PUBLIC RISK – THE ROLE OF INSURERS

Mark Boleat

Insurers play a significant role in influencing how the public, businesses and government perceive and react to risk. They do this through the terms on which they provide insurance and to a lesser extent by their influence of legislation, regulation and standards.

In analysing the impact of insurers on risk it is therefore necessary to understand three separate sets of issues -

- What influences the policies and practices of insurers in determining whether to insure, what conditions to impose and how much to charge?
- How do the policies and practices of insurers influence the behaviour of their customers?
- How do insurers influence the policy making process?

What Determines the Policies and Practices of Insurers?

The starting point for this analysis is that insurers are in business to maximise their long term profits. They are no different from other businesses in this respect. This might mean that in the short term they are prepared to tolerate losses in order to build market share, or to stay in the market or to avoid public relations problems. For example, at present a number of insurers may be deliberating writing motor business at a loss, because if they charged an amount sufficient to make a profit they would get very little business. However by continuing to do business, they may cover their variable costs if not their fixed costs, and position themselves to be able to take advantage of an upturn in the market.

The influence of brokers is relevant for those insurers that do their business through this channel. If an insurer is seen as being in and out of the market, then it will find it difficult to get much business from brokers who know that it cannot be relied on. In some cases an insurer may deliberately do certain business at a loss with a broker in order to secure more profitable business from that broker in the long term. However, these sorts of arrangements are no different from those in other markets, and have little bearing on the key point, that is that insurers are in business to maximise their profits.

In determining which markets to be in and how to price insurance, insurance companies are influenced by the same market forces as other businesses such as the actions of their competitors, the changing needs of their customers and changes in the ability to deliver services in different ways.

What are relevant to the policy issue are the insurance-specific issues that affect pricing and the willingness to insure. Insurers will change their pricing and possibly their willingness to be in a market based almost entirely on the expected future trend in claims, which may well be influenced by a significant actual change in the volume of claims in a previous period, and the premiums they expect to be able to obtain in the marketplace. Some of the changes in claims experience are entirely market factors while others are the consequence of decisions of courts, government and regulators, but still operating through the market mechanism by impacting on claims.

Over the years there have been a number of major market developments that have had a significant impact on claims against insurers, which in turn have influenced their willingness to be in a market and their pricing. Examples include -

- Terrorism in the early 1990s, which had the effect of making it impossible for insurers to provide cover against terrorist attacks without putting their own solvency at risk. The government duly intervened by sharing some of the risk.

- The increase in flooding over the last few years, much of it in areas not previously thought liable to flood, which has led to higher insurance premiums generally and much higher premiums for those in areas now perceived to be particularly liable to flooding.

- Subsidence in the 1980s, which resulted in an increase in household insurance premiums combined with higher excesses in areas liable to subsidence.

- The development of AIDS, which had a significant impact on the profitability of life insurance business, which led to a huge increase in life insurance premiums for single men. This was subsequently reversed as it became easier to treat AIDS and as deaths turned out to be much lower than had been anticipated.

- The current recession will be manifested by significant business failures, which is already being reflected in tougher terms or the withdrawal of cover for trade credit. For example, at the end of November 2008, Amlin pulled out of the credit insurance market, where it had a 4% market share.

- The huge increase in mortgage losses in the late 1980s and early 1990s led to a significant increase in the cost of mortgage insurance, and ultimately the withdrawal of the commercial insurers from this market.

Examples of the actions of government and regulators that have had a significant influence on insurability have included -

- The government has made significant reforms to the process for handling personal injury claims, in particular the introduction of conditional fee arrangements, which allow people to make a claim for personal injury at no cost to themselves. This has contributed to a huge increase in claims management businesses, which, in turn, has contributed to the perception of a compensation culture through the advertising of those companies. It has also contributed to an increase in insurance fraud through induced and contrived accidents.

- The tough action that the FSA took against IFAs in respect of mis-selling of personal pensions led to huge claims on professional indemnity insurance policies, the terms of which were subsequently changed such that many IFAs could not get cover. This led to the FSA relaxing the requirement to hold PI insurance.

- The NHS is seeking increasingly to recover from insurers the cost of treating people for accidents where a third party can be held to blame; this feeds through to insurance premiums.

The decisions of courts and tribunals can have a similar effect. A court decision which has the effect of increasing the liability of a third party which in turn leads to an increase in insurance claims will have an effect on the terms on which insurance is provided. And court decisions on quantum of damages in particular circumstances will feed directly through to premiums.

In addition to these substantive points, it is also necessary to note the impact of political and media pressure. Generally, this is a short term phenomenon and follows a particular event such as flooding, and results in comments such as:

> "*Insurers have made huge profits over the years and they should now be using those profits to help people who have suffered loss"*
>
> "*Insurers should set up a fund to help those people who do not have insurance*
>
> *"Insurers should be prevented by law from withdrawing cover from those who live in properties most prone to flooding"*
>
> *The principle of insurance is that the many pay for the misfortunes of the few, and it is unfair to charge higher premiums to those people more likely to make a claim."*

Such quotes indicate a perception of the insurance industry that it is a social service or a charity and not commercial businesses operating in a very competitive marketplace.

Where a market is subject to regular political pressure and adverse media comment, a number of insurers may choose to stay out of it even if it is otherwise profitable.

In respect of flooding, these sort of pressures described in the quotes can result, as it has in the past, in "*agreements*" demanded by the government that insurers will maintain cover. This may be sufficient to appease the media and the politicians, but the reality is that no such agreement is worth much for very long. For example, insurers generally are always willing to maintain cover even if somebody's house is regularly flooded, and equally they will always be willing to quote for a driver they had insured even if he has been convicted of drink driving and other motoring offences. The additional risk, either in respect of the individual or in respect of other people now deemed to be bearing the same risk, is covered by one or more of a substantial hike in prices, the imposition of conditions that are costly to meet, and if not met will invalidate any claim, an increase in the excess, that is the amount the policy holder has to pay in the event of a claim, and much closer scrutiny of claims.

In respect of flooding, the more important point is that no-one can force insurers to take on new business. If an area is suddenly deemed liable to flooding, while existing home owners can continue to get insurance, it may be the case that no new owner will be able to, and subsequently properties cannot easily be sold, if indeed they can be sold at all.

The key point from this analysis is that short term political and media activity does nothing to alter the fundamentals of the issue, that is that insurers will provide cover only if it is profitable for them to do so. Any deviations from this general principle have a short life and risk detracting from the fundamentals.

The influence of reinsurers

Insurers are risk averse by nature. They protect themselves by a variety of means in addition to underwriting specific risks. They have limits on their exposures to particular risks. On large risks they may share the risk with other insurers through the London Insurance Market. And all insurers reinsure, particularly to cover themselves against a catastrophic risk. Swiss Re and Munich Re are the two largest reinsurers for domestic and small scale business insurance. The reinsurers are influenced by the same factors as insurers. If they perceive that risk has increased, either for a sector of the market or for a particular line of business, they will increase premiums, impose conditions or withdraw cover. This in turn will lead to similar actions by the insurers.

The example was given earlier of Amlin withdrawing from the credit insurance market. The reason given for this was it was having difficulty securing reinsurance. However, it is important not to overstate the role of reinsurance. Reinsurers are part of the market mechanism. They operate in a competitive market and take decision based on market factors. Amlin's problem was not that it had difficulty getting reinsurance, but rather that it had experienced increased claims and probably felt unable to increase premiums to cover the cost of likely future claims, reflected in the cost of its reinsurance.

Compulsory Insurance

It is useful to digress slightly here to consider the issue of compulsory insurance. There is a temptation for policymakers to require businesses or individuals to have insurance. There are a number of different motives for this -

- To protect the public, for example in respect of the consequences of a motor accident which is not their fault. There is a requirement for drivers to have third party insurance.

- To add a layer of regulation by proxy in that the requirements of the insurance companies in effect become a regulatory requirement.

- To reduce public expenditure, by requiring people to insure against the cost of something that would otherwise fall on the government.

- A knee jerk reaction that it is a "*good thing*", and always a useful point to include in the "*ten point plan*" that governments love so much.

But compulsory insurance is fraught with difficulty as a concept. While it can be made compulsory for people to have insurance, it is not compulsory for insurers to provide insurance, and there is a risk that government may require people to do the impossible. Consequently, where there is compulsory insurance the government may seek to bully the insurers into providing cover, but as will be seen in a way that is not effective.

More importantly, the protection provided by compulsory insurance is to a large extent illusory. Compulsory third party motor insurance has to be backed up by the Motor Insurers Bureau which pays out hundreds of millions of pounds a year to people who have been the victims of an accident where the driver cannot be traced or was not insured. Without such a back-up it cannot be assumed that compulsory insurance will deliver what the policymakers expect it to deliver. All insurance policies have conditions, and many claims are a result of the conditions not being complied with, in which case insurers are within their right not to meet a claim. Exclusions, excesses and high prices can also mitigate the effects of having an insurance requirement.

Where businesses are required to have insurance this immediately provides a barrier to entry, which is precisely why existing businesses frequently demand such a requirement. A newly established business cannot easily get, for example, professional indemnity insurance because it has no track record. This leaves policymakers, particularly in respect of professional indemnity insurance requirements, to come to rather bizarre arrangements, which include giving newly established businesses time to put a policy in place, that time being when they are most inexperienced and perhaps most likely to cause a claim.

Pension miss-selling led to such huge claims on professional indemnity insurance policies that the insurers reacted either by withdrawing cover or raising the premiums to such an extent that the FSA had no choice but to relax the requirements. This rather negates the point of having compulsory insurance if at the very time it is most needed the requirement to have it can be withdrawn.

Where there is compulsory insurance then the effect is bound to be to restrict the activity for good or bad, and some people would not be able to get insurance. It is also possible that insurance is used as an excuse, either to not provide a particular service or to increase the price.

The firm conclusion from this analysis, borne out from the practical experience of attempts to introduce compulsory insurance over many years, is that the government should firmly resist such calls, particularly from itself. The same applies to local government and also to businesses. Small businesses in particular may well find that in order to obtain business they are required to have a particular insurance cover that in no circumstances can be of any benefit to them, and which they might not be able to obtain anyway.

How Insurers Influence Behaviour

The conditions under which insurers provide cover inevitably have some influence on behaviour. The insurers are seeking to reduce claims, not simply to pay claims. However, insurers cannot be forced as an instrument of policy to seek to change behaviour in a way that is not relevant to the contract of insurance.

There are some beneficial effects as a result of the actions of insurance companies through changing customers' behaviour. This is evident in the motor field. Insurers load insurance premiums substantially for drink driving and motor traffic offences. The additional insurance cost as a result of a speeding fine is likely to be a multiple of the fine itself, and the consequences of a drink drive conviction can be massive in respect of the insurance premium that will be required. This has all contributed to a reduction in the number of motor accidents. Young drivers in particular are now much more careful knowing that even one speeding fine will have a significant impact on their insurance premium. It should be noted in passing that the very high premiums charged to young people (which fairly reflect the risk that such people pose) do lead to uninsured driving, and also an element of fraud with parents wrongly claiming that they are the main user of a vehicle.

In respect of property insurance, the requirements of insurers to have security arrangements and in the case of commercial buildings adequate fire detection and prevention devices probably has had a significant effect in reducing property damage, and thereby insurance claims.

More generally, the risk management work that insurers and brokers do has contributed to a significant improvement in the handling of risk, reflected in a steady reduction in the number of industrial accidents, and probably also property damage.

Insurance facilitates a number of activities by largely removing the financial cost should anything go wrong. The best example is home ownership. People would be running a big risk if they owned, say, a £200,000 house which could be severely damaged by fire or flood, such that their house was valueless. For a premium of just 1% of the value of the property, this risk can be guarded against and home ownership is facilitated. The same argument applies to foreign travel, where without insurance the consequences of serious illness or accidents can be quite severe. There is a similar position in respect of participation in sports where injury is likely such as skiing, football and rugby.

But insurance also creates a moral hazard. To a very limited extent people might be careless knowing that they are insured, although in practice this is very marginal as the events that cause insurance claims can be severely disrupting and damaging regardless of the financial cost. More importantly, insurance opens up the scope for fraud, particularly in respect of travel insurance and motor insurance, where there is a thriving industry built on the back of claims based on fraudulent or induced accidents.

Insurers seemingly have the capability to prevent certain activities taking place or to deny particular people the right to participate in an activity. Press articles regularly appear on such things as unreasonable insurance requirements for school trips or bonfire night events. Such comments are generally wide of the market. Insurers do not act in a concerted way and will seek to offer insurance provided that they can make a profit. The insurance issue is generally a symptom of another issue such as regulatory requirements or an increase in claims. If teachers are held liable for anything that might go wrong on a school trip then insurers have to price for that. Insurance companies are a messenger in the marketplace rather than an independent player making decisions in a vacuum.

How Insurers Influence Policy

Insurers can influence the policymaking process in respect of the management of risk, and more generally both through their actions and through their lobbying. Insurers have at their disposal a huge amount of information on insurance claims - trends in claims, the causes of claims and how claims can be reduced. They also undertake serious research on likely future trends in claims. But it is important to remember why they do this; it is in pursuit of the objective of profit maximisation. An insurer that has got better information than its competitors is better placed to make a profit by pricing risks appropriately. Insurers have no intention of sharing such commercially sensitive information, particularly with their competitors.

However, there are some areas where insurers are willing to pool information if this will result in a reduction of claims that would benefit them all equally. There are some low level examples of this, for example it is understood that as a result of pressure by insurers there are now stronger requirements in respect of installing sprinklers in schools, as this has proved to be a cost effective means of reducing insurance claims in schools resulting from fires.

At a higher level insurers have pooled information on the safety of motor cars and operate a vehicle testing facility. This has resulted in the classification of cars into insurance groups based entirely on the claims record. Manufacturers want their cars to be in the lowest possible group and have designed cars accordingly. This has led to cars being safer.

Flooding is another area where insurers have pooled information. Insurers have a huge amount of information on flood risks, and over many years have been using that information to persuade the government to seek to improve flood defences. Because this requires public expenditure the activity has not been very successful, although gradually it has had an impact. This reflects the experience of insurers generally. Insurance is a long term business and insurers need to be able to predict the likely future course of claims. Government tends to have a very short term time horizon, unless there is a crisis today. Substantial research indicating that there is likely to be a significant amount of flooding in certain areas within the next ten years may have little effect on government, whereas a significant flood today is more likely to lead to immediate action.

Some Conclusions

This analysis leads to the following general conclusions -

- Insurers are in business to make a long term profit, and everything that they do or can be expected to do in relation to risk must recognise this. The terms of which they provide insurance are based solely on expected future claims.

- Government is capable of increasing risks through policy measures which subsequently lead to a significant increase in insurance claims, which in turn causes changes in the terms on which insurance is available.

- Compulsory insurance, whether imposed by government or by local government or businesses as a commercial decision, is fraught with danger, and should be imposed only after very careful consideration of the merits of such a requirement.

- By loading insurance premiums to adequately reflect risk, insurers have had a significant effect in helping to reduce risk, particularly in respect of the consequences of motor accidents and damage to property.

- Insurance greatly facilitates some activities such as home ownership, foreign travel and sport by significantly reducing the financial consequences of anything going wrong.

- Insurers collectively have a great deal of information relevant to risk, but rightly this is generally regarded as commercial. Insurers are willing to pool and share such information where it is in their collective interests to do so.

****

Mark Boleat is a consultant specialising in regulation, consumer protection and trade associations. He was the Director General of the Association of British Insurers between 1993 and 1999. He currently holds a number of positions including a non- executive director of Travelers Insurance Company, a member of the Gibraltar Financial Service Commission and Chairman of the Association of Labour Providers.

Tel: 01923 840498
E-mail: mark.boleat@btinternet.com
Website: www.boleat.com

December 2008