

Rate Making as a Part of Insurance Operations

Ratemaking Goals:

Insurer Perspective --- Develop a rate structure that enables the insurer to compete effectively while earning a reasonable profit

Premiums must be adequate to cover all losses and expenses leaving a residual amount for profit and contingencies

Regulatory Perspective ---- Rates must not be excessive, unfairly discriminatory, or inadequate to meet claims

Ratemaking Responsibility --- Actuaries supervise the rate making process

Actuaries will use historical, objective data to determine credible rates, in addition to including prospective loss costs to estimate future claim costs not incorporated in past statistical losses

Rate Components:

1. An amount to cover future claims and loss adjustment expenses [prospective loss costs]
2. An amount needed to pay future expenses, such as acquisition expenses, overhead expenses, and premium taxes [expense provision/functional costs]
3. An amount for profit and contingencies [profit and contingencies factor]

Terms:

Expense provision – an amount required to pay expenses associated with issuing, maintaining and servicing the policy

Loss Adjustment Expenses – expenses for adjusting claims – settling claims covered under the policy

Earned Exposure Unit – exposure unit on which the insurer is giving coverage

Loading for Profit and Contingencies – An additional amount to protect insurer from consequences where actual losses exceed what was expected, and provide a return to the equity holders in the insurance operation.

Distinction between Insurance Operations and Investment Operations when underwriting insurance:

Insurance operations --- write and issue policies, collect premiums and pay claims.

Investment operations – use the funds generated by insurance operations [in the form of premium income, return on invested assets and expense savings] to earn a safe and profitable return for policyholders [in a mutual co] or shareholders [in a stock insurance co.]

Fating Factors:

Estimating Losses

Past Loss Experience – based on using statistical information on previous loss experience covering past coverage periods, and then adjusting those losses for future conditions.

One significant difficulty --- past loss experience is not completely known at the time of a past loss study, because not all covered losses are paid immediately, and some claims may be delayed in being reported

Delay in the payment of a known loss

Long-Tailed Claims Experience – Due to Occurrence Based Claims Underwriting in the Policies

Insurance Rates are based partly on incurred losses:

Incurred losses include:

1. Paid losses
2. Outstanding loss reserves

Loss Reserves – are estimates of future payments for losses that have already occurred, whether the losses are reported or not. These reserves are a legally reported liability to the insurer.

Note: If loss reserves are set too low, the as a consequence rates that are based on those reserves will also prove to be inadequate.

