

General Insurance Study Group

1994 Convention

Workshop Session on

RISK SELECTIVITY

or

The Availability of Insurance

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Summary

This paper discusses the connected issues of risk selection, pricing and the availability of insurance with a view to helping the General Insurance Joint Practice Board form a view on the extent to which this is an issue for the profession and what action, if any, the Board should take.

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Introduction

1. Objective

To help the General Insurance Joint Practice Board form a view on the extent to which this is an issue for the profession and what action, if any, the Board should take.

2. Method

There follows a paper which sets out some preliminary thoughts on the matter. The paper is deliberately provocative and does not pretend to be definitive. It does not represent the view of any individual or organisation. The intention is that the paper should be used to stimulate debate at the GISG Convention.

I suggest that we may get a more fruitful debate if we try to see the issues from the perspective of our (that is the profession's) customers, the insurers, and also their customers, those insured.

3. What is it we are talking about?

The general insurance market place is becoming ever more sophisticated and competitive. All insurers are trying to identify "niche" segments of the market where the market price is high compared to the cost of delivering the service that the segment requires. These segments are by definition profitable. As the same segments get identified by more insurers, the availability of insurance within the segment will be high and the market price will fall. This is not a problem for consumers in the segment.

The corollary is that all insurers are also trying to identify those segments where the market price is low compared to the cost of delivering the service that the segment requires. These segments are by definition unprofitable and the insurers will divert resources away from doing business in them. As the same segments get identified by more insurers, it could become increasingly difficult to find an insurer willing to write the business. It is conceivable that the availability of insurance could dry up completely if the risk was perceived as being so unattractive as to be uninsurable, for example because of

the nature of the insurable interest. Alternatively the price could go up so much that the effect on the insured was quite significant compared to his other expenses of living or of carrying on his business. These consumers may feel threatened because of their inability to adjust to the new order. In this scenario there is a problem for the (would be) customers of the insurers and, by implication, therefore, also for the insurers themselves.

The question for debate: is it also a problem for the insurers' suppliers, and in particular for the actuarial profession?

Some General Points For Discussion

1. Objectives of Insurance

Insurance is meant to cover people against calamity: the comparatively rare event which is severe when it happens. It is not a contract which covers regular expenditure, even if that expenditure is great and even if that expenditure is accidental or caused by some agent external to the insured. Arguably insurance was not designed to cover this but perhaps it should.

2. Principle of insurance

Insurance is a means by which people may pool risks. The contribution each makes to the pool should be commensurate with the risk he contributes to the pool. Irrespective of whether this was ever true, is it relevant in 1994 and beyond?

3. Objective of Insurers

Insurers are in business to make a profit. They aim to do this by providing a service, which, in accordance with the insurance principle, is at a fair price related to risk and aimed at avoiding one group subsidising another.

4. Why Companies are Selective

Insurers want to keep down the variability of their profitability and the risk of losing the capital that provides the safety margin. They will therefore tend to specialise in segments where they can get a reasonable exposure and hence can learn the characteristics of the particular segment. They do not want to participate in all markets. If a risk is presented to a company that it feels unsure about, it has difficulty knowing what to charge and will quote a comparatively high premium. Companies specialising in that segment will quote lower premiums. This is one of the features of the market that leads to the wide variation in quotes that different insurers may give for a particular risk.

5. The General Insurance Market

If insurers have to provide cover at uneconomic rates the implication is that other customers have to pay more than the economic rate. There is thus a cross subsidy. Cross subsidies are inconsistent with a free market. The market place is very competitive due to advances in telecommunications. Any insurer who charges prices which include an element of cross subsidy will be selected against by the rest of the market and will lose money. Cross subsidies will lead to a disorderly market as insurers try to exploit the cross subsidies.

6. Intermediaries

Much of the publicity about insurers effectively declining business through quoting high premiums ignores the fact that cover is available from other insurers. Finding these insurers and placing the risk is the service provided by the insurance intermediary.

7. "Moral" issue

Is it immoral for an insurer to refuse to quote for a risk? What difference does it make if another insurer is willing to quote? Is there a distinction between refusal to quote and quoting a high price? What difference does it make if another insurer is willing to quote a smaller price?

8. The Right to Insurance

One view is that there is no more right to insurance than there is to any other service. The market provides services on the terms which the market will bear. People have to go without services if they cannot afford them.

Another view is that people do have a right to compulsory insurance, such as third party motor, household buildings and employer's liability.

9. Low Income Groups

Some people may not be able to afford to replace their household goods if they are stolen when they have no insurance. They may live in an area which has a crime rate such that they cannot afford to pay the insurance either. Is it desirable for small shopkeepers to continue to provide a local service in an area with a high crime rate without having to mark up the prices of their goods to cover high insurance costs? Are these social problems or insurance problems?

10. Boundary between Affordable and Unaffordable

The boundary is naturally subjective. If the political decision is to have cross subsidies, the price for those paying the subsidies will have to go up. This will move more people into the position where they cannot afford insurance. A parallel can perhaps be drawn

with the MIB whose costs are escalating and are a matter of concern to insurance companies who have to pass the ever increasing costs on to their customers.

11. A Tariff as one Solution

One way to prevent the cross subsidies causing a disorderly market would be to revert to the old system of a tariff rate charged by all companies for all risks within particular classifications. Is this politically acceptable? How desirable would this be?

12. An Insurance Pool as one Solution

If the decision is that the problems are to be solved through the mechanism of insurance (rather than, for example, Social Security), a properly funded pooling arrangement could be the way forward with all insurers playing their part. We should recognise the implications of this: insurance would be being used instead of taxation as a wealth transfer mechanism. Such a solution could have major drawbacks which would need to be addressed as part of the solution. Some possible drawbacks are discussed in what follows.

13. Efficiency

There is an administrative cost associated with the provision of insurance. In the nature of the service, these costs are higher when the incidence of claims is higher. This needs to be taken account of in a comparison of insurance versus other funding mechanisms.

14. Targeting by Burglars

There has been a suggestion (can this be proved?) that in high theft areas householders who have insurance are specifically targeted for burglaries. If this is true the provision of blanket insurance through a pooling arrangement may exacerbate the situation.

15. Adverse Selection

In some cases insurance cover is difficult or impossible to obtain because the nature of the risk and of the insured's interest in it provide an incentive to the insured to exploit the fact that he has insurance. Such cases are arguably uninsurable because the only realistic price may be so high (for example in an extreme case equal to the sum insured) as to make the insurance meaningless. If a pooling arrangement is set up all these cases will naturally go into the pool. This will encourage even more claims. The cost of the pool could spiral.

When insurance is voluntary (such as household contents) there is a potential for selection against insurers. There will be a tendency for purchases to be made by people who feel they can make a profit out of it. These cases too will be attracted to the pool and will cause a spiralling of costs.

16. Individual Underwriting

Although statistics may show that certain aggregations of insurance business are unprofitable this argument cannot be sustained with an individual risk. Thus there will always be the political dimension that it is possible to find cases where the claims experience has been good but cover is difficult to obtain or expensive because the risk is, for example, situated in a postcode with a bad overall experience.

17. Insurance as a Positive Agent for Change

Throughout history, the price of insurance (or the difficulty in obtaining it) has acted as an incentive for risk protection. If insurers have to charge uneconomic rates for some risks this incentive will no longer apply.

18. Another Possible Way Forward

There are positive things which the insurance industry can do, should do, and does do to help bring down the price of insurance. One is to restrict cover by the imposition of a large excess. This, arguably, would restore insurance to its real objectives, namely to cover the catastrophe. Losses below the excess could fall to the Social Security system or some other social arrangement. No claims bonus can also bring down the cost, but only for those who are claims free.

Some Thought on the Issues for the Profession

External Issues

1. Our customers, the general insurance industry, may be hurt by accusations of "red lining". They may perceive that they are being hurt, even if they are not.
2. Our customers may be blamed, or feel that they are being blamed, for political or economic problems such as the difficulty of inner city regeneration, depression of house prices in areas prone to flood, subsidence, theft, etc. They may be blamed for preventing the redevelopment of industrial sites where there is a perceived pollution problem.
3. Our customers may become the scape-goats for the problems mentioned in item 2 and may be expected to pay.
4. Our customers may be hurt by the unilateral imposition of solutions by politicians with different objectives.

Internal Issues

1. The profession may be seen, by the very nature of the support it provides to the insurance industry, to be promoting selectivity.
2. The profession needs to avoid taking a political stance.
3. In any action that the profession takes on this issue it must be very clear as to whom it is doing it for and why.

Political Dimension

One view is that this issue is none of our business. We only take instructions and advise strictly in accordance with those instructions.

Another view is that such an approach is not acceptable in the 1990s. The profession has to take responsibility for playing an *active* part in the determination of issues affecting business sectors where actuaries add value to the business process.

The Way Forward

1. Is this an issue for the profession?
2. How important is it?
3. If it is important, what objective should the profession have with respect to it?
4. How should the profession proceed towards that objective?

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