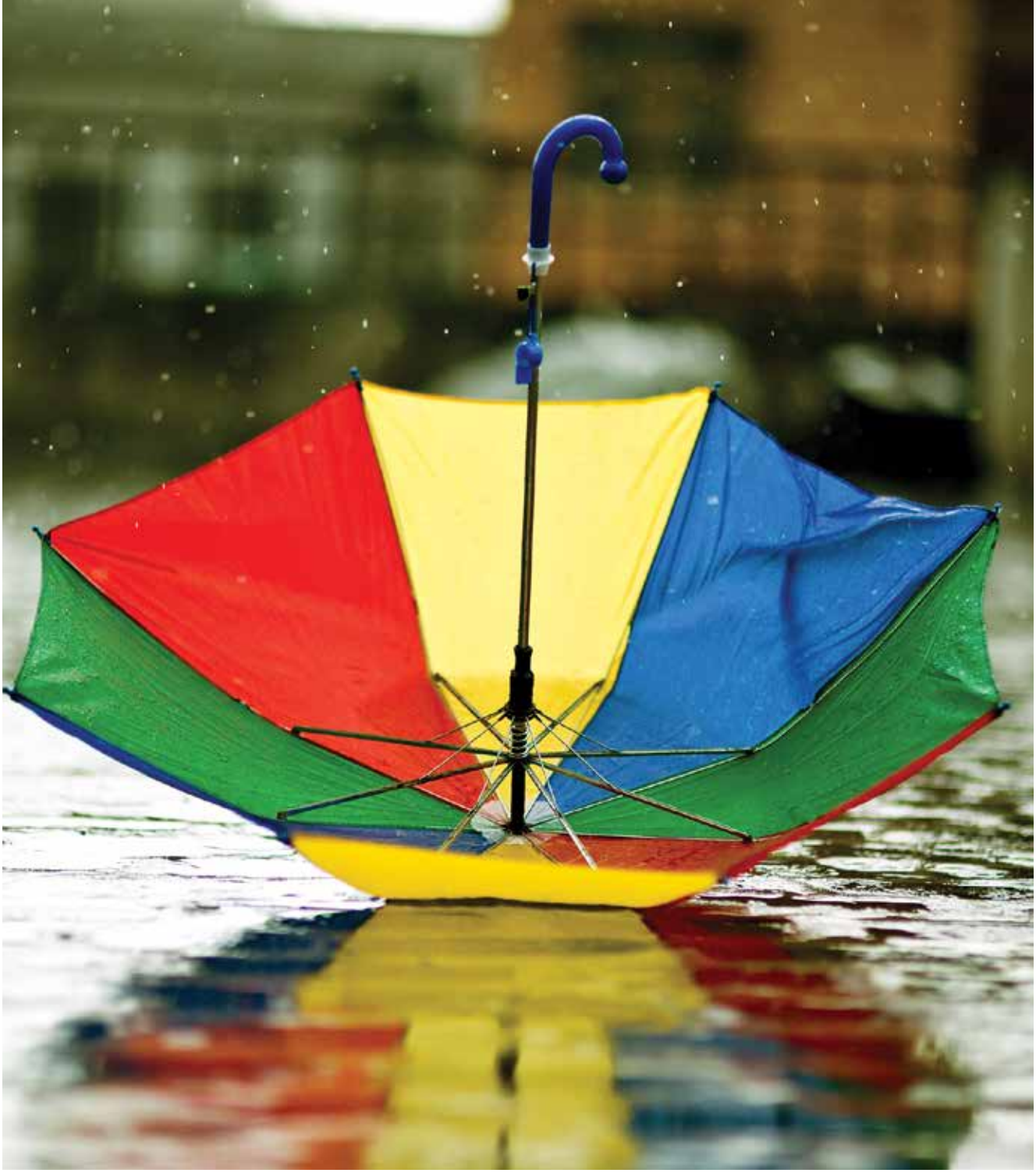


INSURANCE MODEL UNDER THREAT

A FUTURE OF COMPULSORY RISK SHARING?

FADY KHAYATT

Insurance is made possible through the pooling of risk. No one knows for certain whether or not they will be in a serious car accident in the coming year. Nor can other drivers predict whether they will have accidents. What can be predicted is that, say, 1 percent of all drivers will be in accidents. If enough drivers contribute 1 percent of the value of their cars into a fund that promises to pay for the replacement of cars written off in those accidents, then the fund will have enough money to pay for all claims on it for a year. By pooling risks, they can be converted into predictable ongoing expenses – insurance premiums, in other words.

Risk pooling is of great economic and social importance. Most valuable activities entail risk, from international trade to building power stations to performing surgery to playing rugby. If people could not insure themselves against the risks involved in such societally beneficial activities, then they would engage in those activities much less frequently and society would be much the poorer.

Yet risk pooling via insurance is under threat, for the apparently perverse reason that insurers are rapidly getting better at measuring risk.

Here's why.

Some insurees are riskier than others. Jack's chance of smashing his car might be twice Jill's. If the insurer cannot identify this difference, it will charge Jack and Jill the same premium. This means Jill pays for more than her share of the risk she contributes to the pool, while Jack pays for less. In other words, Jill's premiums will subsidize Jack's insurance.

If, however, the difference between the risk presented by Jack and by Jill can be determined and quantified, then the cross-subsidy will soon disappear. Even if their insurer were to decide nevertheless to charge Jack and Jill the same premium, Jill will soon be "cherry picked" by a competitor charging low-risk drivers lower premiums. Without Jill's inflated premium available to subsidize Jack's, he will have to bear the full cost of the risk he represents.

Risk pooling via insurance is under threat, for the apparently perverse reason that insurers are rapidly getting better at measuring risk

MORE ACCURATE RISK MEASUREMENT

Accurate risk measurement thus eliminates cross subsidies. And risk measurement is swiftly becoming more accurate.

Telematics, though hardly new, provides a good example. Devices installed in cars send insurers information about their policyholders' driving behavior and patterns and, thus, their chances of getting into an accident. Safe drivers end up paying lower premiums than risky drivers.

Telematics is but one example of the burgeoning "Internet of things." Homes and commercial assets are increasingly being fitted with sensors that can provide insurers with detailed real-time information about insured objects and their environments.

Nor is this explosion of monitoring and quantification restricted to objects. People are collecting far more data about themselves – for example, about their health – which many are keen to share with insurers in return for lower

premiums. Big Data analysis, by drawing on policyholders' Internet footprints, is able to paint an increasingly accurate picture of their circumstances and behavior.

Insurance pricing that accurately reflects the risk presented by individual policyholders has social benefits. In most cases, it incentivizes people to take actions that reduce risk, provided such actions cost less than what is saved on premiums. And they discourage activities that are not worth the cost when risk is properly accounted for. In other words, accurate risk pricing promotes economic efficiency.

THE DOWNSIDE TO ACCURATE RISK PRICING

But greater accuracy in pricing risk has its downside, too. Some people can find themselves suddenly priced out of an insurance market. Homes in areas that are prone to flooding, for example, may face premiums so high that they become effectively uninsurable. Or people predisposed to serious diseases may face health insurance premiums they cannot realistically afford.

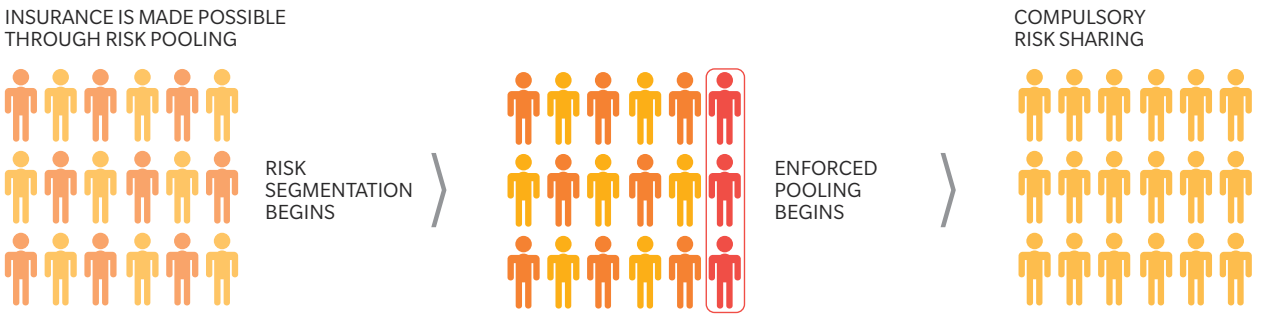
By making segments of the population effectively uninsurable, accurate risk-based pricing removes the benefit of risk pooling from precisely those who need it most.

How then can affordable insurance be made available to high-risk populations?

One approach that is increasingly being applied to the industry is to force low risk policyholders to subsidize high-risk policyholders. For example, after a spate of floods in England, the government of the United Kingdom will require insurers to provide flood insurance at capped premiums and has established a re-insurance fund (Flood Re) into which all home insurees must make the same contribution, regardless of flood risk. (See Exhibit 1.)

EXHIBIT 1: MOVING TOWARD MANDATORY POOLING

THE INSURANCE INDUSTRY IS MOVING TOWARD MANDATORY POOLING TO COPE WITH THE UNINSURABLE POPULATIONS CREATED BY MORE ACCURATE PRICING. BUT AS THE MANDATORY POOL GROWS, THERE IS LESS PRICE DIFFERENTIATION. HERE'S HOW IT WORKS:



Source: Oliver Wyman analysis

The difficulty with this approach lies in forcing low-risk insurees to remain in the pool. In the case of flooding, the small ratio of high-risk to low-risk homes makes the now transparent cross-subsidy small. However, in other areas, such as health insurance, mandated cross-subsidies may be large enough to drive low-risk insurees out of the pool. ObamaCare deals with this problem by imposing a fine on anyone who refuses to buy health insurance equal to 2 percent of his or her income.

Government policies that require people to buy insurance may look like a boon for the industry. But they could profoundly change the insurance business.

POTENTIAL OUTCOMES

When low-risk insurees are forced into insurance pools with high-risk individuals, their policies receive an implicit government guarantee. If the government makes you buy insurance policies, it must stand behind them. Insurers may end up in the position that banks now find themselves – not proper businesses but quasi-state utilities, where everything is under indirect political control, from risk management to pricing to staff bonuses.

Furthermore, where cross-subsidization is enforced across very large proportions of the population, capabilities in terms of risk selection and pricing that insurers have invested in so heavily become worthless, leaving insurers to compete on service and cost efficiency.

Insurers might argue quite correctly that mandated cross-subsidies place an unfair burden on low-risk insurees. Why should a less affluent woman living in an area not prone to flooding be made to subsidize the insurance of a wealthy man who has built a mansion on a floodplain? Why should a struggling healthy young musician subsidize the health insurance of a retired banker?

Targeted subsidies funded from general taxation might be a fairer way of keeping high-risk people in the pool. And it would allow insurers to remain independent, commercial businesses.

Rapidly rising risk and price differentiation raises a policy issue that must be answered. If insurers cannot come up with a good answer on their own, politicians may come up with a bad one for them.

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