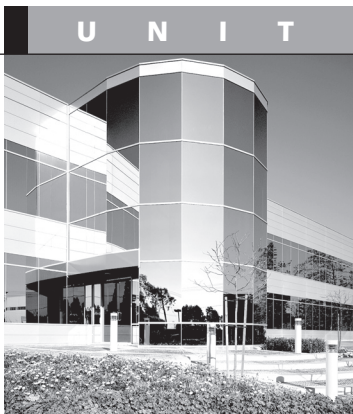




3

Insurance Company Organization and Regulation

TYPES OF INSURANCE ORGANIZATIONS

Stock and Mutual Companies

Now that we've talked about the insurance contract in general, we want to look more closely at the organizations that issue these contracts. There are several types of insurance companies we want to consider that represent different ways in which companies raise the money necessary to begin business and enroll their prospects for insurance.

The first type is called a **stock** company. When a stock company first forms, it sells stock to stockholders to raise the money necessary to operate the business. Stockholders are not necessarily insured by the company, and insureds do not necessarily own stock in the company. The company is in the business to sell insurance to the insured. Profits attributed to the operation of the company are returned as dividends to the stockholders, not the insureds.

The second type, a **mutual** insurance company, functions differently than a stock company. In a mutual company, the insureds are also owners of the company. As owners, they can vote to elect the management of the company. Profits are returned to the insureds in the form of dividends or reductions in future premiums.

Most mutual companies are advance premium companies that charge non-assessable premiums. A small number are **assessment** companies, providing primarily fire and windstorm insurance for small towns and farmers. Assessment mutuals charge members a pro-rata share of losses at the end of each policy period.

Reciprocals and Lloyd's Associations

The third form of company organization, although not as common as a stock or mutual, is known as a **reciprocal** company. The word "reciprocate" means to give and take. A member of a reciprocal agrees to *share* the insurance responsibilities with all other members of the unincorporated group. In a sense, all members insure each other and share the losses with each other. A reciprocal is managed by an **attorney-in-fact** who is empowered to handle all of the business of the reciprocal.

Another type of insuring organization is called a **Lloyd's Association**. Perhaps you have heard of the famous group, Lloyd's of London. It may surprise you to know that Lloyd's of London is not really an insurance company at all. It is a voluntary association of individuals, or groups of individuals, who agree to share in insurance contracts. Each individual, or "syndicate," is individually responsible for the amounts of insurance they write. There are also a limited number of Lloyd's Associations in the United States.

Fraternal Benefit Societies

Another type of insuring organization is a **fraternal benefit society**. A fraternal benefit society is an incorporated society or order, without capital stock, that is operated on the lodge system and conducted solely for the benefit of its members and their beneficiaries, and not for profit. Fraternal benefit societies offer insurance that is available only to their members. Most write only life and health insurance.

Risk Retention Groups and Purchasing Groups

In 1981, Congress passed the Liability Risk Retention Act to give product manufacturers more options when insuring against product liability. To facilitate this process, the Act allowed product manufacturers to establish group self-insurance programs or group captive insurance companies, called **risk retention groups (RRGs)**, to protect them against product liability exposures and to purchase Liability insurance on a group basis through **purchasing groups (PGs)**. The Act accomplished this by limiting the states' authority to regulate Product Liability insurance. Risk retention groups and purchasing groups are regulated in the states where they are domiciled but they can transact business in all other states. This exempts them from state insurance regulation and guaranty funds. The Liability Risk Retention Act of 1986 amended the 1981 Act by giving the right to form RRGs and PGs to nearly all businesses. They are prohibited from writing Workers Compensation and Personal Lines insurance.

Self-Insurance

Some companies and individuals choose to **self-insure**. With this option, part or all of the risk of loss is borne without the benefit of insurance coverage to fall back on if a loss occurs. Some large companies are self-insured because they have the resources to withstand losses and their claims experience demonstrates that it is cheaper to be self-insured than to pay for insurance coverage.

Private, Government Insurers

Insurance companies may be privately owned or operated by the state or federal government.

The government sometimes steps in to provide insurance that is not ordinarily available from private insurers. This type of insurance is sometimes called **residual market insurance**. The federal government provides:

- War Risk insurance
- Nuclear Energy Liability insurance
- Flood insurance
- Federal Crop insurance

At the state level, the government is involved in providing unemployment insurance and may provide Workers Compensation benefits through state funds.

LINES OF INSURANCE

Four Lines of Insurance

Another way of classifying insurance companies is by the type of insurance policies they write. There are four broad categories, or **lines**, of insurance:

- Property
- Casualty
- Life
- Health And Disability

An insurance company that writes only one line of insurance is referred to as a **mono-line** company. An insurance company that writes more than one line of insurance is called a **multi-line** company.

Life and Health

Now, let's look a little closer at these four lines of insurance.

Life insurance is designed to handle the risk of premature death or the risk that an individual may outlive his or her financial resources. **Health And Disability insurance** is designed to handle the risk of medical bills and loss of income resulting from injury or sickness. In this course, we will not deal with these lines of insurance, although your company or agency may offer them.

Property and Casualty

The remaining two lines of insurance make up the property-casualty industry. We'll be concentrating on the kinds of insurance that are a part of the property-casualty field for the remainder of this course.

Property insurance is relatively simple to define. It includes many types of insurance designed to handle property risks—risks that we will suffer financial loss because something we own is damaged or destroyed. The following types of insurance are generally considered to be property insurance:

- Dwelling
- Homeowners
- Commercial Property
- Inland Marine
- Ocean Marine
- Crime

We'll look more closely at each of these types of insurance later.

Casualty insurance is more difficult to define because it includes a wide variety of basically unrelated insurance products.

One of the most important risks covered by the casualty line is the **liability** risk—the risk that we will suffer financial loss as a result of our actions toward others. A good example is the all-too-familiar auto accident in which Mr. A backs out of his driveway, hits Ms. B's car and causes \$500 in damage. If the accident was Mr. A's fault, then he is liable for the damage he caused to Ms. B or her auto.

Although insurance against the liability risk is an important casualty coverage, there are many other types of insurance that have historically been classified as casualty:

- Aviation
- Auto
- Workers Compensation
- Surety Bonds

You'll learn more about these coverages later in the course.

Exercise

- A. Bonnie Saylor drives a school bus. She drives very carefully because she knows she's responsible for the lives of the children on board. This is an example of a (property/casualty) _____ risk.
- B. Bart Tomkins lives in the midwest and wants to insure his home against damage by a tornado or windstorm. This is an example of a (property/casualty) _____ risk.

Answers: A. casualty; B. property

Personal and Commercial Lines

Insurance can be written to meet the needs of an individual or family as well as the needs of a business. **Personal lines** are property-casualty coverages that protect an individual or family. **Commercial lines** are coverages designed for businesses.

Exercise

Label each of the following as a personal line (**P**) or commercial line (**C**).

- ____ A. Mabel wants insurance protection for her home.
- ____ B. Willoby Industries would like to purchase property insurance for its new warehouse.
- ____ C. The Jensens have insurance coverage for their two family cars.
- ____ D. Toyland, Inc. has insurance that protects it against liability arising out of the toys it manufactures.

Answers: P A.; C B.; P C.; C D.

INSURANCE COMPANY ORGANIZATION

Introduction

Whether an insurance company is mono-line or multi-line, whether it specializes in personal lines or commercial lines, an insurance company is made up of people.

In this section, we'll consider how an insurance company is organized and the various functions people perform within the company. Although you may not find your specific position listed, this review should give you an idea of where you fit in the total picture.

The Agent

Duties

Perhaps the first person most people think of when they think of insurance is the **insurance agent**. The insurance agent, who represents the insurance company, is the direct link between the company and its insureds. As such, the agent has many responsibilities, including:

- Selling insurance
- Issuing and countersigning policies
- Collecting premiums
- Providing a link between the insured and the insurance company

Most of these duties are self-explanatory, but you may be curious about countersigning. **Countersigning** means the agent signs each new policy prepared by the company before delivering it to the insured. In most states, the agent's countersignature is required to validate the contract.

The agent's duty to provide a link between the insured and the insurance company involves a number of responsibilities.

The agent is responsible for **field underwriting** each risk. This means using preestablished criteria to seek out the type of business that is likely to be acceptable to the company. While the company underwriter makes the final decision to accept a risk, the agent also has a responsibility to seek out quality business.

Before selling a policy, the agent must obtain information on the prospect's particular exposures and review existing policies. The agent must analyze the prospect's coverage needs and make recommendations as to the amount and type of coverage appropriate for each exposure.

The agent may prepare a **quotation** that will show the prospect what the premium for the proposed coverage will be. And when the prospect buys, the agent must complete a detailed **application**. The application must be carefully, completely and accurately filled out and submitted on a timely basis.

The agent must make sure the client understands the type of coverage being purchased and what the insured's responsibilities are under the policy, as well as

the services that will be provided by the agent and the insurance company. The agent may also be expected to deliver the policy.

Once a policy is in force, the agent has a continuing responsibility toward the insured. At least once a year, the agent should review the client's coverage and evaluate the adequacy of the coverage provided. The agent must also stay current with new coverages that might be appropriate for the client. An agent should maintain a **suspense or diary system** that alerts the agent prior to the time of policy renewal. This is an appropriate time for the agent to ensure that the insured's coverage is still adequate and that there have been no significant changes in the risk.

At any time during the policy year, the agent must be available to assist the insured with **service needs**, such as a name change or a change in the method of premium payment, and maintain accurate records of all such changes requested by the insured. The agent may also assist the insured in filing and following up on claims. Some companies give the agent authority to settle certain types of claims.

Not only does the insurance agent have a moral obligation to fulfill these duties, but there are legal obligations as well. Agents who are negligent in meeting their responsibilities may be liable for their inadvertent errors. Later in the course, we'll discuss **Errors And Omissions insurance**. E & O insurance, as it is sometimes called, should be purchased by agents to protect themselves against legal liability arising from inadvertent errors or omissions.

The insurance business is constantly changing, so it's critical that insurance professionals maintain lifelong educational programs to keep their professional knowledge and skills up-to-date.

Many states have continuing education laws that require producers to take a certain number of hours of insurance-related course work before their licenses can be renewed. In states that do not have continuing education laws, insurance professionals must assess their own needs for continuing education and engage in ongoing improvement of their knowledge and skills.

Insurance professionals may also earn **professional designations** from educational organizations such as The American Institute for Chartered Property Casualty Underwriters and the Insurance Institute of America. These organizations have developed a variety of programs to meet the educational needs of insurance professionals. Some of the designations offered by the Institutes include Chartered Property-Casualty Underwriter (CPCU), Accredited Adviser in Insurance (AAI) and Associate in Personal Insurance (API).

An agent also has responsibilities toward the insurance company or companies he or she represents. An agent must:

- Be loyal to the insurer's interests and avoid engaging in any business activity that competes or interferes with the insurer's business
- Obey all legal instructions provided by the insurer
- Deposit funds belonging to the insurer in a separate account in the insurer's name
- Perform all duties with the degree of care and skill that a reasonably prudent person would exercise in the same circumstances
- Keep the insurer informed of all facts related to the agency relationship

Authority

An **agency** relationship exists when one party (an **agent**) is authorized to act on behalf of another (a **principal**). In the insurance business, the principal is the insurance company and the agent is a person authorized to act on the company's behalf. Principals grant certain powers, or authority, to their agents, and when agents act under these powers, their acts are considered to be the acts of the principal. These acts include making contracts and accepting money.

Even the "knowledge" of the agent is held to be the knowledge of the principal. For example, suppose the applicant tells the agent something that is very important with regard to the applicant's insurability. The agent does not list this information on the application. According to the law of agency, the applicant is revealing the information to the insurance company through the "knowledge" of the agent.

There are actually three separate levels of agent authority. **Express authority** is the authority specifically given to an agent, either orally or in writing, by the principal. Written authority is usually provided through an agency agreement that allows the agent to countersign, issue and deliver policies and provide other customary services on all contracts accepted by the insurer from the agent.

Implied authority is authority given by the insurance company to the agent that is not formally expressed or communicated. This implied authority allows the agent to perform all of the usual and necessary tasks to sell and service insurance contracts and to fully exercise the agent's express authority.

Apparent authority is a doctrine that holds that an agent may have whatever authority a reasonable person would assume he or she has. In the public's eye, an agent acting under apparent authority binds the company as fully as under expressed or implied authority.

Insurance Marketing Systems

There are four basic distribution systems used to market insurance:

- Exclusive agency system
- Direct writer system
- Direct response system
- Independent agency system

TAKE NOTE

Insurance Marketing and the Internet

Advertising and selling insurance through the Internet is a relatively recent development in insurance marketing. Insurance company Web sites offer information about insurers, the various lines of insurance provided, and links to regulatory information, financial rating, and quotation services, as well as "locator" services to put consumers in touch with local agents. Some companies use the Internet to solicit leads, accept applications and even issue insurance policies. Some insurance agencies have also developed home pages that advertise products and services over the Internet.

These practices raise some interesting questions about the regulation of Internet sales. Since the Internet essentially dissolves state geographic boundaries, at issue is

whether the insurance company is licensed to do business in the state, and whether the agent is properly licensed and appointed for the companies represented. Other challenges include how to track premium taxes, how to ensure the security of disclosed personal information, how to audit Internet transactions, whether Internet advertisements comply with state laws, and what the implications are for state guaranty associations. The NAIC has established an Internet Marketing Issues Working Group to further explore these issues.

In an **exclusive** or **captive agency system**, the insurance company contracts with agencies, which are independent businesses, to represent and sell insurance only for that insurance company.

In the **direct writer system**, the insurance company's agents are actually employees. They may receive a salary, be paid by commission or a combination of both.

In the **direct response system**, there are no agents. These companies sell through direct mail or over the phone.

In the **independent agency system**, agencies that are independent contractors contract with several different companies to represent and sell insurance for those companies. An agent who represents more than one company is called an **independent** or **nonexclusive agent**. Several companies may authorize the agent to sell insurance for them, but the agent remains an independent businessperson. The agent collects commissions on the policies sold, but collects no salary from the companies he or she represents.

In the exclusive agency, direct writing and direct response systems, the insurance company owns and controls its accounts, policy records and renewals. If the agency or employment relationship terminates, that person loses all rights and interest in company business and related commissions.

In contrast, in the independent agency system, the agent owns and controls accounts, policy records and renewals. If an independent agent's contract with a particular insurer terminates, that agent retains rights to active accounts and may place them with another insurer and continue to receive commissions.

Other Insurance Professionals

Perhaps you have also heard the terms solicitor, broker, excess or surplus lines agent, and producer used in conjunction with a person who sells insurance. Although not every state recognizes these classifications, we'll explain briefly how these positions differ from that of an agent.

A **solicitor**, like an agent, sells insurance and may even be authorized to collect premiums. However, a solicitor cannot issue or countersign policies—this responsibility can only be handled by an agent. So a solicitor, who often works with or for an agent, has more limited authority than the agent.

Both agents and solicitors represent the insurance company. A **broker**, on the other hand, represents the insured. A company that is seeking insurance could contact a broker, who in turn might contact several insurance companies to find the insurance that is best for the client. Although a broker may sometimes act as an agent of the insurer in certain activities, such as policy delivery, a broker does not have the authority to bind an insurer to an insurance contract.

Excess or **surplus lines** are highly specialized insurance coverages, such as auto racing liability and tuition refund insurance, that are often not available

from any company admitted to do business in a state. An **excess or surplus lines agent** is an agent licensed by the state to handle the placement of such coverages with nonadmitted companies (ones that are not authorized to conduct business in the state under ordinary circumstances).

Producer is a general term used to describe someone who sells insurance, such as an agent, broker or solicitor.

Another type of insurance professional you might encounter is an insurance **consultant**. A consultant is someone who, for a fee, offers advice on the benefits, advantages and disadvantages of various insurance policies. Consultants don't actually sell *insurance*; they sell *advice*.

Exercise

Mark the following as examples of an excess lines agent, consultant, solicitor, or broker.

- A. Garraway Construction wants insurance to cover its multi-million dollar foreign construction project. The company contacts a professional to represent Garraway in finding the best coverage for the money. _____
- B. Janice McKinley provides advice about various insurance policies for a fee. She does not sell insurance. _____
- C. Bill Williams is licensed to handle highly specialized insurance coverages. He is authorized to obtain these coverages from insurance companies not admitted to do business in the state where he works. _____
- D. Jim Jordan, an employee of the Goodwill Agency, spends his days collecting premiums and finding prospective clients. He has no authority to issue or countersign policies. _____

Answers: A. Broker; B. Consultant; C. Excess lines agent; D. Solicitor

Other Insurance Functions

Of course, an agent would have nothing to sell if it weren't for the other functions taking place in the insurance company—at both its central, or “home” office and its regional or branch offices.

TAKE NOTE

Loss, Expense and Combined Ratios

An insurance company evaluates its overall book of business for given periods of time to measure its financial performance during those periods and to look for trends that may have occurred over an extended period of time. An insurer uses three ratios to evaluate its book of business: loss ratio, expense ratio and combined ratio.

The **loss ratio** is used to compare the company's operations from year to year. It shows the percentage of losses the company incurred for every dollar of earned premium. It is calculated by dividing the amount of incurred losses by the amount of earned premium. Here is the loss ratio as a formula:

$$\text{Loss Ratio} = \frac{\text{Incurred Losses}}{\text{Earned Premiums}}$$

Earned premium is the premium that the company actually earned by providing insurance protection for the designated period of time. **Incurred losses** include amounts paid on claims for covered losses and various expenses related to handling claims.

The **expense ratio** indicates the cost of doing business. The formula is:

$$\text{Expense Ratio} = \frac{\text{Underwriting Expenses}}{\text{Written Premium}}$$

Underwriting expenses are the costs required to acquire and maintain a book of business. They include expenses for advertising, commissions, salaries and other administrative costs, and regulatory costs such as taxes and licensing fees.

Written premium is the gross amount of premium income on the company's books. It includes both earned and unearned premium. Premiums for new business, renewals and policy endorsements make up written premium.

The **combined ratio** is simply the sum of the loss ratio and the expense ratio:

$$\text{Combined Ratio} = \text{Loss Ratio} + \text{Expense Ratio}$$

Traditionally, 100% is considered to be the break-even point. A combined ratio of less than 100% indicates the company had an underwriting profit; a ratio greater than 100% indicates a loss.

Underwriting Department: *Underwriting* is the process of selecting certain types of risks and rejecting others so the insurance company will have a book of business that will produce the company's desired results. The Underwriting department is usually made up of many individual *underwriters* who make the decisions about whether to accept or reject the applications sent in by agents based on the company's standards and their own judgment. They may also be called on to review loss experience, provide judgment rates and specify the particular policy forms that are required to provide the coverages applicants have requested.

Policy Issue And Administration: Once the underwriter has approved a new application or a change to a current policy, a whole series of events takes place. The application is checked by a **policy analyst** or **screener** to make sure that all information is correct and complete. It then goes to a **rater** who computes the premium to be charged. The policy forms may be printed by computer or assembled in an **Assembly And Filing area**. Copies of the policy will be mailed to the agent and/or insured.

In many companies, policy rating, policy issue and assembly are combined with the underwriting function in a single unit. Each unit has responsibility for all of these functions within a specific geographical region or territory.

Claims Department: The Claims department sees that the company's insureds are adequately indemnified for their losses. **Claim adjusters** or **representatives** are used to inspect a loss, determine if there is coverage for the loss, estimate indemnification and, in some cases, pay for the loss immediately. Large companies have their own claim adjusters, while smaller companies may use the services of **independent adjusters**.

Actuarial And Statistical Department: The Actuarial And Statistical department is the "numbers" department. Using the tremendous amount of data

generated by computer, together with statistics available from other companies, **actuaries** determine the rates to be charged for various types of insurance.

Accounting Department: As with any profit-oriented business, the determination of financial condition is a very important function in an insurance company. However, insurance companies must place special emphasis in this area because their finances are closely regulated by the states—for example, premiums must be credited to specific accounts, agents must be paid commissions and proper reserves must be maintained. All of these functions are handled by the Accounting department.

Investment Department: The Investment department oversees the funds the company needs to invest to make sure adequate funds will be on hand to pay claims. The Investment department attempts to maintain a healthy rate of return while maintaining the safety of the investment. Since money must be on hand to pay future obligations, highly speculative stocks are not appropriate, and at least some of the investments must be readily convertible to cash, as needed.

Legal Department: Since insurance policies are legal contracts, it is not surprising that insurance companies maintain a legal staff. This department interprets the various state insurance laws and helps the company keep its policies and practices in compliance. A key role is the department's involvement with court cases arising from claims. The Legal department is instrumental in helping determine fair indemnification for insureds and is also involved in the company's other legal actions.

Audit Department: For certain insurance coverages, a premium is determined after or during the policy term, instead of at the beginning of the policy term. These “after-the-fact” premiums may be based on a number of factors such as payroll, number of employees or amount of receipts. The Audit department checks the accounting records of these insureds at the required intervals to obtain the necessary information used to determine these types of premium.

Loss Control Department: While an insured is glad when insurance pays for a loss, he or she would rather have no loss at all. This is why prevention and control of losses are very important aspects of the insurance business. The Loss Control department, or Engineering department as it may be called in some companies, inspects factories, certifies boilers and makes recommendations to insureds as to how risks may be avoided or reduced.

Agency Department: This department works very closely with, and directs the operations of, the agents who represent the company. Its responsibilities include recruiting, appointing and training, especially if an agent will be an exclusive agent. The department must monitor the sales and marketing efforts of these agents and make sure that the number and quality of agents are closely tuned to the market the company serves.

Marketing Department: Closely related to the Agency department, the Marketing department helps determine the company's overall marketing strategy. It develops advertising and sales aids or works closely with a separate Advertising department to accomplish these goals.

Reinsurance Department: Insurance companies themselves often purchase insurance to cover their own exposure to loss. This is called **reinsurance**. Reinsurance helps protect insurance companies from catastrophic losses and from wild fluctuations in underwriting results. This coverage may be obtained on a policy-by-policy basis or on the basis of a whole block of policies. The reinsurance may cover the initial insurer for losses above a certain amount or may call for losses to be shared on a pro rata basis.

Support Departments: Like other businesses, insurance companies have departments whose contributions help all other departments operate smoothly. They include **Personnel, Training, Information Systems, Administration, Forms And Filings, and Building And Maintenance.**

Exercise

Match the name of the department listed in the left-hand column with the function it performs listed in the right-hand column.

- | | | |
|----------------------------------|-------|--|
| 1. Underwriting | _____ | A. Decides whether to accept or reject applications based on company standards |
| 2. Policy Issue & Administration | _____ | B. Determines the rates to be charged for various types of insurance |
| 3. Claims | _____ | C. Oversees the company's investments to ensure there are adequate funds to pay claims |
| 4. Actuarial And Statistical | _____ | D. Performs a variety of functions such as checking applications for accuracy and completeness, rating policies and printing and assembling policies |
| 5. Accounting | _____ | E. Makes sure insureds are properly indemnified for losses |
| 6. Investment | _____ | F. Handles transactions related to the company's financial condition |

Answers: 1 A.; 4 B.; 6 C.; 2 D.; 3 E.; 5 F.

REGULATION

State Insurance Regulation

Because of the long-term nature of the insurance contract and the principle of utmost good faith on which such contracts are based, insurance is closely regulated for the good of the insurance industry and the general public. And since insurance needs and practices differ from one area to another, it is the states that regulate the insurance business that is conducted within their boundaries.

Each state has an **insurance department** headed by an official charged with the responsibility for controlling insurance matters within that state. These officials are called **Directors, Superintendents or Commissioners of Insurance,**

depending on the state in which they hold office, but they all perform similar duties.

The commissioners of each of the states together make up the **National Association of Insurance Commissioners (NAIC)**, which meets at regular intervals to exchange information and provide coordination of the regulatory measures of each state. Through its recommendations, much of the nation's insurance laws take shape. Although nonbinding on individual states, the NAIC's recommendations are generally followed.

Regulation and the Company

Admitted, Nonadmitted Companies

A state insurance department has four areas of responsibility:

- Companies
- Agents
- Ratification
- Enforcement

We'll first consider the department's duties with regard to companies.

One of the duties of an insurance department is to determine which insurance companies will be allowed to do business in the state. A company that meets the insurance department's standards and is authorized to do business in a state is called an **admitted** or **authorized insurer**. Perhaps it is obvious, but an insurance company that is not authorized to do business in a state is a **nonadmitted** or **unauthorized insurer**. A nonadmitted insurer may only do business in the state under special circumstances.

Domestic, Foreign, Alien

Although a company may conduct business in several states, it is formed and incorporated in only one state. Within its home state, an insurance company is known as a **domestic** company. Within states other than the state in which it is incorporated, an insurance company is a **foreign** company. A company that is incorporated in a country other than the United States, but doing business in the states, is known as an **alien** company.

For example, Amalgamated Indemnity is incorporated in the state of Ohio. Within Ohio, Amalgamated is known as a domestic company. In all other states in which Amalgamated is admitted to do business, Amalgamated would be considered a foreign company.

Another insurer, Rio Grande Insurance Company, is incorporated in Mexico but writes some business in Ohio. In Ohio, Rio Grande would be referred to as an alien company.

Financial Regulation

In addition to examining and authorizing companies to conduct business within the state, the state insurance department keeps close watch over the financial health of all companies doing business within its boundaries.



Various regulations are designed to preserve insurance company solvency, to detect financial problems, and to protect insureds in the event that insolvency occurs. State laws impose capital and surplus requirements on insurers, require the preparation of annual financial statements, and require periodic examinations of insurers. These laws establish initial financial requirements and help in the early detection of financial problems. If an insurer falls into a hazardous financial condition, the insurance department attempts to rehabilitate the company. If an insurer becomes insolvent, the insurance department will handle the liquidation. In many states, the public is also protected by one or more **insurance guaranty associations**, which provide funds for payment of unpaid claims when an insurer becomes insolvent.

Company Ratings

There are several organizations that rate the financial strength of insurance carriers, based on an analysis of a company's claims experience, investment performance, management, and other factors. These organizations include A.M. Best, Standard & Poor, and Best's. These ratings are one of the most widely used indicators of financial health (or the lack of it) in the insurance industry.

The approach taken by A.M. Best illustrates one approach to evaluating companies. Best uses nine alphabetical ratings for insurers to which it gives an assigned rating, and uses other designations to evaluate financial health, which are explained below:

A++, A+	Superior—strongest position
A, A-	Excellent
B++, B+	Very good
B, B-	Good
C++, C+	Fair
C, C-	Marginal
D	Below minimum standards
E	Under state supervision
F	In liquidation

Various **modifiers** (one of eight lower case letters) may be added to assigned ratings, which are shown in upper case, to qualify the status of a rating. For example, “g” is used to indicate a *group* rating involving a pool of affiliated companies. The letter “e” indicates a *parent company* rating, when the financial strength of the parent is used to evaluate a newly affiliated company. Caution is signaled by a “w” which means *watch list*—meaning that some decline has occurred, but not enough to cause a drop in the assigned rating. An overall rating might look like this:

B+w: Very good, but watch

Regulation and the Agent

Licensing

The state insurance department devotes much of its time to working with insurance agents. One of its most important duties with regard to agents is licensing. It is illegal for someone to sell insurance without first obtaining a license from the state to do so.

To make sure that agents will be prepared to undertake their substantial responsibilities, each state requires its agents to pass a licensing exam to receive a license. This exam is administered by the state insurance department.

Codes Regulating Agents

In addition to licensing, the state is responsible for the way agents conduct business within the state. State insurance codes are very specific about the standards agents must meet. Although we won't try to cover each of the many types of laws governing agent conduct, we'll introduce you to some important terms.

Fiduciary: A fiduciary is a person who stands in a special relationship of trust to another person. Agents have fiduciary duties toward their clients, especially regarding the handling of premiums.

Misrepresentation: Agents may not misrepresent or falsely advertise the terms or benefits of a policy or the financial condition of the company. The agent must make complete, accurate statements about the product being sold.

Twisting: Twisting is a form of misrepresentation where the agent convinces the client to cancel already-existing insurance and buy another policy from the agent, to the detriment of the insured. Twisting is illegal.

Rebating: Rebating is giving or offering some benefit other than those specified in the policy, such as cash, gifts or securities, to induce a customer to buy insurance. For example, an agent might kick back part of a commission to the customer, thus lowering the price of the insurance in return for the business. Rebating is illegal in all but two states.

Unfair Discrimination: Agents can be in violation of the law if they unfairly discriminate against insureds. This means that an insured cannot be given a lower or higher rate than another insured in identical circumstances. It also means that the agent cannot accept a bribe from a client to provide insurance or lower the premium.

Exercise

Identify each of the following examples as twisting (**T**), rebating (**R**), failure of fiduciary responsibility (**F**), misrepresentation (**M**), or unfair discrimination (**U**).

- ____ A. Agent Joe agrees to split the commissions he earns with his clients. He's able to sell more insurance this way.
- ____ B. Agent Ann receives a check from the insurance company that is a refund to one of her insureds. She cashes the check herself and pockets the money.
- ____ C. Agent Allen tells an applicant that her new policy covers earthquake damage, although it does not.
- ____ D. Agent May agrees to offer an insured a lower premium if the insured will agree to direct other family members to Agent May.
- ____ E. Agent George persuades a prospect to let her current policy lapse and buy insurance through him. He tells the prospect that his company's policy provides more coverage at a lower premium, even though this is not true.

Answers: R A.; F B.; M C.; U D.; T E.

Ratification

Forms and Rates

Another important function performed by state insurance departments is approval, or **ratification**, of the policy forms, endorsements and rates used by companies doing business in their states.

In some states, called **prior approval** states, the insurance company must obtain official approval before using new forms and rates.

In **file and use** states, a company may begin using forms and rates as soon as they have been filed. The state eventually reviews the filing and officially accepts or rejects it.

With **use and file** states, insurers must file rates and forms within a certain period of time after they are first used.

In **open competition** states, the state allows the companies to compete openly with the forms and rates they select, subject only to requirements of adequacy and nondiscrimination (we'll discuss these two requirements in a moment).

In some states, for some lines of insurance, the use of unique state forms or rates may be **mandatory** for any company doing business in the state.

You've learned that the state insurance department must also approve the rates each company uses. **Rates** are the basic charges an insurance company sets for various types of insurance.

When a company establishes a rate it will use, it calculates a rate that will be adequate to pay:

- The cost of losses that will have to be paid
- The cost of conducting the business
- A small profit

Insurance companies collect extensive data in each of these areas to assist them in calculating rate levels. Data is collected on a large number and variety of risks. Within a specific line of insurance, risks with similar characteristics are grouped together in classes, and rates are determined for each class.

When the state examines rates for approval or rejection, the state will require that the rates be **adequate** so the company can meet its obligations to insureds. It also requires that the rates be **nondiscriminatory**, meaning the insurer cannot charge different rates for the same class of insureds, and **not excessive**, meaning the rates cannot be so high as to allow the company to make a windfall profit or make insurance an unrealistic purchase.

Rating Organizations

Some states establish their own rates for certain types of insurance and require all companies to use these mandatory rates. For most types of insurance, however, the company must establish the rates and submit them to the state.

We've already indicated that this involves collecting extensive and accurate financial, operational and loss records. To assist the insurance company in collecting these statistics, certain central **service bureaus** have been established. These organizations, made up of numerous individual insurance companies, gather, pool and analyze statistics from all of the member companies. The bureau then establishes **loss costs** based on these combined figures and files them with individual states. Loss costs represent the key component of an insurance rate—how much an insurance company needs to collect to cover expected losses.

Member companies may use these loss costs combined with factors covering their own expenses and profit margins to establish finished rates. Companies

must file rates with the state but may do this by referencing the service bureau's loss costs and filing their own individual factors reflecting expenses and profit. Some companies do not belong to a service organization and collect their own statistics and file independently.

Companies that use bureau filings sometimes **deviate** from the published rates by charging something either higher or lower than the recommended rate. Deviations are usually permitted within a specified range, provided that the insurer is consistent in applying the same deviation to all similar risks.

One of the largest services bureaus is the **Insurance Services Office**, commonly referred to as **ISO**. ISO files both loss costs and standardized forms on behalf of its member companies. The **National Council On Compensation Insurance (NCCI)** is a rating bureau that has jurisdiction over the Workers Compensation field. The **Surety Association of America** functions as a rating bureau for surety bonds. There are numerous other rating bureaus.

Enforcement

The final area of regulatory responsibility for the state insurance departments is enforcement. We've already talked about many of the rules that apply to the conduct of the companies, agents and types of insurance transacted within the state. The department is responsible for seeing that the insurance business within the state is in compliance with these codes and standards. Reported violations must be investigated, and appropriate penalties assessed. Violations can result in fines, license suspension or revocation, suspension or revocation of a company's authority to do business in the state and, in some cases, imprisonment.



Federal Regulation

Although most insurance operations are primarily regulated by the states, there are some areas where the federal government has some regulatory impact on insurers.

For example, federal law imposes penalties for **fraud and false statements** made in connection with insurance transactions. Anyone engaged in the insurance business who makes a **false material statement or report** or **willfully and materially overvalues** any land, property or security in connection with financial reports or documents presented to an insurance regulatory official or agency for the purpose of influencing their actions will be punished accordingly. The punishment for this offense is a fine and/or imprisonment for up to 10 years. The term of imprisonment may be up to 15 years if the statement, report or overvaluing of land, property or security jeopardized the safety and soundness of an insurer and was a significant cause of the insurer being placed in conservation, rehabilitation, or liquidation by an appropriate court.

Any insurance officer, director or agent who **willfully embezzles, abstracts, purloins, or misappropriates** any of the moneys, funds, premiums, credits, or other property of an insurer may be punished accordingly. The punishment may consist of a fine and/or imprisonment for up to 10 years. If the crime jeopardizes the safety and soundness of an insurer and was a significant cause of the insurer being placed in conservation, rehabilitation or liquidation by an appropriate court, imprisonment may be up to 15 years. If the amount or value does not exceed \$5,000, whoever violates this section will be fined and/or imprisoned for up to one year.

Any insurance professional who knowingly makes any **false entry of material fact** in any book, report or statement of a person engaged in the insurance business with intent to deceive another person about the financial condition or solvency of the business may be punished accordingly. The punishment for this offense is a fine and/or imprisonment for up to 10 years. If the false entry jeopardized the safety and soundness of an insurer and was a significant cause of an insurer being placed in conservation, rehabilitation, or liquidation by an appropriate court, imprisonment may be up to 15 years.

Anyone who **threatens, forces, or corruptly influences, obstructs, or impedes the due and proper administration of the law** under any proceeding involving the insurance business may be fined and/or imprisoned for up to 10 years.

An insurance professional who has been convicted of any **criminal felony involving dishonesty or a breach of trust**, or who has been **convicted** of an offense under this section, may be fined and/or imprisoned for up to 5 years. After committing a felony of this nature, the offender may only engage in the business of insurance if he or she has the written consent of an insurance regulatory official. (18 USC 1033–1034)