Insurability and Uninsurability: An Introduction*

by Jan H. Holsboer**

In the past 22 years, extensive research has been carried out under the auspices of the Geneva Association into the assessment and management of risks. The Association's efforts have increased the awareness of uncertainty and risk as important factors in the economy and in society in general. As people become more aware of the risks they run, they will look more actively for ways and means to protect themselves to reduce those risks. They expect their governments to enact legislation which will alleviate the consequences of illness, disability, unemployment and other misfortunes. Depending on the extent of the protection offered by the State, they will also make their own provisions or buy insurance to minimize their risks. As people become better educated and more self-confident, they will increasingly try to pass on risks or damage resulting from these risks to others. This trend is boosted by the individualization of society. People stand up for their own rights and if the State or insurance do not safeguard these rights, they – at least in our part of the world – more often choose to go to court to defend them. These trends take us to our subject of “Insurability and Uninsurability”. In a recent poll amongst the members of the Geneva Association this topic stood out as their clear number 1 priority for further research.

In my introduction I would like to present a bird's eye view of some areas in which the problem of possible uninsurability manifests itself clearly. Being a representative of a Group which combines insurance and banking activities, I would also like to take a brief look at our subject from the point of view of financial conglomerates.

First, however, I think that it is important to look for objective criteria which can define whether a risk is insurable or not. There have already been numerous publications and discussions on (un)insurability. At a recent workshop of the Dutch Association of Insurers the following brief and clear definition was given: Uninsurability occurs when a prospective policyholder cannot buy the coverage he *reasonably* needs to combat the adverse consequences of damage resulting from an uncertain occurrence.

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** President of the Geneva Association and member of Executive Board of ING Group.

This can happen in three situations:

1. The insurance product cannot be made available.
2. The insurance product is available, but sufficient coverage cannot be obtained.
3. The insurance product is not affordable to certain groups because of its price.

It is obvious that especially in the second and third situation the designation “uninsurable” depends on a number of subjective factors.

In a report published by the Swiss Re on “Limits of insurability of risks” in 1992, Baruch Berliner gives nine criteria of insurability. They are: randomness of the loss occurrence, maximum possible loss, average loss amount upon occurrence, average period of time between two loss occurrences, insurance premium, moral hazard, public policy, legal restrictions and cover limits. Berliner defined that a criterion is satisfied if it confirms the insurability of a risk. The interpretation of these criteria depends, of course, of the subjective opinions of individual risk carriers. Berliner concluded that risks are objectively uninsurable if a certain insurability criterion cannot be considered as satisfied by any risk carrier.

Within the time limits of this introduction, it is by no means possible to give a comprehensive survey of all the areas in which insurers are confronted with the question whether certain risks are uninsurable. Therefore, I will restrict myself to a number of classes of business in which the problem of uninsurability is clearly apparent.

Starting with *life insurance*, the ageing population in many countries is an important development in connection with our subject. While the working population in our part of the world is declining, the percentage of people older than 65 is on the increase. A historical decline in the birth rate and improved health care provisions are the principal causes of this development. The result of these demographic changes is that an ever smaller working population will have to support an increasing number of dependents, which puts pressure on government pension schemes. There is serious concern in many countries about the future affordability of State pensions and other social security coverages. Governments are stimulating their citizens to build up supplementary provisions themselves. Governments often support these initiatives by allowing tax facilities for life insurance premiums. We also witness how more and more companies and institutions are arranging pension or savings schemes for their employees. The future for the private life insurance industry looks bright with great opportunities for growth in both individual and group life insurance. The increase in the life expectancy of the average citizen has, however, also a negative effect on the existing book of business of pension insurers. They will have to reinforce their reserves substantially in order to be able to absorb the financial consequences of this longevity risk.

If genetic technology should be applied on a larger scale, the question even arises whether it is justified to continue to offer open-ended pension contracts.

It is obvious that genetic technology will have substantial implications for life as well as for medical insurance. Scientists are making significant progress in this field and within the insurance industry there is much discussion how genetic technology and particularly genetic engineering may impact their present and future books of business.

The general view is that a complete genetic passport will not become available on a large scale because of the substantial costs involved and the enormous computer capacity required to make such a passport. However, the use of genetic technology to test vulnerability to a certain disease will probably become more widespread in the near future. In essence, insurers should be able to have access to the same information as their prospective

policyholders in order to be able to make an accurate assessment of the risks they accept. Genetic engineering is quite another matter. It is currently applied to produce insulin or vaccines. Insurers regard such use as a positive development because it fights or prevents certain diseases. However, if genetic engineering should be applied to change the hereditary traits of humans, the basic principles for underwriting life and medical insurance will be completely overthrown, probably resulting in the verdict "uninsurable" for the greater part of the risks offered for insurance.

Medical and disability insurance are on top of the political agenda in many parts of the world. Higher standards of living have resulted in ageing populations in most developed countries. Simultaneously, medical science has made enormous strides forward to improve the quality of life and to prolong life. These developments have resulted in a dramatic increase in health care costs and this poses a problem to governments, private insurers and consumers.

In many countries where medical and disability insurance are largely provided by the State, we see a debate on a reduced role for the government in offering these provisions due to budget constraints. In the United States, on the other hand, where these types of insurance were left entirely to private enterprise and where soaring medical costs have put medical insurance beyond the financial reach of large sections of the population, we hear a call for increased government participation.

The privatization of medical and disability insurance presents substantial opportunities for private insurers and will also entail new tasks for them. In addition to providing tailor-made insurance coverage, they will be concerned with related activities such as improving working conditions and reducing absenteeism.

However, the privatization of these types of insurance also constitutes a danger and that is the possible uninsurability of people who are considered adverse risks according to the underwriting criteria of private insurers. Solidarity between normal and adverse risks can usually only be realized through legislation. Therefore, the government and the private insurance industry should cooperate closely to ensure that adequate medical and disability cover can be provided for all citizens in a cost-efficient manner.

As a personal side note, I would like to express the opinion that the extent to which a nation is prepared to make and keep pensions, medical and disability provisions insurable, is an important indicator of the degree of civilization of that nation.

While in several types of insurance, the possibility of uninsurability is a relatively recent phenomenon, it has always been one of the main topics concerning the insurance of *catastrophe risks*. Insurers in the Netherlands, for instance, have never covered the risks of earthquakes and floods. Especially the latter is not surprising in our "Low Lands" country of which vast areas are below sea level. If the dikes which protect the densely populated province of South Holland were to break through, the loss incurred could amount to more than a hundred billion guilders. This exceeds the total capacity of the entire Dutch insurance industry by a considerable margin. The debate for some form of insurance against disasters was revived when a flood of the river Maas caused considerable damage to properties in the southern part of the Netherlands last year. So far, the Dutch insurers and the government have not been able to come to an agreement, contrary to, for instance, France, where the government and the insurance industry have succeeded in developing a disaster policy. In essence, however, insufficient statistical data, the magnitude and the number of losses, possible adverse selection in catastrophe-prone areas and limits to claims handling capacity,

make it virtually impossible to provide adequate private insurance cover against large-scale natural disasters. Recent studies which suggest a connection between global warming and an increase in the frequency of natural disasters as well as between the thinning of the ozone layer and the increase in skin cancer are aspects on which I cannot elaborate within the scope of this introduction, but which certainly complicate the problems related to coverage of catastrophe risks.

Liability insurance is a class of business in which uninsurability is one of the main topics. Throughout the world the amounts and the frequency of claims have risen substantially. Consumerism, supported by legislation and a rising trend towards litigation, is the principal reason for this increase. The liability problem is most serious in the United States where, in my opinion, judges are awarding damages which are totally out of proportion compared with the actual losses incurred. With close to 800,000 lawyers on a population of 250 million, and with lawyers offering clients their services in return for a percentage of the damages on a no-cure-no-pay basis, the U.S. legal system has gone out of control. Moreover, legislation with respect to, for instance, pollution with retro-active and joint and several liability for claims incurred 30-50 years ago, implicitly forces an unacceptable pay-as-you-go burden on and unfair competition within the private insurance industry. Insurance premium rates in some cases have risen so exorbitantly and policy conditions have been tightened to such a degree that some professionals were forced to stop their activities because they were unable to obtain adequate insurance coverage. This trend has potentially a paralysing effect on current economic activities and on new initiatives. There is serious concern that with the ongoing internationalization of society, the trends in the American jurisprudence system will also be adopted by European lawyers and judges. Recent verdicts in liability suits in Europe seem to confirm this concern. Technological developments have also contributed to higher liability claims. Doctors and psychologists are now able to prove connections between past accidents and injuries which occur many years later. Whiplash claims, which constitute an ever larger proportion of the claims burden of motor insurers, are an example of this. Long-tail product-related claims are one of the most serious concerns in the field of liability insurance. The prevalent system of liability coverage based on claims occurrence apparently leads to open-ended obligations which cannot be quantified and are thus uninsurable. Especially in the London market, long-tail claims have already played havoc with the infrastructure of the market. I find it difficult to understand and accept that infrastructure of the national supervision systems is unable to offer adequate protection against this international threat to the insurance and reinsurance industry. Apparently, the informal market regulation is not an appropriate response to avert this threat to insurability either.

I would like to say a few words about crime and insurance fraud. Many countries are confronted with an alarming increase in crime. Unfavourable economic conditions are an important reason for this development. Open borders and communication have revealed large differences in affluence between countries and the resulting influx of large numbers of economic and political refugees is causing problems in several western countries. A growing number of criminal organisations which are active on an international scale, declining moral values, the higher density of the population and integration problems of immigrants are other causes for the increase in crime. This increase presents a serious danger to the insurance industry. Certain risks, such as burglary-prone companies (computer, consumer electronics, textiles) and objects and properties in large urban areas are virtually becoming uninsurable due to an excessive claims burden.

The insurance industry tries to counteract this development with measures such as geographic premium differentiation, premium reductions for policyholders who have installed safety devices and investments in publicity campaigns to stimulate prevention. Nevertheless, this action seems insufficient to reduce the losses incurred from crime. Insurance fraud is a specific problem, which is aggravated by the fact that it is not regarded as a crime by large sections of society, but as the pardonable sin of "robbing the rich". Conservative estimates in the Netherlands indicate that approximately 3.5% of all claims are fraudulent. Similar estimates in the United States even show 10%. The combat against insurance fraud also requires more drastic government action as it currently does not rank high on the priority list of the police.

The problems discussed regarding several lines of business do not only apply to direct insurers, but also to their reinsurers. As a result, insurance companies sometimes experience difficulty in obtaining adequate reinsurance cover, especially for catastrophe provisions. Therefore, insurers are more often forced to decline risks or accept higher proportions of risks for their own account, which can endanger their solvency.

Consequently, insurers are looking for other solutions to solve their reinsurance problems such as financial reinsurance constructions. Nowadays, banks are also actively moving into this field with creative reinsurance solutions, risk swaps and risk transfers (derivatives). They are thereby penetrating a domain which was traditionally dominated by insurers and reinsurers.

Having made the bridge between insurance and banking, I would also like to touch briefly on the risks which face financial conglomerates. Even in integrated financial services companies such as ING Group, we have to make a clear distinction between insurance and banking risks because of the different nature of these activities and the different regulations which supervisory authorities pose to insurers and banks. The distinction becomes less clear as companies increasingly offer products which combine insurance and banking aspects. In my opinion, financial conglomerates do not proportionally run higher risks than individual insurers or banks. For any financial services company, it is absolutely essential that the management is able to make a precise assessment of all the risks which the company runs. This becomes more complex as the activities become more diverse. The management of a financial conglomerate is thus confronted with the challenge of developing an overall risk management system which enables continual, adequate assessment of the risks the company runs in its various activities. Within ING Group, risk management is considered a top strategic priority. Therefore, we have created a special department for risk management at group level. Risk management at group level concentrates on aggregation of risks beyond the borders of the several management centres, concurrence of risks, audit on risk management control systems and identification of possible "blank spots" in our risk management. We have divided the risks we run as a financial conglomerate in three main categories:

- **counterpart risks**, which comprise, among other things, credit risk, reinsurance risk and country risk;
- **market risks**, such as interest risk, currency risk, liquidity risk and other market risks;
- **underwriting risks**, for both banking and insurance-activities.

Although ING Group has only three years' experience as a financial conglomerate, we see a trend that the variety of the Group's financial services and the wide geographical spread of our activities make the development of the total profit more stable than the results of our individual business units.

Reliable risk management systems and procedures which adequately allocate income and surplus at stake are also important ingredients to define the limits of (un)insurability. In my opinion, the assessment and management of risks within financial conglomerates could be a challenging new research topic.

Finally we should recognize that insurance risks are not exclusively confined to the liability side of the balance sheet. Also investments at the asset side can pose serious risks and restrictions to the insurability.

I have already touched briefly on a number of aspects relating to risks and to the insurability or uninsurability of these risks. The individualization of society will continue, especially with technological developments such as the electronic highway which gives consumers access to a variety of services and a wealth of information through their TV or personal computer. The insurance industry tries to respond to the process of individualization with premium differentiation according to age and geographical area, reductions related to claims prevention measures, bonus-malus systems, etcetera. The ongoing technological developments enable insurers to make a detailed assessment of individual risks and consumers are increasingly making a thorough analysis of the premium rates and conditions of several companies. In spite of all these measures, insurers will more often come to the conclusion that risks are uninsurable. Ultimately, the question of insurability or uninsurability hinges on one word: solidarity. In its fundamental form, solidarity is a strong connection within a group of people or risks who support each other on a voluntary basis when one of them is struck by disaster. This elementary form of solidarity is the basis of the insurance industry in which people build up a fund from which assistance can be rendered if one of the contributors suffers a loss. The system is based on an assessment of the income and expenditure of the fund and premiums are calculated on the basis of the risks involved.

In the case of social insurance, there is no balance between the income and expenditure per individual and therefore this type of insurance can only operate on a compulsory basis where one part of the population subsidizes the other. As remarked earlier, many governments are reducing their involvement in the provision of social insurance and are giving more scope to private enterprise. By doing this, they are making these types of insurance more dependent on the voluntary solidarity within society. The limits to insurability are determined to a considerable degree by the limits to solidarity. Insurers will not be able to provide insurance cover if there is insufficient solidarity among their prospective clients. With ongoing individualization, solidarity tends to decrease and uninsurability could increase for many types of insurance.

One might assert that governments are primarily responsible for covering uninsurable risks and that the insurance industry can only assist in this process in an executory capacity without accepting financial responsibility.

Conversely, one might argue that insurers have the social responsibility to cover uninsurable risks, which they can subsidize from profitable lines of business. A remarkable example of social responsibility in another area of the financial services industry was recently displayed by Fleet Financial Group (USA), which committed a programme of \$8 billion to improve access to credit for low and moderate income families and small business including a substantial amount in the form of direct grants.

Though I immediately acknowledge the social responsibility of the insurance industry, I would not like to defend the proposition that insurers should subsidize uninsurable risks from their profitable lines of business. This would erode the financial basis of the insurance industry.

In my opinion, it is the joint responsibility of governments, the legal profession, financial services companies and consumer organizations to ensure that risks can be controlled in *all fairness* and thus remain insurable.

I believe that this introduction has made it clear that a vast amount of research still needs to be carried out to gain a better understanding of all the trends and developments in our industry and to provide answers to the questions that confront us.