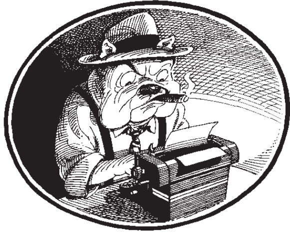

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INSURANCE OBSERVER

The Loss of the Certainty Effect

Will Claims Be Paid?

We've been concerned about insurance companies' financial strength since...well, since forever. Over the years we've written dozens of articles about insurance buyers' disregard for financial strength and the danger that entails. Risk that is "transferred" to weaker companies may turn out to be risk that is not transferred at all.

While an insurance company's ability *to pay claims is essential, so is its* willingness *to do so. Richard and Barbara Stewart believe that recent changes in the commercial property-casualty business have made it unlikely that insurers will pay large claims promptly and willingly. This is a provocative notion, but the Stewarts are not provocateurs. Richard Stewart is chairman of Stewart Economics, a consulting firm specializing in insurance. He has been New York's insurance commissioner, president of the National Association of Insurance Commissioners, general counsel of Citibank, and chief financial officer of the Chubb Corporation. Barbara Stewart is president of Stewart Economics. She was Chubb's corporate economist.*

Referring to insurance companies' claims-paying willingness, the Stewarts ask two rhetorical questions: "What is the value to you of a deal with someone whose handshake is 100% solid and dependable? Now, what is the value of the same handshake from someone who performs most of the time, but not always?"

An efficient insurance market requires "certainty," which we'll define as the buyer's belief that the insurance company is willing and able to pay claims. In May, the Stewarts published "The Loss of the Certainty Effect" in Risk Management and Insurance Review. *(The article was 20 pages long and contained 29 footnotes and 73 bibliographical references.) It has not been as widely read as it deserves to be.*

"It's 7-to-1 that my insurance company won't pay a claim."

We asked the Stewarts if they would provide us with a shorter version of their tome—a welterweight champion rather than a heavyweight champion—which they did. The editorial team at Schiff's *then went to work, editing the article so that its tone and style are consistent with what you usually read in this publication. The result follows.*

A defining characteristic of insurance is that the product is sold and paid for long before it's delivered. An insurance buyer pays a premium and, in return, receives an insurance company's promise to deliver money and services in the future, if an uncertain event occurs.

The insurance buyer's belief that claims will be paid is essential to the value of what insurers sell. If, between the time of sale and a claim, the insurance company becomes unable or unwilling to pay claims, its promise becomes worth much less than what it was sold for.

Recent changes in the insurance business have placed a cloud over the assumption of certain payment, particularly for large commercial buyers of property-casualty insurance. That's not good for either buyers or sellers.

Insurance can become uncertain in two ways. One is by the insurance company's financial inability to pay claims. (Preventing insolvencies has long been considered the primary goal of insurance regulation.) Insurance can also become uncertain if the insurance company is unwilling to pay claims—or unwilling to pay them promptly—causing policyholders to litigate after claims are made. *continued*

Over the past three decades, the commercial property-liability insurance business has undergone changes that make it more likely that an insurance company will now deny coverage for a large claim that it would have agreed to pay in the past.

During the half century ending in 1945, property-liability rates in most states were prescribed by a legal cartel: rating bureaus. Between 1945 and 1975, judicial rulings, legislative actions, regulatory actions, and market forces did away with the cartel. Price competition, however, created an emphasis on controlling claims and claims expenses (the primary factors that affect prices).

Insurance companies also became more oriented toward shareholders than toward policyholders. In the late 1980s, securities analysts and corporate managements latched onto the buzzword of "shareholder value"—shareholders, of course, get the benefit of what is *not* paid out for claims—and insurance executives, as a result of their stock options, became increasingly concerned about their company's stock price.

As interest rates rose in the 1970s, the income on "float" (mainly funds reserved for claims), became the primary component of earnings for property-liability insurance companies. The income from float depends on two things: 1) how long the funds are held before being paid out, and 2) the cost of obtaining the float (premiums minus claims and expenses). Insurance companies are, of course, aware that delaying the payment of claims increases the income they make from float, and that denying claims decreases the cost of float.

Risk management enabled corporate policyholders to save money by retaining smaller, more predictable risks, which squeezed insurance companies' cross-subsidies between categories of policyholders and added further pricing pressure. Risk management also changed the nature of insurance buying; it's become more about transactions than about relationships. Accounts are shopped frequently and memories are short. Risk managers and brokers focus on the point of sale—where premiums are saved and commissions earned—rather than on the point of claim.

The consolidation of brokerage firms over the past 30 years has created a situation in which a few giant firms have unprecedented influence over both insurance companies and policyholders. But brokers are still compensated by commissions and fees at the point of sale, not by performance with claims.

Unexpected liability catastrophes have also affected this dynamic. After World War II the industry's rating bureaus began broadening the standard policy form for the highly profitable general-liability line. From the 1970s to the present, there were three liability catastrophes: asbestos, pollution, and medical product liability. Sudden and huge liabilities are especially difficult for insurers to manage. The industry has coped with the liability catastrophes by resisting the payment of claims. Spreading the payment over a longer time has probably reduced the amount that insurers have had to pay, which is bound to influence insurers' response to the next commercial insurance catastrophe, whether it's property, liability, or surety.

A final change that's had a profound effect has been the birth of a sophisticated and aggressive coverage bar. As a result, insurance sellers *and* buyers now have first-class lawyers looking forward to the next fight.

In the past, insurers' claims denials have led to major changes in the industry and in regulation.

From an insurer's point of view, denying coverage for large claims has become an effective—perhaps even necessary—strategy. From a policyholder's point of view, the cost of collecting a claim has gone up and the reliability of insurance has gone down.

Usually, the market corrects such problems. But large commercial property-casualty claims are not part of an efficient market; the time between the sale and the claim is too long, the claims are sporadic, the facts are too complicated, and reliable data about claims practices are not available.

Economic theory and historical experience suggest that the present situation is untenable and that the outcome presents a threat to the insurance business.

Three modern lines of scholarship in economics and psychology are relevant to the subject of insurance reliability: option theory, asymmetric information theory, and prospect theory.

Option theory observes that financial proxies for economic outcomes are effective only if they really correspond to the outcome, and if both parties are sure to perform. Insurance, like other derivatives, needs two parties. Each needs to have absolute confidence in the ability and willingness of the other to perform. The chance that the other party will not perform is called counterparty risk. If insurance loses the certainty of performance (through insolvency or claims practices) it becomes a derivative with substantial counterparty risk. In the financial markets, derivatives with substantial counterparty risk are just about worthless.

Asymmetric information theory observes that when sellers are known to have more information about the quality of a traded item than buyers do, buyers will pay based on worst-case assumptions. A classic example is used cars, where buyers tend to assume the worst, and pay accordingly. If insurance buyers came to doubt insurance contracts' certainty of performance, and assumed that insurance companies knew more about the certainty than they did, the price that they'd be willing to pay would be far less than what they pay now.

Prospect theory observes that people place a high value on certainty ("the certainty effect"). Research in prospect theory has concluded that if buyers of insurance believe that 1% of their valid claims will not be paid, the price they'd be willing to pay as premiums would drop 30%.

Option theory, asymmetric information theory, and prospect theory lead to the same conclusion—that the loss of the certainty effect would be expensive for insurers. The loss of the certainty effect could even create a spiral: due to reduced rates, insurers could become even tougher about paying claims, which would alienate buyers, who would then want to pay even less, which could cause insurers to get even tougher, and so on.

The severity and duration of the recent price war may have been an early symptom of a spiral.

continued

Although option theory, information theory, and prospect theory are modern, the problem of the loss of the certainty effect is not. We'll cite four instances in the past where insurers' claims denials (in response to unexpectedly heavy claims) have led to major changes in the industry and regulation.

The first instance took place just after the Civil War, when life insurance became the main way for families to provide for the premature death of the wage earner. When death claims came in, some insurers avoided payment by claiming that a fatal disease—or a disposition to it—was not disclosed in the application. Popular resentment of this practice became so damaging to life-insurance marketing that in 1879 The Equitable (then the largest life insurance company), introduced an "incontestable clause" in which it gave up all grounds for denying a claim—except nonpayment of premium—after a policy had been in force for a few years. Other insurers adopted similar clauses, and soon the incontestable clause became required by law.

The second instance also occurred in the second half of the nineteenth century, when fire insurance was essential to the development of cities and industries. Competition among fire insurers was intense; paying higher commissions and reducing underwriting standards were common ways of competing. (They still are.) After a large fire, some insurance companies tried to avoid paying claims by invoking obscure warranties, limitations, or exclusions. Public resentment of these practices threatened to undermine the value and sales appeal of fire insurance. Reform ensued: fire-insurance companies lost the power to draft their own policies; states prescribed and required the use of a standard fire-insurance policy.

The third instance was in accident and health insurance, an important protection for workplace injuries before workers' compensation. Policies typically contained prohibitions against increasing an insurer's risk—changing work, for example—without the consent of the insurance company. When claims came in, some insurers would assert that the insured was doing different work at the time of the accident. Unscrupulous claims practices led to resentment, loss of confidence in the coverage, and, in 1911, a major investigation by the National Convention of Insurance Commissioners, which resulted in sanctions on individual companies, a proposed standard policy form, and the prohibition of certain practices (such as profit sharing for loss adjusters).

The fourth instance concerned cancellation and claims practices in automobile insurance. In the late 1940s, many companies cut back on their automobile writings, leaving those that didn't cut back with more business than they could handle. For a time, insurers coped by getting tougher on cancellations and claims. Responding to the public resentment, regulators and legislatures prohibited cancellations and unfair claims practices.

The remedies for the loss of the certainty effect for accident and automobile insurance were moderate and in keeping with the regulatory tradition of general guidelines and specific enforcement. The remedies for life insurance and fire insurance were radical: life insurers lost even the defense of fraud, and fire insurers lost the power to write their own contracts. History has shown that the radical reforms worked better.

Before addressing ways to prevent the loss of the certainty effect, we need to discuss one more economic characteristic of the present situation—that of externality, or unintended consequence. (Pollution, for example, is an unintended consequence of industrialization.)

Insurance companies have economic incentives not to pay each large claim. The damage to any one insurance company when it wrongfully denies a claim is slight and occurs some time in the future, whereas the benefits of refusing to pay a claim (longer use of float and a reduced cost) are immediate and inure entirely to one company. Cumulatively, however, individual companies' wrongful denials of claims lead to a loss of the certainty effect—which will ultimately hurt all insurance companies.

What can be done? Here are three possibilities that address loss of the certainty effect and the externality. All are essentially free-market approaches, or supports for them. Other approaches, including more coercive ones, exist as well.

Increased disclosure is one approach. Because insurers don't willingly open their claims files or disclose their overall claims practices, buyers can't see patterns of claims handling. But an insurance department in a market conduct examination, or a court in a punitive-damages trial, could require an insurance company to disclose its handling of all comparable claims. A business journal could survey big corporations about their experience with large claims during the past 20 years. (It's almost inconceivable that any publication would conduct a comprehensive study.) The ultimate objective would be for information about insurers' claims practices to become publicly available in a comparable format. While the foregoing techniques would tend to work on one insurer at a time, they could—and perhaps naturally would—lead to broader and more uniform disclosure.

A second approach would be product differentiation that would involve mak-

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ing dependable claims practices a visible and verifiable competitive advantage. Differentiation would be reminiscent of the incontestable clause. One insurer would lead and the others would probably stay skeptical long enough for the innovator to become entrenched. Then the market might force other insurers to adopt similar practices.

Differentiation might involve changes in policy text—providing for payment before litigation, or for the elimination of defenses. It might involve securitizing all or part of the risk. This would be difficult to do and the coverage would almost certainly cost more than today's coverage—unless it was so attractive and amenable to such fine underwriting that the innovator could attract the best risks.

A third approach would be to motivate insurance brokers and corporations to pay more attention to performance at the point of claim. Brokers, for example, could be held liable for an insurer's wrongful denial if it could be shown that the broker knew—or should have known—that the insurer had a history of not paying claims properly. Corporations, for example, might be more motivated to pay attention to claims-paying willingness if old or disputed insurance recoverables couldn't be carried on their balance sheets as assets, or if their directors were found liable when a claim was denied (assuming that the denial was by an insurance company with a history of such behavior). While this is a legal, accounting, or regulatory approach rather than a free-market one, it could lend essential support to whatever market approaches were taken.

If nothing is done to avert the loss of the certainty effect, today's unstable situation would most likely resolve itself in a downward spiral. Tight claims practices would become even tighter, then spread widely among coverages and companies. Coverage contests could get rougher, longer, and more expensive. Eventually, sophisticated corporations would decide that having commercial insurance for situations susceptible to large claims was disadvantageous and that insurance companies were inimical to their needs. They would look for alternatives. Leaders in the theory and practice of risk management, derivatives, securitization of risk, investment and commercial banking, and financial consulting would see that disaffection as an immense opportunity. The property-casualty insurance business for large commercial risks would start to go away.

Standing in the way of that bleak outcome are the three approaches above, and others like them—all of which are unlikely, difficult, and not certain to succeed. But the biggest failing of any remedy now is the lack of desire of any participant in the insurance transaction—insurers, brokers, policyholders, courts, regulators, lawyers, consultants, or commentators—to consider it, or to do anything about the certainty problem other than to fight over individual claims.

Ultimately, if nothing is done to prevent the loss of the certainty effect, it will indeed be lost, with unfortunate consequences for insurers and the corporate clients that stick with them. ■

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The unedited version of "The Loss of the Certainty Effect" can be obtained from Risk Management and Insurance Review *or Stewart Economics. The article is also available at www.stewarteconomics.com.*