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The Fundamentals of Insurance: A Primer for Public Policymakers

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In keeping with the non-partisan, non-advocative mission of The Griffith Foundation, I will keep my comments and contributions to today's program unbiased and purely educational.

Mission

The Institutes Griffith Insurance Education Foundation seeks to empower public policymakers and their staff members through a greater understanding of insurance and risk management by providing unbiased educational programs.

Public Policymaker Education (PPE)

Rationale

- RMI Plays a Critical Role in the Financial Security of Our Country.
- Informed Risk Management Serves as Catalyst for a More Secure Future.
- Better Informed Policymakers are Better Equipped to Make Sound Decisions.

Public Policymaker Education (PPE)

Methods

- Delivered via: live webinar, on-demand playback; and traditional in-person sessions (greater focus on remote programming in recent years given pandemic)
- Many programs offered in collaboration with complementary organizations
- Lecture, Interview-based sessions, and panel presentations
- Visit **griffithfoundation.org** to learn more about our offerings and/or to view content.

About me…

Career Summary

- Professor of Insurance for 33 yrs (23 at Cal State Northridge CSUN)
- Began selling life ins for financial planning firm in college (1980s)
- Earned Ph.D. in Ins and Risk Management from Wharton (1990s)
- Published research on several topics, plus two books
- Served as expert witness in US Tax Court on Insurance
- Served as expert witness for cases in Los Angeles Superior Court
- Served on the board of two insurance companies, including as Chair

Important Roles for Insurance

- Protects families' health and most important assets
- Required by government to demonstrate financial responsibility
  - Example: auto liability coverage required by motor vehicle code
  - Example: workers compensation coverage required by labor code
- Required by lenders to demonstrate security of collateral
- Required by contract counterparties to provide evidence of capacity to meet contingent responsibilities
- Provides stability when activities might otherwise prove too risky

What Is **Insurance**?

- Provides *indemnification*: restores insured to preloss condition
  - "Actual Cash Value" designed to make insured "whole," but not better off
  - Not always possible to return to *exact* preloss condition
  - Examples: old couch, life insurance, KY Derby winner, valuable painting
  - Solutions: replacement cost insurance, valued policies
- Within limits, insurance provides reimbursement for losses
- Reduces fear and need for a large emergency fund
- May help reduce and prevent losses through policy conditions, such as safety requirements and deductibles

Foundational **Insurance Terms**

- Loss **frequency**—how often
- Loss **severity**—how bad
- **Peril** (cause of loss)
  - Examples: Fire, Wind, Theft, Collision
- **Hazard** (conditions that increase frequency or severity of loss)
  - Examples: Climate change, dishonesty (moral hazard), carelessness (morale hazard), gasoline can in garage

Not all risks are **insurable**...

- Insurance covers **pure** risks
  - Pure risks are risks that results in a loss or no loss
  - Examples: Damages from a lawsuit, fire losses, water damage
- Insurance does not cover **speculative** risks
  - Speculative risks provide the opportunity for *profit* or loss
  - Examples: ins does not cover market values or failure of a business idea
- Example: Business Income (BI) insurance covers losses due to fire
  - But it does not cover losses due to low volumes (recession)
  - Business volumes are speculative (can also rise, producing more profit)
  - Coverage of business volumes also would increase moral/morale hazard

Some risks are **difficult to insure**…

- Some risks are difficult to insure
  - Catastrophic losses such as earthquake, flood and hurricane
  - Insurers use reinsurance, higher deductibles and exclusions
  - Government programs can assist with catastrophic events
- Some perils and losses are excluded
  - Illegal activity (example: speeding tickets)
  - Intentional losses (example: arson by insured)
- Difficult to value or verify
  - Pets (not covered under standard homeowners policy)
  - Large amounts of cash (standard homeowners policy covers $200)

Objectives of **Insurance Regulation**

- To protect consumers
- To maintain insurer solvency (ability to pay claims)
- To prevent destructive competition
- To ensure availability of insurance

Insurance is Regulated at the **State** Level

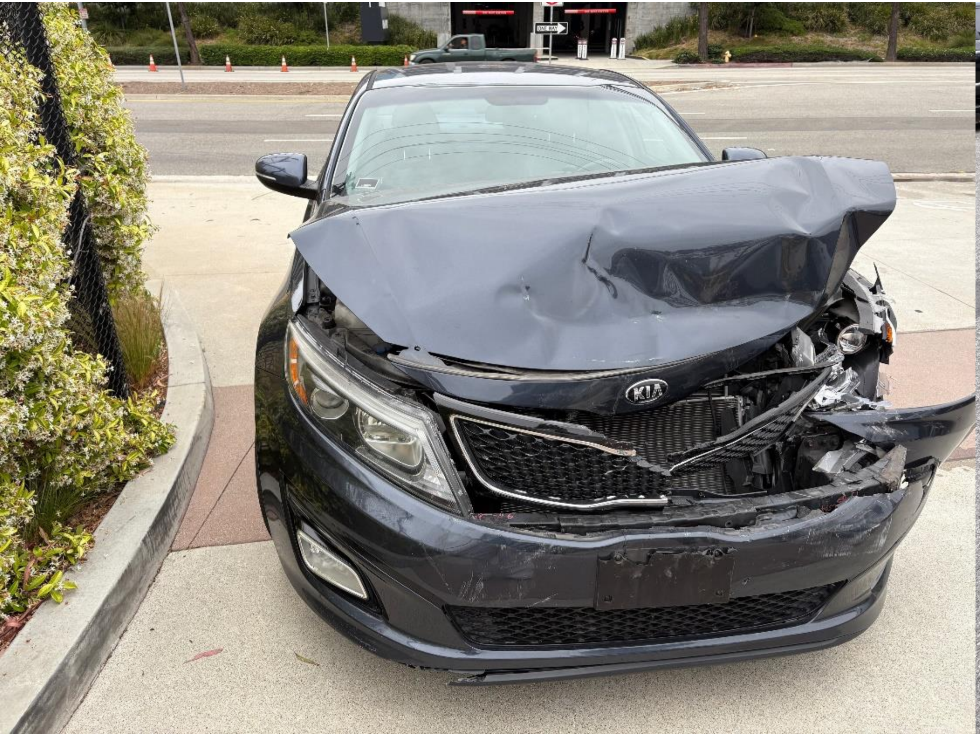
- States regulate insurance products in their jurisdiction
- 1945 McCarran-Ferguson Act assigned regulation to states
- States depend largely on guidance from NCOIL and National Association of Insurance Commissioners (NAIC)
  - NCOIL and NAIC draft model laws and regulations for states
- Some Federal insurance programs
  - National Flood Insurance Program is operated by FEMA
  - Federal Insurance Office collects data
  - Terrorism Risk Insurance Act (response to 9/11 attacks)

Regulatory **Functions**

- Conduct licensing and solvency surveillance
- Regulate and standardize insurance policies and products for clarity and reasonableness
- Control market conduct and prevent unfair trade practices, such as unfair claims settlements
- Ensure that insurance coverage is *available*
- Increase opportunities for *affordable* coverage

The Law of Large Numbers

- The mathematical basis of insurance
- ‘Pooling’ generates better predictions of average loss per policy
- Larger numbers of policies results in actual loss results closer to expectation, assuming accurate expectations
- Allows spreading the losses of a few across many policies
- Pooling breaks down when losses are correlated across many policies (e.g. earthquake, flood, large simultaneous wildfires)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Insurance Pricing (Premiums)

- Actuaries use prior loss data and trends to make forecasts
- Premiums are based on anticipated claims and expenses
- Example: A pool of 10,000 Ford Mustangs experienced $10 million in losses over the last year: $10m / 10,000 = $1,000 per Mustang
- To this expected loss, insurer adds inflation, expenses & a profit margin to calculate premium for next policy period
- Premiums kept in check by competition and regulators

Other Factors Affecting **Insurance Pricing**

- Inflation and supply chain challenges/delays
- Catastrophes and reinsurance costs/availability
- Interest rates
- “Social inflation” and legal system abuse
- Insurance fraud

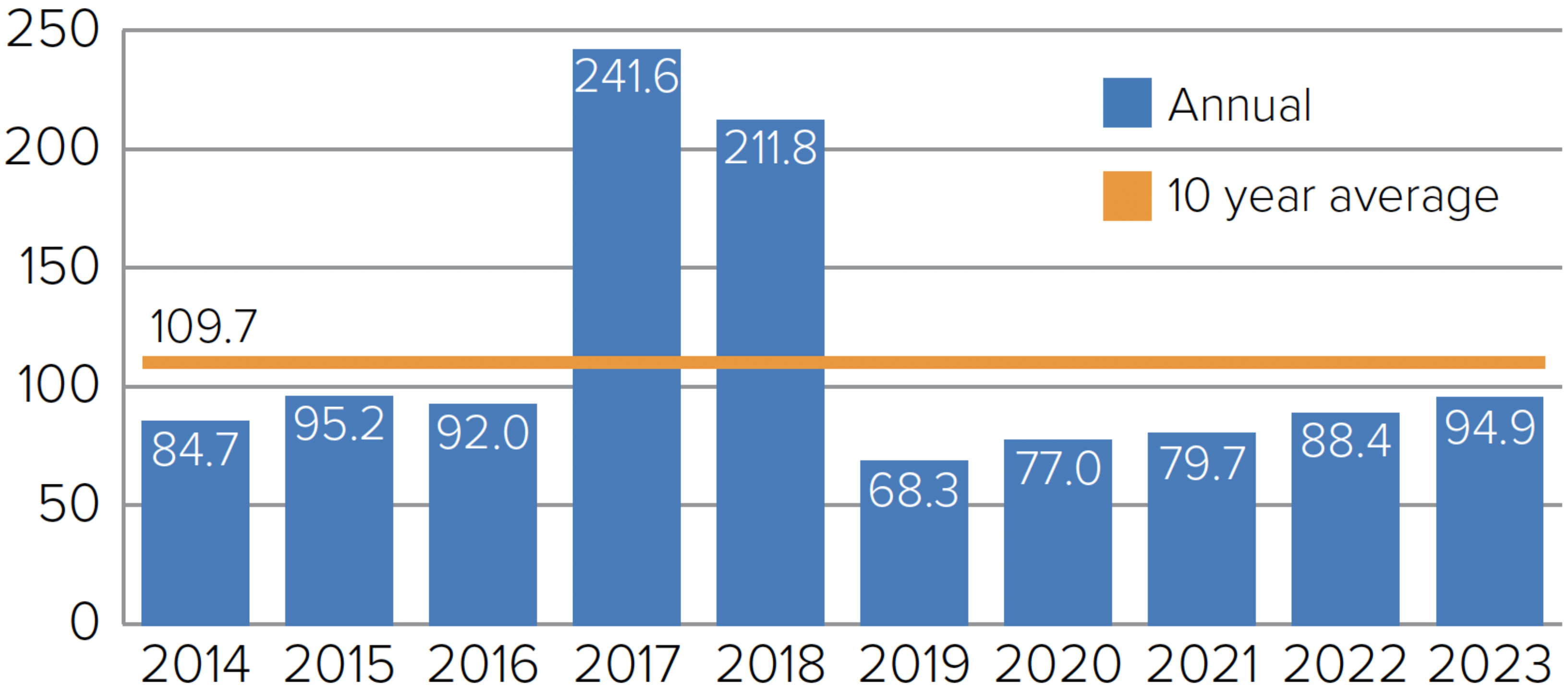
Sources of Insurer Profit and Loss

- Premiums are set to cover expected claims and expenses, with expectations of a profit that reflects their risk
- Insurance companies hold policyholder funds as well as their own capital; this "float" earns interest and capital gains
- Consequently, investment income contributes to revenue
- Insurance company profit margins are generally quite low, reflecting competitive markets
- If claims exceed expectation or if investment activity is unsuccessful, then insurers lose money

Surplus

- Surplus is the capital “cushion” that supports the promise to pay
- Regulators want to be sure this “cushion” is sufficient
- Insurers’ owners place capital at risk to cover bad years
- Insurers earn a profit in good years, lose money in bad
- Over time, insurers must earn a return on their surplus, or investors will deploy that capital elsewhere
- Note: Surplus is not to be confused with “reserves” which represent expected claims payments

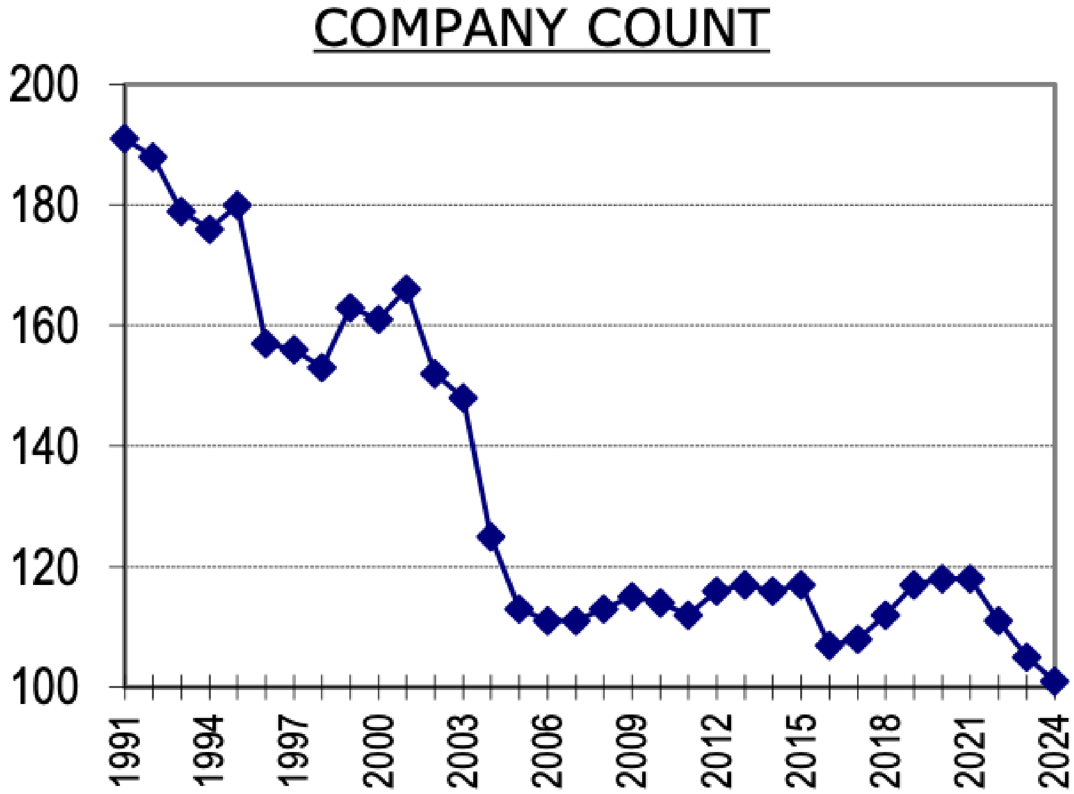
California Homeowners Insurance Combined Ratio



Source: Best's Market Share Reports, Homeowners Multi-peril

Preliminary combined ratio for 2024 is lower than 2023; 2025 will be higher

Homeowners Insurers in California



Source: CA DOI Market Share Reports. insurance.ca.gov

Major Lines of Insurance

- Personal Lines
  - Automobile
  - Homeowners
  - Life, Health, Dental and Vision
  - Umbrella and others…
- Commercial Lines
  - Commercial Multiple Peril (CMP)
  - Workers Compensation, General Liability
  - Professional Liability (Errors and Omissions aka “Malpractice”)
  - Commercial Auto, Business Income, others…

Other Lines of Insurance

- Some lesser-known products
  - Annuities (very large market)
  - Marine (goods in transit)
  - Cyberliability (protection against hacking)
  - Title insurance (protects lenders against title defects)
  - Difference-In-Conditions (provides protection against gaps)
  - Long Term Care (coverage for care of the elderly)
- Niche Products
  - Pet insurance
  - Longevity insurance (specialized annuity product)

Primary Forms of Insurer Organization/Ownership

Forms of Insurer Ownership

Type of Insurer	Form of Ownership	Managed by
Stock insurer	Corporation owned by its stockholders	Board of directors, elected by the stockholders
Mutual insurer	Corporation owned by its policyholders	Board of directors, elected by the policyholders
Reciprocal insurance exchange	Unincorporated association of subscribers	Attorney-in-fact chosen by the subscribers

Insurance Distribution

- Exclusive Agents (Agents represent one company)
- Independent Agents (Agents represent many companies)
- Brokers (brokers represent insurance buyers rather than sellers)
- Direct Channels
- Omnichannel

Admitted vs. Non-Admitted Markets

- **Admitted** insurers are licensed in a given state
- **Non-Admitted** insurers are *not* licensed in a given state
  - Non-admitted insurers operate in the ”excess and surplus lines market”
- In some cases, no admitted insurer wants to accept the risk at the regulated price…or at any price
  - Example: Florida wind near the beach or California wildfire near WUI
- Agents and Brokers can approach non-admitted insurers to obtain insurance, usually at higher rates with restrictive terms

Underwriting

- The process of selecting and classifying insurance applicants
- Affects new business, renewals and pricing of coverage
- Similar to how banks review loan applications
- May* include:
  - Algorithms
  - Human judgment
  - Review of loss history and credit profile
  - Physical inspections, drone images or satellite photography
  - *Some methods not allowed in certain jurisdictions

Claims

- The **Claims Department** meets the promise made by insurer
- Claims adjusters a/k/a claims ‘representatives’ review claims for validity and settle any amounts owed
- During a crisis, insurers may bring in additional adjusters from out of state
- State regulations govern response times, and regulators offer channels whereby consumers can complain about settlements
- Regulators review claims settlements regularly using audits
  - Claims personnel are responsible for not underpaying or overpaying
  - States require insurers to combat insurance fraud to keep premiums down

Reinsurance: Insurance for Insurance Companies

Homeowner Policy

- Limit
- Premium
- Deductible
- Duration
- Promise of Payment

Reinsurance Treaty

Panel of Reinsurers

- Limit
- Premium
- Deductible
- Duration
- Promise of Payment

Other Important Information

- A.M. Best is primary rating agency (A++, A+, A, A-, B++…)
- Mortgage lenders require that insurers carry a minimum rating
- Catastrophe models
- Effects of interest rates and equity market trends

Government Participation in Insurance Markets

- Government sometimes steps in to ensure insurance is solvent, available and affordable for some residents
- FAIR Plans (Fair Access to Insurance Requirements)
- State Guarantee/Guaranty Funds—protects against insolvency
- Catastrophe Facilities
  - Citizens Property Insurance in Florida
  - California Earthquake Authority
- State Workers Compensation Plans (SCIF in CA)
- Covered California (offers health ins tax credit subsidies)

Proposition 103 (1988)

- Passed as a voter revolt to rapidly rising auto ins premiums
- Reforms also apply to homeowners insurance and other lines
- Created prior approval requirement for rate increases
- Slowed down rate increases over 7% through an intervenor process
- Insurance commissioner now elected rather than appointed
- Emphasized three factors for rating auto insurance
  - Driving history, annual miles driven and years of experience

CA FAIR Plan

- Provides insurance when homeowners can't obtain it elsewhere
- Covers only fire, lightning, explosion and smoke damage; other perils are covered by "Difference in Conditions" policies
- FAIR Plan policies cover relatively little, perceived as expensive
- Designed to break even, but losses and profits shared by member companies according to market share
- In the event there is a deficit, FAIR Plan can request assessment
  - In February, the FAIR Plan assessed member companies $1 billion
  - Half of the assessment is expected to be paid by policyholders

Protecting Consumers*

- Promote competition
- Reduce fraud, which reduces claims and premiums
- Speed up rate consideration/approvals
- Encourage/require private insurers to return to high-risk areas
- Allow forward looking models which many states already do
- Modernize and depopulate FAIR Plan

**Includes elements of Commissioner Lara's Sustainable Insurance Strategy (insurance.ca.gov)*

Current Issues in Insurance

- Impact of climate change on availability + affordability
- Effects of tariffs/cost inflation on auto and homeowners rates
- Social inflation and nuclear verdicts
- Technology, regulation and prevention
  - Telematics and usage-based insurance
  - Risk mitigation
  - Insurance scores based on credit bureau data

Questions?

- *Always happy to help!*
  - David.Russell@csun.edu (best contact method)
  - 818-677-2438

ADDITIONAL SLIDES

The Risk Management Toolbox

- There are several ways to manage financial uncertainty
- Risk Control
  – **Loss Control** and **Mitigation** (take steps to reduce frequency and severity)
  – **Avoidance** (discontinue the risky activity)
- Risk Financing
  – **Insurance Transfer** (transfer the uncertainty to a pool/insurer)
  – **Retention** (keep the risk and pay out of pocket or with borrowing)
  – **Non-Insurance Transfer** (use contracts and hold harmless agreements)

Insurer Investment Activity

- Insurance companies hold a variety of assets
  - Cash (provides liquidity)
  - Bonds (provides safety, with reasonable return)
  - Equities (allows for growth in the long term)
  - Other (allows for growth and other special situations)
- Regulators and rating agencies monitor asset risks to avoid unexpected asset value declines or illiquidity in certain markets
- While insurer insolvencies are rare, many of these insolvencies originate from poor investment selection