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The Internet Industry As a result of globalization , deregulation and terrorist attacks, the insurance industry has gone through a tremendous transformation over the past decade. In the simplest terms, insurance of any type is all about managing risk. For example, in life insurance , the insurance company attempts to manage mortality death rates among its clients. The insurance company collects premiums from policy holders, invests the money usually in low risk investments , and then reimburses this money once the person passes away or the policy matures. A person called an actuary constantly crunches demographic data to estimate the life of a person. The greater the chance that a person will have a shorter life span than the average, the higher the premium that person will have to pay. This process is virtually the same for every other type of insurance, including automobile, health and property. In the insurance business, this has led to a flurry of merger and acquisition activity. In fact, a majority of the liability insurance underwritten in the U. Ownership of insurance companies can come in two forms: If the company is owned by shareholders, it is like any other public company. That is, its shares trade on an exchange like the NYSE , and it is required to report earnings on a quarterly basis. The other type of ownership is called "mutually owned insurance companies. It should be mentioned that in recent years many of the top mutual insurance companies have gone through demutualization to become shareholder-owned. Today, only a small handful of companies are still policyholder-owned. Types of Insurance There are several major types of insurance policies. Some companies offer the entire suite of insurance, while others specialize in specific areas: Life Insurance - Insurance guaranteeing a specific sum of money to a designated beneficiary upon the death of the insured, or to the insured if he or she lives beyond a certain age. Health Insurance - Insurance against expenses incurred through illness of the insured. Liability Insurance - The miscellaneous category. There are many factors to examine when looking at insurance companies. Poor fundamentals not only indicate a poor investment opportunity, but also hinder growth. Nothing is worse than insurance customers discovering that their insurance company might not have the financial stability to pay out if it is faced with a large proportion of claims. Over the years, there has been a big shift in the life insurance industry. Instead of offering straight insurance, the industry now tends to sell customers on more investment type products like annuities. As a result, insurance companies have been able to compete more directly with other financial services companies such as mutual funds and investment advisory firms. To capitalize on this, many insurance companies even offer services such as tax and estate planning. Return on Assets ROA: In general, a life insurer should have an ROA that falls in the 0. Return on Total Revenue: Net Income Total Revenue This is another variation of the profitability ratios. If possible, use the premium income and investment income as the numerator to find the profitability of each area. This is the process of multiple insurers sharing an insurance policy to reduce the risk for each insurer. You can think of reinsurance as the insurance backing primary insurers against catastrophic losses. The company transferring the risk is called the "ceding company"; the company receiving the risk is called the "assuming company" or "reinsurer. Lapsed Life Insurance Specified Period Contracts in Force in effect at Start of Specified Period This ratio compares the number of policies that have lapsed expired within a specified period of time to those in force at the start of that same period. A lower lapse ratio is better, particularly because insurance companies pay high commissions to brokers and agents that refer new clients. Best dubs itself "The Insurance Information Source. Many analysts equate the quality of A. If you are analyzing an insurance company, you may want to consider looking for the A. Analyst Insight There are three major factors that we must consider when analyzing an insurance company. Coincidently, these are the same ones that the A. Best ratings among other things take into account. The first things you want to check when considering an insurance company are the quality and strength of the balance sheet. Everyday insurers are taking in premiums and paying out claims to policyholders. The ability to meet their obligations toward these policy holders is extremely important. Companies should strike a balance between high returns while keeping leverage intact. A company that is highly leveraged might not be able to meet financial obligations when a large catastrophic event occurs. The following three things act to increase leverage: Too much dependence on reinsurance means that the company is not keeping a fair portion of responsibility for each premium dollar. It tests whether a firm has enough short-term assets without selling inventory to cover its immediate liabilities. Also take a close look at cash flow. An insurer should almost always have a positive cash flow. Too many high and medium risk bonds could lead to instability. As with any company, profitability is a key determinant for deciding whether to invest. For an insurance company, there are two components of profits that we must consider: Underwriting income is just that: Growing premium income is a "catch 22" for insurance companies. Ideally, you want the growth rate to exceed the industry average, but you want to be sure that this higher growth does not come at the expense of accepting higher-risk clients. Conversely, a company whose premium income is growing at a slower rate might be too picky, looking for only the highest quality insurance opportunities. The one thing to remember is that higher premium collections do not equate to higher profits. Lower numbers of claims via low risk clients contribute more to the bottom line. The second area of profitability that you need to include in your analysis is investment income. A majority of the assets should be invested in low-risk bonds, equities or money market securities. Some insurers invest a substantial portion of their assets in real estate. If this is so, take a look at what type of property it is and where it is located. ROA, ROE, and the lapse ratios discussed above are also useful for evaluating the profitability of the insurer. Calculate the ROA and ROE numbers over the past several years to determine whether management has been increasing return for shareholders. The lapse ratio will help to tell whether the company has managed to keep marketing expenses under control. The more policies that remain in force are not canceled , the better. Other Factors Another major item that affects the performance of an insurance company is interest rate fluctuations. Insurance companies invest much of the collected premiums, so the income generated through investing activities is highly dependent on interest rates. Declining interest rates usually equate to slower investment income growth. Another downside to interest rate fluctuations not exclusive to insurance companies is the cost of borrowing. If the company is about to borrow or reprice its debt, there could be a big shock to cash flows as interest expense rises. Demographics play one of the largest roles in affecting sales for insurance, particularly life insurance. As people age, they tend to rely more and more on life insurance products for their retirement. Because baby boomers are quickly approaching retirement age, take a close look at the suite of insurance products that the company is offering and, from that, see if it stands to benefit from this large portion of the population getting older. We should also note that A. Best ratings take all of this information and more into account when they determine their ratings. The threat of new entrants lies within the insurance industry itself. Some companies have carved out niche areas in which they underwrite insurance. These insurance companies are fearful of being squeezed out by the big players. Another threat for many insurance companies is other financial services companies entering the market. What would it take for a bank or investment bank to start offering insurance products? In some countries, only regulations that prevent banks and other financial firms from entering the industry. If those barriers were ever broken down, like they were in the U. The suppliers of capital might not pose a big threat, but the threat of suppliers luring away human capital does. If a talented insurance underwriter is working for a smaller insurance company or one in a niche industry , there is the chance that person will be enticed away by larger companies looking to move into a particular market. Large corporate clients have a lot more bargaining power with insurance companies. Large corporate clients like airlines and pharmaceutical companies pay millions of dollars a year in premiums. Insurance companies try extremely hard to get high-margin corporate clients. This one is pretty straight forward, for there are plenty of substitutes in the insurance industry. Most large insurance companies offer similar suites of services. Whether it is auto, home, commercial, health or life insurance, chances are there are competitors that can offer similar services. In some areas of insurance, however, the availability of substitutes are few and far between. Companies focusing on niche areas usually have a competitive advantage, but this advantage depends entirely on the size of the niche and on whether there are any barriers preventing other firms from entering. The insurance industry is becoming highly competitive. The difference between one insurance company and another is usually not that great.

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Early methods[edit] Merchants have sought methods to minimize risks since early times. Methods for transferring or distributing risk were practiced by Chinese and Babylonian traders as long ago as the 3rd and 2nd millennia BC, respectively. The Babylonians developed a system which was recorded in the famous Code of Hammurabi , c. This allowed groups of merchants to pay to insure their goods being shipped together. The collected premiums would be used to reimburse any merchant whose goods were jettisoned during transport, whether due to storm or sinkage. The first known insurance contract dates from Genoa in , and in the next century maritime insurance developed widely and premiums were intuitively varied with risks. Insurance became far more sophisticated in Enlightenment era Europe , and specialized varieties developed. Property insurance as we know it today can be traced to the Great Fire of London , which in devoured more than 13, houses. Initially, 5, homes were insured by his Insurance Office. In the late s, Edward Lloyd opened a coffee house , which became the meeting place for parties in the shipping industry wishing to insure cargoes and ships, and those willing to underwrite such ventures. By the late 19th century governments began to initiate national insurance programs against sickness and old age. Germany built on a tradition of welfare programs in Prussia and Saxony that began as early as in the s. This gave the British working classes the first contributory system of insurance against illness and unemployment. The insured entities are therefore protected from risk for a fee, with the fee being dependent upon the frequency and severity of the event occurring. In order to be an insurable risk , the risk insured against must meet certain characteristics. Insurance as a financial intermediary is a commercial enterprise and a major part of the financial services industry, but individual entities can also self-insure through saving money for possible future losses. Insurability Risk which can be insured by private companies typically shares seven common characteristics: Since insurance operates through pooling resources, the majority of insurance policies are provided for individual members of large classes, allowing insurers to benefit from the law of large numbers in which predicted losses are similar to the actual losses. However, all exposures will have particular differences, which may lead to different premium rates. The loss takes place at a known time, in a known place, and from a known cause. The classic example is death of an insured person on a life insurance policy. Fire , automobile accidents , and worker injuries may all easily meet this criterion. Other types of losses may only be definite in theory. Occupational disease , for instance, may involve prolonged exposure to injurious conditions where no specific time, place, or cause is identifiable. Ideally, the time, place, and cause of a loss should be clear enough that a reasonable person, with sufficient information, could objectively verify all three elements. The event that constitutes the trigger of a claim should be fortuitous, or at least outside the control of the beneficiary of the insurance. The loss should be pure, in the sense that it results from an event for which there is only the opportunity for cost. Events that contain speculative elements such as ordinary business risks or even purchasing a lottery ticket are generally not considered insurable. The size of the loss must be meaningful from the perspective of the insured. Insurance premiums need to cover both the expected cost of losses, plus the cost of issuing and administering the policy, adjusting losses, and supplying the capital needed to reasonably assure that the insurer will be able to pay claims. For small losses, these latter costs may be several times the size of the expected cost of losses. There is hardly any point in paying such costs unless the protection offered has real value to a buyer. If the likelihood of an insured event is so high, or the cost of the event so large, that the resulting premium is large relative to the amount of protection offered, then it is not likely that the insurance will be purchased, even if on offer. Furthermore, as the accounting profession formally recognizes in financial accounting standards, the premium cannot be so large that there is not a reasonable chance of a significant loss to the insurer. If there is no such chance of loss, then the transaction may have the form of insurance, but not the substance see the U. Financial Accounting Standards Board pronouncement number There are two elements that must be at least estimable, if not formally calculable: Probability of loss is generally an empirical exercise, while cost has more to do with the ability of a reasonable person in possession of a copy of the insurance policy and a proof of loss associated with a claim presented under that policy to make a reasonably definite and objective evaluation of the amount of the loss recoverable as a result of the claim. Limited risk of catastrophically large losses: Insurable losses are ideally independent and non-catastrophic, meaning that the losses do not happen all at once and individual losses are not severe enough to bankrupt the insurer; insurers may prefer to limit their exposure to a loss from a single event to some small portion of their capital base. In the United States, flood risk is insured by the federal government. Such properties are generally shared among several insurers, or are insured by a single insurer who syndicates the risk into the reinsurance market. Legal[edit] When a company insures an individual entity, there are basic legal requirements and regulations. Several commonly cited legal principles of insurance include: Benefit insurance â€” as it is stated in the study books of The Chartered Insurance Institute, the insurance company does not have the right of recovery from the party who caused the injury and is to compensate the Insured regardless of the fact that Insured had already sued the negligent party for the damages for example, personal accident insurance Insurable interest â€” the insured typically must directly suffer from the loss. Insurable interest must exist whether property insurance or insurance on a person is involved. The concept requires that the insured have a "stake" in the loss or damage to the life or property insured. What that "stake" is will be determined by the kind of insurance involved and the nature of the property ownership or relationship between the persons. The requirement of an insurable interest is what distinguishes insurance from gambling. Utmost good faith â€” Uberrima fides the insured and the insurer are bound by a good faith bond of honesty and fairness. Material facts must be disclosed. Contribution â€” insurers which have similar obligations to the insured contribute in the indemnification, according to some method. The Insurers can waive their subrogation rights by using the special clauses. Causa proxima, or proximate cause â€” the cause of loss the peril must be covered under the insuring agreement of the policy, and the dominant cause must not be excluded Mitigation â€” In case of any loss or casualty, the asset owner must attempt to keep loss to a minimum, as if the asset was not insured. Indemnity To "indemnify" means to make whole again, or to be reinstated to the position that one was in, to the extent possible, prior to the happening of a specified event or peril. Accordingly, life insurance is generally not considered to be indemnity insurance, but rather "contingent" insurance i. There are generally three types of insurance contracts that seek to indemnify an insured: If the Insured has a "reimbursement" policy, the insured can be required to pay for a loss and then be "reimbursed" by the insurance carrier for the loss and out of pocket costs including, with the permission of the insurer, claim expenses. Most modern liability insurance is written on the basis of "pay on behalf" language which enables the insurance carrier to manage and control the claim. Under an "indemnification" policy, the insurance carrier can generally either "reimburse" or "pay on behalf of", whichever is more beneficial to it and the insured in the claim handling process. An entity seeking to transfer risk an individual, corporation, or association of any type, etc. Generally, an insurance contract includes, at a minimum, the following elements: An insured is thus said to be " indemnified " against the loss covered in the policy. When insured parties experience a loss for a specified peril, the coverage entitles the policyholder to make a claim against the insurer for the covered amount of loss as specified by the policy. The fee paid by the insured to the insurer for assuming the risk is called the premium. Insurance premiums from many insureds are used to fund accounts reserved for later payment of claims â€” in theory for a relatively few claimants â€” and for overhead costs. Social effects[edit] Insurance can have various effects on society through the way that it changes who bears the cost of losses and damage. On one hand it can increase fraud; on the other it can help societies and individuals prepare for catastrophes and mitigate the effects of catastrophes on both households and societies. Insurance can influence the probability of losses through moral hazard , insurance fraud , and preventive steps by the insurance company. Insurance scholars have typically used moral hazard to refer to the increased loss due to unintentional carelessness and insurance fraud to refer to increased risk due to intentional carelessness or indifference. While in theory insurers could encourage investment in loss reduction, some commentators have argued that in practice insurers had historically not aggressively pursued loss control measuresâ€”particularly to prevent disaster losses such as hurricanesâ€—because of concerns over rate reductions and legal battles. However, since about insurers have begun to take a more active role in loss mitigation, such as through building codes. Watson, is a slapstick silent film about the methods and mishaps of an insurance broker. Underwriting and investing[edit] The business model is to collect more in premium and investment income than is paid out in losses, and to also offer a competitive price which consumers will accept. Profit can be reduced to a simple equation: Insurers make money in two ways: Through underwriting , the process by which insurers select the risks to insure and decide how much in premiums to charge for accepting those risks By investing the premiums they collect from insured parties The most complicated aspect of the insurance business is the actuarial science of ratemaking price-setting of policies, which uses statistics and probability to approximate the rate of future claims based on a given risk. After producing rates, the insurer will use discretion to reject or accept risks through the underwriting process. At the most basic level, initial ratemaking involves looking at the frequency and severity of insured perils and the expected average payout resulting from these perils. Thereafter an insurance company will collect historical loss data, bring the loss data to present value , and compare these prior losses to the premium collected in order to assess rate adequacy. Rating for different risk characteristics involves at the most basic level comparing the losses with "loss relativities"â€”a policy with twice as many losses would therefore be charged twice as much. More complex multivariate analyses are sometimes used when multiple characteristics are involved and a univariate analysis could produce confounded results. Other statistical methods may be used in assessing the probability of future losses. Insurance companies earn investment profits on "float". Float, or available reserve, is the amount of money on hand at any given moment that an insurer has collected in insurance premiums but has not paid out in claims. Insurers start investing insurance premiums as soon as they are collected and continue to earn interest or other income on them until claims are paid out. Some insurance industry insiders, most notably Hank Greenberg , do not believe that it is forever possible to sustain a profit from float without an underwriting profit as well, but this opinion is not universally held. Naturally, the float method is difficult to carry out in an economically depressed period. Bear markets do cause insurers to shift away from investments and to toughen up their underwriting standards, so a poor economy generally means high insurance premiums. This tendency to swing between profitable and unprofitable periods over time is commonly known as the underwriting, or insurance, cycle. Claims may be filed by insureds directly with the insurer or through brokers or agents. The insurer may require that the claim be filed on its own proprietary forms, or may accept claims on a standard industry form, such as those produced by ACORD. Insurance company claims departments employ a large number of claims adjusters supported by a staff of records management and data entry clerks. Incoming claims are classified based on severity and are assigned to adjusters whose settlement authority varies with their knowledge and experience. The adjuster undertakes an investigation of each claim, usually in close cooperation with the insured, determines if coverage is available under the terms of the insurance contract, and if so, the reasonable monetary value of the claim, and authorizes payment. The policyholder may hire their own public adjuster to negotiate the settlement with the insurance company on their behalf. For policies that are complicated, where claims may be complex, the insured may take out a separate insurance policy add-on, called loss recovery insurance, which covers the cost of a public adjuster in the case of a claim. Adjusting liability insurance claims is particularly difficult because there is a third party involved, the plaintiff , who is under no contractual obligation to cooperate with the insurer and may in fact regard the insurer as a deep pocket. The adjuster must obtain legal counsel for the insured either inside "house" counsel or outside "panel" counsel , monitor litigation that may take years to complete, and appear in person or over the telephone with settlement authority at a mandatory settlement conference when requested by the judge.

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