

Risk Management: is the logical process used by businesses and/or individuals to deal with exposure to loss.

Risk Mgt Encompasses more techniques
Than just insurance:

- ① Risk Avoidance
- ② Risk Assumption
- ③ Loss Control / Prevention
- ④ Loss Transfer / Sharing

4 Basic Building Blocks for Developing Insurance Premium

- ① Actual Cost of Losses
(Historical, relatively Stable)
- ② Expenses of Operating & Maintaining the
Insurance Pool (loading)
- ③ Earnings on Investment (Investment Return)
- ④ Allowance for unexpected losses
(Reserve)

Cash Flow Underwriting:

The practice of trying to acquire new insurance business by pricing coverages "at a loss," (i.e. below the cost to pay for losses)

$$\text{Loss Ratio} = \frac{\text{Incurred losses (reported losses + adj. expenses)}}{\text{Earned Premiums}}$$

(Premiums earned at end of the coverage period)

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Life Insurance

Expense Ratio: $\frac{\text{Total Expense}}{\text{Written Premiums}}$

Combined Ratio = Loss Ratio + Expense Ratio

Financial Results for U.S. Property Insurance Industry

	1990	1991	1992
Loss Ratio	82.3	81.1	88.1
Expense Ratio	26.0	26.4	26.5
Combined Ratio	109.6	108.8	115.7

Note: Combined Ratio > 100%

Insurable Loss Exposures

Characteristics of an Ideally Insurable Risk Exposure

- ① A large number of homogeneous (similar) risks exposed to the same peril
 - ② Accidental losses definite in time
 - ③ Definite losses capable of causing economic hardship
 - ④ Extremely low probability of a catastrophic loss to the insurance pool
- Static, Particular, Pure Risks

Insurable Interest:

An interest that might be damaged if the peril insured against occurs.

Insurable Interest must be shown:

At the inception of the contract for Life Insurance

At the time of loss for Property / Casualty Insurance

Recent Catastrophic losses

Year	Event	Loss (\$ Billions)
1992	Hurricane Andrew	16.3
1994	Northridge Earthquake	12.50
1989	Hurricane Hugo	4.99

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Note: Recent Tobacco Liability Settlement
in Florida - \$11 Billion (1997)

⇒ Liability losses can be substantially
greater than physical damage loss.

Ethical & Social Issues Raised With
Federal Disaster Relief

① Cross Subsidization U.S. Citizens paying
for huge losses in Florida/California
through higher taxes

② Moral Hazard - Some people have
come to rely on government aid
living in a earthquake prone area.

Beach Plans - Florida, Louisiana, Miss.,
N. Carolina, S. Carolina, Texas have
enacted legislation setting up insurance
pools covering property in areas not
insured by private carriers.

National Flood Insurance Program

Through this program FEMA makes
available insurance to communities
meeting special requirements (zoning/
construction) for flood coverage.

Subsidization -

Occurs if each insured does not pay the mathematically fair price of insurance

e.g. AIDS - has changed mortality rates for certain ages / classification of policyholders.

Adverse Selection

the tendency of poorer than average risks to seek and obtain insurance at standard rates.

Insurance? Risk

Basic Characteristics of Insurance

Pooling of Losses - Spreading losses among a group

Payment of fortuitous losses - unforeseen losses to be covered

Risk Transfer - pure risk transfer insured to insurer

Indemnification - insured is restored to his/her financial position prior to the occurrence of loss.

Requirements of an insurable Risk

Large # of Exposure Units

Accidental & Unintentional Loss

Losses Determinable & Measurable

Losses that are not Catastrophic

Loss Subject to Chance, Economically Feasible Premium

Ch. 1/2
Types of Insurance

Adverse Selection: Tendency of Persons with a higher than average tendency of loss to seek insurance at standard (average) rate,
 if not controlled by underwriting
 ⇒ results in higher-than-expected loss

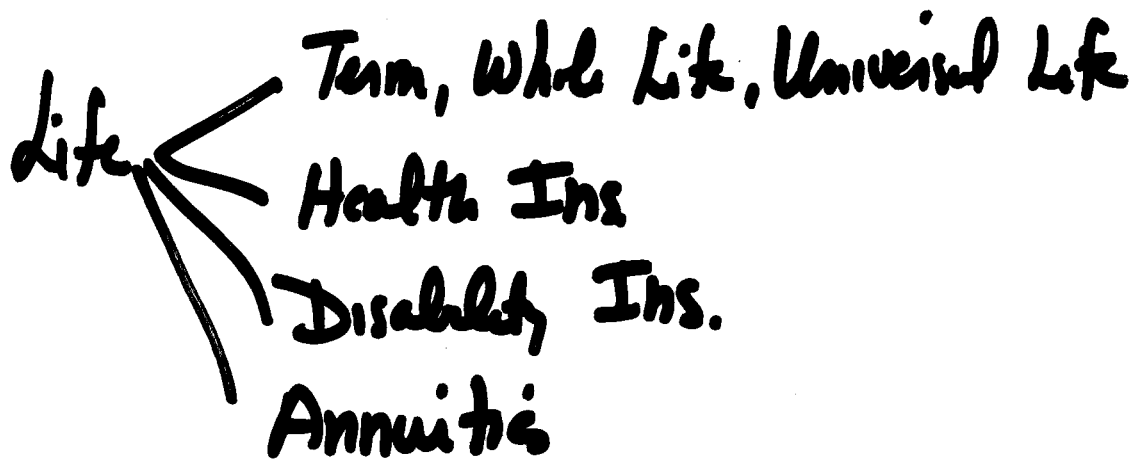
Type of insurance

Private vs. Public Insurance

Type of Coverage < Casualty
 Life

Casualty

- Fire/Auto
- Ocean Marine
- Inland Marine
- General Liability
- Workers Compensation
- Disability



Ch. 1/2
Life Insurance

Government Ins.

OASDHI - Social Security

Fed. Employees Retirement System

FDIC

Federal Flood Ins.

Fed. Crop Ins.

Railroad Retirement System.

Benefits of Insurance to Society

Indemnification for Loss

Less Worry & Fear

Source of Investment Funds

Loss Prevention

Enhancement of Credit

Costs of Insurance to Society

Cost of Doing Business

Fraudulent Claims

Inflated Claims

Risk Mgt

Defⁿ A systematic process for the identification, evaluation of pure loss exposures faced by an organization or individual, and for the selection and implementation of the most appropriate techniques for treating such exposure.

Objectives of Risk Mgt.

Pre loss: - Reduction of Anxiety
Meeting Externally Imposed
Obligations