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INSURANCE UNDERWRITING

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The central part of the insurance business is underwriting. Underwriting is a process, by which an insurer decides whether to accept a proposed risk or not - if the risk is accepted, the insurer needs to fix the price and terms. The person, who deals with matters of underwriting, is referred to as an underwriter.

In essence, by nature of their business, underwriters are the hub of an insurance company - they can make or break an insurance company. There is a joke that circulates in insurance that underwriters are 'gate-keepers' of an insurance company akin to bouncers at a get-together party. Surely, you know what bouncers are capable of doing - don't you?

An insurance underwriter differs from that in the equity market. In the capital market, an underwriter is one, who undertakes to buy up excessively issued shares to ensure that the issuing company raises the target amount of capital. The common denominator between the two is that their business involves taking risks.

In insurance, underwriting calls for two elements, namely, risk selection and risk classification. When you approach an underwriter with a proposal to insure property, say a motor car, the underwriter will first evaluate your application to determine the level of risk exposure. He will, thus, ask you to complete an application form - or proposal form, as it is popularly referred to.

The next step involves assigning your proposal to a group of risks or persons of approximately the same expected loss propensities or probabilities. This is the trickiest part of underwriting. If the proposed risk is extraordinary to the effect that it cannot blend with existing groups, then, your proposal will be turned down or alternatively, attract high premium rates and or terms.

There is a misconception among the insuring public that every risk brought to an insurer is admissible for cover. That is not true. Underwriters have the prerogative to admit your proposal or repudiate it, without even telling you why the business has been turned down. An underwriter has a noble duty to protect his employer's 'wallet' from bad proposals and people with bad intentions.

So, what does it take to be a good underwriter? Underwriters deal with probabilities. For one to be a seasoned underwriter, one must be numerate. One must be at home working with figures. Underwriters rely very much on statistical studies that associate certain characteristics with the probability of loss, damage, injury, or death of the subject matter of insurance. Underwriting involves calculations of net present values, internal rate of return, and similar statistics.

Let me illustrate this with a simple example - if you want to buy a personal accident insurance policy, the underwriter will inquire about your drinking and driving habits. He will then weigh the attributes and assign probabilities of you crashing dead on the road. The rest is beyond the scope and intention of this column.

You have heard before that insurers depend on the 'law of large numbers of identical or homogenous risks' for proper underwriting. Notwithstanding the foregoing, it is impossible for an underwriter to state, whether his client will suffer insured loss within a given period of insurance. The rationale is that if he could predict the loss with accuracy, then there would be no need for insurance. Is this true? Each policyholder would be charged a price equal to the amount of the known claim payment rather than the expected value of claims.

At this point, it is important to know that insurance involves making contributions to a common pool, amounts of which are paid to the few that suffer loss.

There are two types of underwriters – bad and prudent. Whereas a bad underwriter always tries to get business from competitors by undercutting the latter's premiums, a prudent underwriter strives to make sure that the pool or fund does not dry up. He achieves this by selecting and classifying proposals or policyholders with due diligence and caution. This is comparable to the 'parable of the ten virgins' in the Bible. "The five wise virgins took oil in jars along with their lamps. The foolish ones took their lamps, but did not take any oil with them," states the Holy Book. My warning is - know the underwriter you are dealing with – the five wise virgins or the foolish one!

The case in point is that if insurance is to function smoothly, each policyholder's contribution to the fund should be based on the expected loss potential that is being proposed to the underwriter. Underwriting seeks to ensure that policyholders pay equitable premiums, vis-à-vis risks being transferred to the pool.

Many people ask me; why do premium rates of the same subject matter of insurance differ from one insurer to the other? The answer is simple. Each insurer establishes its own underwriting policies and practices, often with the guidance of its reinsurers. Suffice to say that objectives and mission statements differ between insurers.

Views from the top are that underwriting is the only essential mechanism through which insurers seek to operationalize shareholders' objectives.

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