RISK MANAGEMENT INSURANCE FUNDAMENTALS

PART 1 OF 4

TUESDAY, SEPT. 13, 2 P.M. EDT | FREE CSG ECADEMY SERIES

in Collaboration with The Griffith Insurance Education Foundation

Insurance Basics

Insurance provides financial security, and it does so based on principles that ensure that all covered losses will be indemnified.

Insurance Markets Underpin the U.S. Economy

What would the US economy look like if insurance markets ceased to exist?

a. No healthcare insurance
b. No homeowners insurance
c. No auto insurance
d. No life insurance
e. No liability insurance
f. No workers compensation

Implication => Well functioning insurance markets are a critical component of a strong economy!

Motivating Theme

Given the importance of information and exponential increase in the use of data, is the performance of insurance markets improving?

- Reduced insurance fraud?
- Improved pricing?
- Privacy concerns?
- Increased innovation?
- Regulatory challenges?

What Is Insurance?

- A contract that transfers the financial consequences of a potential loss from an insured to an insurance company.

- A means of protecting financial interests when losses occur.

Insurance Benefits

- How does insurance benefit the insured:
  - Pays an insured's covered losses (indemnifies)
  - Reduces uncertainty
  - Encourages efficient use of resources
  - Helps reduce and prevent losses
- How does insurance benefit business and society:
  - Supports credit
  - Satisfies legal requirements
  - Satisfies business requirements
  - Provides sources of investment funds
  - Reduces social burdens

Costs Associated With Insurance

Insureds:

- Premiums

Insurance providers:

- Operating costs – including profit
- Fraudulent and inflated claims (moral hazards)
- Claims caused by carelessness or indifference (morale hazards)
- Frivolous lawsuits that are settled as nuisance claims

Fundamental Insurance Principles

Three principles help ensure that the insurance mechanism is actuarially sound:

- Indemnification
- Law of large numbers
- Insurable interest

The Principle of Indemnity

- To "indemnify" means to compensate for a loss.
- Insurance should not benefit an insured beyond the value of a loss:
  - Insurance should, at most, make the insured whole again.
- Violations of this principle can increase the frequency and severity of losses.

The Law of Large Numbers

- The mathematical principle that underlies the provision of insurance.
- What would be a large unexpected loss for an individual becomes a manageable and predictable loss in aggregate for an insurer.

Insurable Interest

- The insured must suffer financially should a loss occur:
  - A driver's own car is totaled.
  - The death of a company's CEO.
- Supports the principle of indemnity—one cannot gain from an insurable loss.

Economic Issues Related to Insurance Pricing

An insurance policy is priced to reflect the loss exposures the policy covers while allowing for expenses, profit, and contingencies.

Key Issues in Insurance Pricing

Insurance markets differ from "traditional" markets in many ways:

- Adverse selection
- Moral and morale hazard
- Equity: actuarial and social
- Timing

Adverse Selection

Adverse selection increases insurers' costs:

- This is a <u>selection</u> problem – who you sell to matters in insurance markets.
- Those with the greatest probability of loss are most likely to buy insurance.
- They tend to have more losses and higher claims than insureds with an average loss probability.

Avoiding Adverse Selection: Data Collection

- Insurers need information about insureds to set prices that accurately reflect risks.
  - The more finely grained the data, the more precise the pricing.

- Data collection raises privacy concerns:
  - What information is relevant?
  - How much information is too much?
  - How is insured information shared/stored?

Moral and Morale Hazard

- Behaviors that increase loss frequency and/or severity:
  - Moral—dishonesty
  - Morale—carelessness or indifference
- Common in auto, products liability, and general liability insurance.
- Can be discouraged with policy risk-sharing features (deductibles).

Actuarial Equity Versus Social Equity

- Fair discrimination—equitable premium for each insured—is essential to insurance pricing.
- State insurance laws prohibit unfair discrimination in insurance pricing.
- What is considered to be unfair varies across the states.

Equity

- Actuarial Equity:
  - Premium is directly proportional to the insured's loss exposure.
  - Cost-based pricing—identifies every variable unique to each insured.
  - Use of some variables may be prohibited by state law.
- Social Equity:
  - Pricing should relate to ability to pay.
  - Factors beyond an insured's control should not affect premium.

Timing

- Short-tail losses:
  - Most losses are recognized, valued, and settled quickly.
  - Comprehensive coverage PPA claim.
- Long-tail losses:
  - Some losses take a long time to manifest, value, and settle.
  - Bodily injury claims related to asbestos.
- The longer the tail, the greater the uncertainty in expected losses for insurance providers.

Characteristics of Insurable Risks

1. A large quantity of similar people or objects that may be subject to a loss.
2. Losses would be fortuitous.
3. The amount of an expected loss can be predicted.
4. Losses would not be catastrophic to the insurer.
5. Time, location, and extent of a loss can be determined.
6. Covering the expected loss is economically feasible for the insurer.

Characteristics of the Insurance Product

Insurance products share several characteristics that distinguish them from other types of consumer products.

Intangibility

Insurance products:

- Lack physical characteristics.
- Represents a promise (to pay only in the event of loss).

Product benefits become most apparent when a loss occurs:

- Insureds or claimants are typically facing unpleasant circumstances.
- Heightened emotions complicate the customer service experience.

Complexity and Legal Status

- An insurance policy contains complicated terms and concepts that are often difficult for consumers to understand:
  - Breadth of coverages.
  - Limits of coverages.
- An insurance policy is a legal contract:
  - Insureds and claimants may hire attorneys to resolve or clarify issues.
  - Some issues may involve courts, regulators, or legislators.

Insurance as a Risk Management Technique

Loss exposures with serious financial consequences typically require the purchase of insurance.

Risk Management Techniques

- Identify
- Analyze
- Mitigate
  - Prevention
  - Reduction
- Retain or Transfer

Retaining vs. Transferring Loss Exposures

Retain:

- Some loss exposures present minimal potential costs and can be safety retained.
- Other loss exposures have the potential to cause financial ruin.

Transfer:

- Some loss exposures are most effectively managed by transfer.
- Transferred financial consequences of a loss are borne by another party.
- Insurance is a common risk transfer technique.

Why Insurance Regulate Insurance Markets

The fundamental purpose of insurance regulation is to protect the public as consumers and policyholders.

Regulation Basics

Consumer Protection:

- Regulating and standardizing insurance policies and products.
- Controlling market conduct and preventing unfair trade practices.
- Ensuring that insurance is available and affordable.

Insurer Solvency:

- Ensure an insurer's claim-paying ability.
- Protect the public interest.
- Safeguard insurer-held funds.

Insurance Fundamentals for Policymakers

For more information, please contact:

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