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POLICY BRIEF

What is Insurance?

by
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Adjunct Scholar

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Key Points

- Insurance exists to pool, spread, and manage risk
- People buy these kinds of insurance to help them deal with serious events. Some products sold as insurance are really just a way of pre-paying for certain services.
- Up to a certain price point people will follow legal mandates to buy insurance. Beyond that price point, the numbers of people willing to buy it—even if legal penalties exist for not doing so—falls off.
- Some level of state regulation is essential for insurance to be effective and to protect consumers against fraud. At the same time, too much regulation drives up prices, stifles competition and reduces choice and affordability for consumers.

Foreword

by Paul Guppy, Vice President for Research

Insurance is heavily regulated in Washington. Some level of state regulation is essential for insurance to be effective and to protect consumers against fraud. At the same time, too much regulation drives up prices, stifles competition and reduces choice and affordability for consumers. In the heat of these policy debates, the real meaning of insurance is often lost, and it becomes easy for policymakers in Olympia to forget why people need insurance in the first place.

In this study, Washington Policy Center Adjunct Scholar Eli Lehrer steps back from the day-to-day controversy and describes what insurance is, why it is regulated, and why reliable, affordable insurance policies are needed to allow citizens to manage risk and to participate in the modern economy.

Introduction

This paper provides an overview of America's property and casualty insurance markets. Although it discusses some issues common to almost all types of insurance, the paper draws most of its examples from the two types of insurance that most Americans buy for themselves: automobile insurance and homeowners' insurance.

The paper consists of four sections:

- The first section describes what insurance is, why people buy it, and the social purposes it serves.
- The second section describes why and how the government regulates insurance.
- The third section describes how insurance actually works and why it is often mandatory.
- The final section briefly outlines some of the major federal and state issues surrounding insurance.

What is Insurance?

Insurance is a type of financial product that serves to pool, manage and mitigate against unexpected - almost always negative - events that involve damage to property and damage that the owner of property might do to others. It is an effort to transfer contingent risks - risks that nobody knows definitely will happen - from one party (the insured) to another (the insurer) in exchange for a payment.

Homeowners' insurance typically covers damage to a house and its contents from fire, sump-pump backup, falling trees, home appliance failure, and wind (a government program covers floods from lakes, rivers, and the ocean) as well as the liability for accidents that visitors might have while in a house. Automobile insurance typically provides coverage against damage or injury that policyholders might do to others. It sometimes also includes coverage for damage that policyholders do to their own vehicles.

Property insurance covers tangible property; casualty insurance originally protected against injury to others or damage to others' property. (For the most part, property and casualty insurance is now one category and nobody distinguishes between the property and casualty parts of policies.)

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People buy property and casualty insurance rather than taking on these risks themselves because the coordination and pooling of non-correlated risks almost always costs less than it does for individuals to manage those costs themselves. Insurance companies enter into voluntary contracts with insured people and pool similar risks together. They underwrite (agree to take on) various risks and try to pool those risks together in ways that will not correlate.

For example, an insurer might write policies that protect homeowners in Buffalo from having their roofs collapse from snowfall and at the same time insure homeowners in Tampa against having their homes destroyed by a hurricane.

One can be pretty confident that the insurer won't have to pay these claims at the same time since hurricanes and snowstorms take place at different times of the year. Thus, insurers can make money by investing the premiums between payouts. The simple spreading of risk also reduces the cost of managing it: not all drivers will get into accidents on the same day, and the great majority of those that remain out of trouble on the roads will provide the dollars needed to pay claims from those that do. (In fact, things get a lot more complex, because nearly all sizeable property insurance companies buy insurance themselves, called reinsurance, swap risks with other insurers, and make investments designed to diversify their risks far beyond the business they write.)

Everything that is insured has a few common characteristics. They relate to very similar risks (the industry calls these "homogenous" risks), relate to something unpleasant, and relate to something that can be quantified. First, the risks in personal lines insurance have to be very similar: everyone who buys auto insurance faces similar types of risks of accidents, theft, and injury - this allows risks to be pooled. This does not mean, however, that everyone has *exactly* the same sorts of risks. Second, the things that insurance insures against are unpleasant, unexpected, and involve *no real upside*. One typically cannot insure against expected business events or even against having a car's brakes repaired.

Third, the risk insured against has to be quantifiable: it has to take place at a known time and place to a known thing or person and have a definite cost. Some scholars propose other factors - such as size of risk - in defining insurance but, in general, such factors are not really absolute. Some "insurance" against small risks or expected expenses - well-patient doctor visits, rental car expenses when a car is in the shop, are not insurance. They are just ways of prepaying for certain services. These kinds of "insurance" do not serve any real risk-management or pooling function. Finally, it is generally impossible to buy insurance against the very largest risks. It is unlikely, for example, that any company would write a policy against the damage caused by an asteroid striking the Earth, since the total damage should this occur would simply be too large.

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Socially, insurance makes it easier for people to undertake and manage risks, especially for activities they would not otherwise undertake. When it facilities behavior that would not happen absent coverage, insurance creates *moral hazard*, that is, the willingness to behave in a certain way because people know that coverage exists.

Some degree of moral hazard is desirable. Before homeowners' insurance became widespread, property owners would often clear-cut the woods around their homes as a precaution against fire and falling trees. On the other hand, too much moral hazard is undesirable. Government-subsidized flood insurance has encouraged enormous amounts of construction in environmentally sensitive, flood-prone areas. Homeowners who build in flood-prone areas think to themselves, "If my home is washed out, the government will pay for it."

Why Insurance is Regulated

Scholars of public policy give three reasons why government should regulate property and casualty insurance: the need to maintain insurer solvency, the mandatory nature of insurance, and, a closely related fact, the nature of demand for insurance.

Insurance regulation began largely as a way of providing a guarantee of insurer solvency. Insurance regulations assure policyholders that insurance companies have the financial ability to pay claims. In principle, laws against fraud *could* do this. An insurer that writes a contract with knowledge that the aggregate premium it collects will not cover expected claims has committed fraud and could face criminal prosecution.

But, because insurance typically exists as a way to deal with unexpected, usually infrequent events, an insurer could perpetuate fraud on policyholders for a long time before eventually going under. A fraudulent product, indeed, could easily cost less than a legitimate one and "work" just as well from a consumers' standpoint, until a true disaster brought about an avalanche of claims. Even a well-meaning insurer who itself fell victim to fraud could end up unable to pay claims. Thus, beginning in the late 19th century, American states, including Washington, began to regulate insurer solvency as a way of protecting both consumers and the industry.

In addition, insurance is mandatory in many cases. Nearly all companies that sell mortgages require their borrowers to obtain homeowners' insurance, and many states mandate that all car owners obtain auto insurance. Because so many people *need* insurance, some feel that the government has a special role in making sure that everyone or almost everyone can afford it (more on this below).

Finally the demand for insurance functions a bit differently than demand for many other products. Essentially, insurance has what economists call a "kinked demand curve." As overall price for insurance (*not* the price from any given company) rises, people will continue to buy it at a similar rate because law and practical necessity require it.

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Beyond that price point, however, people will eventually stop buying insurance no matter what mandates exist to buy it. The same type of demand curves exist for many other "near necessity goods" - air conditioning, Internet access, gasoline, and automobiles are examples of goods that are not technically required to survive, but are needed to participate in modern society. To some people, this implies the government has an additional responsibility to keep insurance affordable so that citizens are not left out of important social activities.

How Insurance is Regulated

In order to regulate insurance, governments engage in three types of interrelated regulation: solvency, rate and form.

Solvency regulation, as the name suggests, exists to ensure the financial solvency of insurance companies. Essentially, the government places price floors on how much insurers can charge and makes sure they have sufficient assets - including reinsurance contracts - to pay the claims they can reasonably expect.

Rate regulation serves as a twin to solvency regulation. Because insurance is mandated in many cases and necessary to participate in modern society, some governments take on the responsibility for more comprehensive regulation of rates. Nearly all states require that rates not be "excessive," "inadequate," or "unfairly discriminatory." Inadequate rates are those that would endanger the financial solvency of the insurer.

Unfairly discriminatory rates discriminate between policyholders on the basis of classifications that the government does not allow. For example, an insurance company that charged one minority group or members of one race higher rates than people of other races would be charging unfairly discriminatory rates. On the whole, however, "excessiveness" generates the most controversy. Common law contract theory includes the principle of conscionability - a form of avoiding "excessive" rates - but, in general, states have interpreted it somewhat more strictly than simply avoiding rates that courts would rule unconscionable.

In some cases, insurance regulators call rates "excessive" when they produce more short-term profit than a politically appointed person thinks the insurer should earn. Insurers, in turn, argue that they need the short-term profits to make up for catastrophic losses in the future, or simply that their stockholders deserve a certain level of return.

Finally, government regulates insurance forms - the legal descriptions of what insurance policies do and do not cover. All personal lines policies - the types of policies that almost all people buy - find, as their root, a standardized policy of some sort. Most homeowners' insurance, for example, exists on the basis of a standardized policy called an "HO-3" that covers 16 specific perils (everything from snow buildup to falling trees) *and* everything else that is not specifically excluded from the policy language.

This standardization exists for two reasons. First, to allow insurance to be sold on the basis of utmost good faith. Secondly, to make it easier for consumers to shop by correcting information asymmetries. Utmost good faith means that policyholders can accept statements made by insurance salespeople as true without actually reading the policy language, and insurers can likewise place a similar reliance on representations that policyholders make. A homeowners' policy that covers fire damage will define "fire" in such a way that it is recognizable to everyone, and all fire insurance sold within a given state (and, generally, the country) defines the meaning of "fire" in the same way.

Without some effort to create standards for language, utmost good faith would not be possible. Insurance law generally assumes that consumers know less about insurance than insurers do and that the insurers are in a stronger position relative to the consumer; they know more and have more power. Thus, the law generally gives consumers the benefit of the doubt. Regulation of insurance forms, in theory, levels the playing field for consumers while making it easier for them to shop around and compare different insurance products.

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Insurance, as most Americans understand it, requires a degree of form regulation. Without some third party reviewing forms, the entire principle of utmost good faith would be impossible and enormous litigation would likely take place to resolve many claims. Insurers, and some consumers, however, feel that stringent form regulation tends to limit the ability of companies to introduce new products and of consumers to buy them.

How Admitted Market Insurance Works

Nearly all insurance that ordinary Americans buy is sold in the *personal lines admitted market.* Businesses, very wealthy people, and people who choose to take great risks - like living on sand dunes or driving in NASCAR - can buy other types of insurance in *commercial lines admitted* or *excess and surplus markets.* Somewhat fewer rules apply to commercial lines markets and many fewer rules apply to excess and surplus markets. (Excess and surplus lines carriers must charge adequate rates but have little other regulation.) Most individuals never have occasion to want insurance policies in either of these markets.

Individuals almost always must buy insurance through an *agent:* a government-licensed person who sells insurance. Some agents are independent and sell policies from a variety of companies, while others are *captive* and sell for only one company. Some captive agents are company employees, others are independent contractors.

Finally, some companies directly employ all their agents and do business mostly or entirely by telephone or the Internet. Independent agents and some captive agents serve a variety of functions. Many serve as financial planners, personal risk managers, and investment advisors. They typically work to develop personal relationships with their customers. Direct sellers that work over the telephone or Internet almost always must employ agents as well, although these agents simply work to answer questions and sign off on paperwork. They rarely develop personal relationships with customers.

Setting Premiums

In return for insurance, an individual theoretically pays a *risk-based premium,* the monthly payment for insurance coverage. People who take greater risks pay higher premiums and those who take smaller risks pay smaller premiums.

Many factors go into determining risk. Some factors relate directly to behavior and claims experience: people who make more claims generally pay higher rates, because past claims generally signify future claims. On the other hand, insurers use many factors other than claims experience. Drivers who get speeding tickets (even without accidents) or who live in high crime neighborhoods, for example, pay higher automobile insurance rates, even if they avoid accidents or thefts from their auto.

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Some indirect factors also impact rates. People with poor credit ratings relative to the rest of the population, for example, are generally worse risks than those with good credit ratings. Members of certain professions, likewise, may pay higher or lower rates. An insurer who believes doctors make especially careful drivers may give them a price break. Likewise, insurers extend discounts to people who buy other products, both automobile and homeowners insurance, from the same company.

In practice, rate regulation makes it very difficult for insurers to charge true risk-based rates. Quite often, politically powerful or favored groups - male drivers, people who live in coastal areas - manage to bend the rate making process to their advantage and pay rates lower than actual risk would suggest. Some states ban the use of certain types of information, including credit scores and location. Insurers sometimes manipulate the rate-making process and use state regulation to secure measures that guarantee their profits, or offload bad risks on to taxpayers.

Insurance coverage typically has a *policy limit* and a *deductible.* The policy limit represents the maximum amount an insurer will pay. The deductible represents the portion of a loss that the policyholder will have to pay out of pocket.

When people who own insurance policies (insureds) suffer a covered loss, they make *claims* against their insurance policies. Insurers typically send *adjusters* to determine the legitimacy of the claims and the amounts that are owed. Some smaller claims are often honored based on a telephone or Internet report, with a visit from an adjuster.

Insurers then pay claims based on the adjusters' findings. Claims can result in higher premiums. In theory, insurers raise premiums not to cover past losses but, rather, as a result of greater projected risks as shown by a past claim. For some insurers, some types of claims, in fact, do not result in higher premiums, because they do not correlate with greater future losses. Some major auto insurance companies, for example, offer "accident forgiveness" for one or more minor accidents every few years, on the reasoning that people who have only a few accidents do not pose a significantly higher risk than those who avoid accidents altogether.

The personal lines market is almost always *rate regulated* and companies in all fifty states participate in *guarantee funds.* These funds, which are typically state-mandated, but privately run, exist to assure that claims will be paid even when an insurance company fails (although guarantee funds do not always cover 100 percent of claims.)

The funds' exact structure and powers differ from state to state but, typically, they have the power to assess (tax) all companies authorized to do business in a state to pay for the losses of a mismanaged company. The funds usually do not take advance action to prevent a company from making a bad business decision - they typically step in only when a company has failed or is just on the verge of failing.

Why Insurance is often Mandatory

Mandatory insurance exists for two reasons: protection of an asset, such as a home, and protection of society.

Forty-six states, including Washington, have laws mandating that drivers maintain automobile insurance and, even though state laws almost never mandate homeowners' insurance, nearly all mortgage lenders require their borrowers to buy homeowners' insurance. Mandatory insurance exists for two reasons: protection of an asset, such as a home, and protection of society.

Anyone making a loan secured by an asset needs some assurance that the asset will remain in existence so that it can be repossessed or foreclosed upon if the borrower defaults on the loan. Insurance therefore protects the lender's interest. Nearly all home mortgages require borrowers to secure coverage for a very substantial fraction of their homes' structure value in order to protect the lender. In many cases, mortgage lenders will buy property insurance for borrowers and pass on the cost to the borrower, if the borrower fails to buy a homeowners' policy of his own. For similar reasons, auto lenders typically require borrowers to purchase automobile insurance as well.

Similarly, laws in 46 states require motorists to carry automobile insurance against damage they may cause to other drivers. A few states also require "med pay" that covers a portion of medical expenses that policyholders or other drivers incur. The rationale for this is simple: every driver has some chance of causing an automobile accident. The existence of insurance provides assurance that every driver will be able to cover the costs of damage that he might cause.

State mandates never require drivers to purchase coverage against damage that they cause to their own cars. Some homeowners' associations and master-planned communities, however, require residents to carry homeowners' insurance when lenders do not. Damage to ones' own house can result in damage to neighboring houses if, for example, loose debris goes flying or neglected drainage problems lead to flooding on someone else's property.

Issues in Insurance

Although particular property and casualty insurance-related issues differ a great deal from state to state, three major issues define the national debate: whether the federal government should have a role in regulating insurance; the way the government should deal with disasters; and the duties that insurers and their customers owe to one another. Although they do intertwine, each of these issues involves distinct concerns.

Federal regulation has attracted the most attention recently. Since World War II, the McCarran-Ferguson Act gave states the responsibility to regulate the business of insurance with little or no input from the federal government. Although most Americans buy their insurance from companies that operate nationally, every state has its own system for regulating insurance. The insurance industry and consumer groups remain deeply and evenly divided on the advantages and disadvantages of this system.

Optional Federal Charter

Three major issues define the national debate: whether the federal government should have a role in regulating insurance; the way the government should deal with disasters; and the duties that insurers and their customers owe to one another.

Most people who oppose the current system favor what they call an optional federal charter or OFC. Under an OFC, insurers would choose between federal and state regulation and consumers could chose to deal with nationally or state-regulated insurers. Some insurers and consumer groups who favor this system believe that a national regulator would allow for more risk-based rates - higher rates for poor risks, lower ones for good risks - and new products. They point to the banking system where, since the Civil War, banks have been able to choose between federal and state regulation and where it has been easier to introduce new products.

Others argue that state-by-state regulation does a better job of regulating insurance in concert with each state's unique interests and, in some cases, argue that rate regulation tends to reduce costs for consumers and protect them from insurers. They also point out that, whatever the burdens of the state-by-state system, it has not stopped insurers from operating nationally.

People who oppose an OFC also point to the long-standing tradition of local control over many important issues - education, transportation, and some aspects of banking regulation - to make the case for the current system. Opponents of OFC point to the threat of a larger federal bureaucracy. Many of those who oppose an OFC nonetheless support some efforts that would increase the federal role in areas like the licensing of insurance agents.

Disaster Insurance

Disaster insurance has also aroused significant controversy. In most of the country, standard homeowners' insurance policies cover people against just about every common peril except flooding (which is covered through a government program administered through private companies) and charge prices that most homeowners can afford.

To deal with these types of catastrophes, particularly when they impact large numbers of people, most insurers rely on private reinsurance to spread the risk. Recently, some politicians, insurers and consumer groups have come out in favor of measures that would either offload some types of risks to the government or get the federal government involved in reinsurance markets. (One state, Florida, already sells reinsurance itself.)

Proponents of these measures argue that broader, government-run risk pools would reduce prices for consumers by spreading risk over more individuals and operate on a non-profit basis. Those who oppose them argue that government-run reinsurance would actually condense rather than spread risk, because government-run insurance funds would concentrate risk in the United States, rather than spreading it through international reinsurance markets.

Opponents of the plans also argue that the non-profit status is illusory, because many insurers already operate on a "non-profit" basis but, because of the need of all insurers to retain earnings, rarely manage to offer lower prices. Opponents contend, furthermore, that the plans would very likely reduce costs only by charging less for coverage than its likely cost, and then stick taxpayers with the bills.

Dealing with "Bad Faith" and "Fraud"

Finally, many states have begun to ask fundamental questions about insurance: the nature of "bad faith" and "fraud" have become particularly relevant. In general, state laws and some common law principles assume that insurers almost always know more than consumers and have the upper hand in every transaction.

Thus, in some states, delays in claim payment, even when done for legitimate business reasons, can be considered acts of "bad faith." Likewise, although utmost good faith is technically a two-way street, people seeking insurance who misrepresent their risks rarely face any penalty besides the cancellation of the policy. Even then, some types of policies, life insurance in particular, cannot be canceled on the basis of misrepresentations after it has been in force for a certain length of time. Insurers who make misrepresentations - even non-material ones - can be held to be acting in bad faith.

Some degree of government regulation is necessary for the proper functioning of insurance, but too much regulation stifles creativity, increases cost and impedes risk transfer.

That said, all of these issues deal with marginal, difficult cases. Nobody really disputes the fundamental common law principles of giving legal protection to less informed parties (the consumer), and making sure that contracts meet standards of conscionable practice. Instead, arguments largely revolve around where courts and legislatures should draw these lines.

Conclusion

Without insurance modern life would not be possible. People buy personal property and casualty insurance policies to protect themselves and to take risks they otherwise would not take. Government regulates insurance at the state level and does so through rate, form and solvency regulation.

Some degree of government regulation is necessary for the proper functioning of insurance, but too much regulation stifles creativity, increases cost and impedes risk transfer. The most effective role for public officials is to adopt policies that protect consumers against fraud, encourage competition and allow insurers to remain solvent, while leaving pricing, product design and the accurate assessment of risk to the marketplace.

Further Reading

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