

Chapter 1 : Rate Making: How Insurance Premiums Are Set

ISBN: GÃ©neros: GB:Encyclopaedias & reference worksSinopsis: Excerpt from Value for Rate-MakingBasis for Rates. - The determination of the value of property used in serving the public has become a very general requirement.

The main regulatory objective is to protect the customer. A corollary of this is that the insurer must maintain solvency in order to pay claims. Thus, the 3 main regulatory requirements regarding rates is that: Although competition would compel businesses to meet these objectives anyway, the states want to regulate the industry enough so that fewer insurers would go bankrupt, since many customers depend on insurance companies to avoid financial calamity. The main problem that many insurers face in setting fair and adequate premiums is that actual losses and expenses are not known when the premium is collected, since the premium pays for insurance coverage in the immediate future. Only after the premium period has elapsed, will the insurer know what its true costs are. Larger insurance companies have actuarial departments that maintain their own databases to estimate frequency and the dollar amount of losses for each underwriting class, but smaller companies rely on advisory organizations or actuarial consulting firms for loss information. An advisory organization formally called a rating bureau is a company that collects loss information to sell to insurance companies. Although the suggestion of rates to charge is generally against antitrust laws, rating bureaus are exempt under the McCarran-Ferguson Act of , which states that federal antitrust laws only apply to the extent that insurance is not regulated by state law. Nonetheless, advisory organizations do not suggest what rates to charge, but only sell the loss data, letting the companies determine what rates to charge. Life insurance companies do not use advisory organizations, since they rely on actuarial tables. Rate Making for Property and Liability Insurance Rates for most insurance is determined by a class rating or an individual rating. Individual rating includes judgment rating and merit rating. Merit rating can be further classified as schedule rating, experience rating, and retrospective rating. Individual rates depend on the individual whereas class rates depends on the underwriting class of the insured. All insurance rates could be class rates, where the insurance company simply adjusts the premium to reflect the losses of the entire class. However, some insurance companies will identify lower risk groups within the class, then offer them lower premiums to grab market share. This, in turn, raises losses for the insurance company offering a class rating, forcing it to subdivide its own class, and offering different premiums that reflect the losses within those subgroups, eventually leading, with enough refinement of the subgroups, to individual rates. However, class rates remain for those risk groups that are more homogeneous, without identifiable subgroups of lower or higher risk. Class Ratings Class rating is used when the factors causing losses can either be easily quantified or there are reliable statistics that can predict future losses. These rates are published in a manual, and so the class rating method is sometimes called a manual rating. The class is defined through statistical studies as a group with specific characteristics that reliably predict the insured losses of that group. A class rating must be applied to a rate class that is large enough to reliably forecast losses through statistical analysis but small enough to maintain homogeneity so that the premium covers the loss exposure and is competitive for each member of the class. Class ratings are often used in pricing insurance products â€” mostly life insurance and product and liability insurance â€” sold to the consumer because there are copious statistics and a large enough population of similar situations that make class ratings effective. It also allows agents to give an insurance quote quickly. There are 2 methods to determine a class rated premium or to adjust it. In the pure premium method, the pure premium is 1st calculated by summing the losses and loss-adjusted expenses over a given period, and dividing that by the number of exposure units. Then the loading charge is added to the pure premium to determine the gross premium that is charged to the customer.

Chapter 2 : Full text of "Value for rate-making"

Excerpt from Value for Rate-Making Basis for Rates. - The determination of the value of property used in serving the public has become a very general requirement.

Demand control or consumer rationing; and Income transfer. These regulatory goals can conflict. When prices exceed the market, prices may not be reasonable. Both events have occurred during the history of utility regulation. The above goals attempt to serve the interests of the utility, its shareholders, consumers, and the general public. To be constitutional, a rate cannot be so high as to be confiscatory. Most state statutes further require rates to be just, reasonable, and non-discriminatory. Accordingly, because of constitutional takings law, government regulators must assure private companies that a fair revenue is available in order to continue to attract investors and borrow money. This creates competing aims of capital attraction and fair prices for customers. Utility companies are therefore allowed to charge "reasonable rates," which are generally regarded as rates that allow utilities to encourage people to invest in utility stocks and bonds at the same rate of return they would in comparable non-regulated industries. Utilities should implement new rates over time so that consumers and business can adapt to the changing prices. This is known as the principle of gradualism. As with most demand curves, a price increase decreases demand. Through a concept known as rate design or rate structure, regulators set the prices known as "rates" in the case of utilities and thereby affect the consumption. With declining block rates, the per-unit price of utility consumption decreases as the energy consumption increases. Typically a declining block rate is offered only to very large consumers. If conservation is the goal, regulators can promote conservation by letting prices rise. A third possible rate design is a flat rate which charges the same price for all consumption. Ratemaking also involves redistribution of wealth among and within classes of customers. Each group is sometimes further subdivided. Just as regulated utilities and their governing bodies struggle to maintain a balance between keeping consumer costs reasonable and being profitable enough to attract investors, they must also compete with private companies for talented executives and then be able to retain those executives. Executive compensation usually consists of four parts: Executives in regulated electric utilities are less likely to be paid for their performance in bonuses or stock options. Limiting their control has been shown to reduce investment opportunities. The same constraints are placed on the board of directors for the utility by the monitoring or oversight of the utility commission and they are less likely to approve compensation policies that include incentive-based pay. These companies have more political constraints than those in a favorable regulatory environment and are less likely to have a positive response to requests for rate increases. The need to encourage risk-taking behavior in seeking new investment opportunities while keeping costs under control requires deregulated companies to offer performance-based incentives to their executives. It has been found that increased compensation is also more likely to attract executives experienced in working in competitive environments. Currently twenty-four states allow for deregulated electric utilities: This is the total amount of money a regulator allows a utility to earn. The traditional rate formula encourages capital investment because it provides a rate of return on the rate base. The more a utility invests, the more money it earns. Operating costs are most often the largest component of the revenue requirement, and the easiest to determine. Occasionally, operating expense items have caught the attention of regulatory agencies and courts, and these items have been examined more closely. Regulators must make two determinations. First, they must determine which items should be allowed as expenses. Second, regulators must determine the value of those expense items. The determination of value has generally been left to the management of the utility under the theory that these are essentially business decisions which will not be second guessed by a regulatory agency or a court. Managerial good faith is presumed. Furthermore, regulated utilities may have the incentive to overinvest. Usually, this is done by setting a cap on prices or revenues. A general formula is: $P_t = P_{t-1} \frac{1 + RPI + X}{1 + RPI}$ where P_t is the price in time t . RPI is the rate of inflation. X is the efficiency factor X-factor. P_{t-1} is the price in time $t - 1$. Since the price is set with regard to the overall inflation rate RPI and required growth of efficiency X-factor, such kind of regulation is also called RPI-X regulation.

Chapter 3 : Rate making - Wikipedia

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A rate "is the price per unit of insurance for each exposure unit, which is the unit of measurement used in insurance pricing". The exposure unit is used to establish insurance premiums by examining parallel groups. The loading "refers to the amount of the premium necessary to cover other expenses, particularly sales expenses, and to allow for a profit". The gross rate "is the pure premium and the loading per exposure unit". Finally, the gross premium is the premium paid by the insured consisting of the gross rate multiplied by the number of exposure units. The first regulatory requirement is that rates must be adequate; meaning the rates the insurers charge should be able to cover expenses. The second regulatory requirement is that rates must not be excessive; meaning rates should not be so high that policyholders are paying more than the actual value of their protection. The third regulatory objective is the rates must not be unfairly discriminatory; meaning exposures that are similar with respect to losses and expenses should not be charged significantly different rates. The business objectives are set as a guide for insurers while designing the rating system. The rating system should meet each of the four objectives: To maintain customer satisfaction, the rates should remain stable over short periods of time. The rapid change of rates could lead to customer dissatisfaction. To meet the objective of rate adequacy, the rates should be responsive over time in comparison with changing economic conditions and loss exposures. Finally, to reduce the frequency and severity of losses, the rating system should encourage loss control activities. Loss control is important in insurance because it tends to keep insurance affordable. Rate making methods[edit] In property and casualty insurance, there are three basic rate-making methods: Judgment Rating is used when the factors that determine potential losses are varied and cannot easily be quantified. This means an underwriter rates each exposure individually. The second rate making method is class rating, or manual rating. This rating means that exposures with similar characteristics are placed in the same underwriting class, and each is charged the same rate. The advantage of class rating lies with its easy application and ability to quickly be obtained. This rating means a plan which class rates, or manual rates are adjusted upward or downward based on individual loss experience. Merit rating is based on the assumption of loss experience will differ substantially from other loss experiences. Rate making in life insurance[edit] Life insurance actuaries determine the probability of death in any given year, and based on this probability determine the expected value of the loss payment. These expected future payment are discounted back to the start of the coverage period and summed to determine the net single premium. The net single premium may be leveled to convert to installment premiums. A loading for expenses is added to determine the gross premium. Principles of Risk Management and Insurance 12th ed. Upper Saddle River, NJ: How Insurance Premiums Are Set". Retrieved 3 December

Chapter 4 : Full text of "Value for rate making purposes"

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world for basic ratemaking. A key concept in the text is the fundamental insurance equation, which balances the expected future income and outgo of an insurance operation.