment income



Underwriting income

Premium dollar



Underwriting profitability ratios

Combined ratio = loss ratio + expense ratio

$$\frac{\text{Incurred losses + loss adjustment expenses}}{\text{Earned premiums}} + \frac{\text{Incurred underwriting expenses}}{\text{Written premiums}}$$

Loss ratio=

$$\frac{\text{Incurred losses + loss adjustment expenses}}{\text{Earned premiums}}$$

Expense ratio =

$$\frac{\text{Incurred underwriting expenses}}{\text{Written premiums}}$$

Combined ratio = loss ratio + expense ratio

Combined ratio < 100%	Good
Combined ratio > 100%	Bad
Combined ratio = 100%	Break even

How to increase underwriting profitability

Increase premiums

Decrease losses

Control expenses

Combined ratio = loss ratio + expense ratio

$$\frac{\text{Incurred losses + Loss adjustment expenses}}{\text{Earned premiums}} + \frac{\text{Incurred underwriting expenses}}{\text{Written premiums}}$$

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Thank you for completing this module.

For more, please complete part 4 of

Foundations of Commercial Lines:
Understanding Insurance Industry Financial Metrics.