

■ VARIABLES QUESTIONED

Insurers Pile On To Consumer Hardship

BY GREGORY D. SQUIRES

AT A TIME WHEN greater transparency in financial services is called for and many are suffering from the collapse of financial institutions and other key sectors through no fault of their own, the insurance industry seems committed to greater opacity, and indeed, compounding the hardship of working families.

The advent of education and employment status as underwriting criteria for property insurance, particularly automobile, is just the latest manifestation. This "innovation" by the industry also undercuts a core underwriting objective.

Use of education and employment in the underwriting of property-casualty insurance undermines a key function of insurance—discouraging irresponsible behavior and incentivizing responsible loss prevention. It also exercises an adverse disparate impact on racial minorities, despite protestations to the contrary by some within the industry. Consequently, some of the most vulnerable segments of the population are hurt.

The issue is NOT whether risk or cost-based pricing and underwriting tools should be utilized.

Robert Hartwig of the Insurance Information Institute appropriately asserted in testimony before the Florida Office of Insurance Regulation in February 2007: "Society also benefits from risk or cost-based pricing. High auto insurance premiums offer poor drivers a significant financial incentive to improve their driving behavior, thereby reducing accidents, injuries and fatalities. These are socially desirable outcomes whose benefits are diminished when restrictions on actuarially valid underwriting criteria result in premiums that are less than accurate messengers of risk."



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In other words, he said, "when the message itself is statutorily redacted—in some way blurred, garbled or lost—the consequences for society are unambiguously negative because the incentive to improve driving behavior is diminished."



► **UNDERWRITING VARIABLES** like education and employment status provide no incentive for responsible behavior.

But statistical correlation is only one part of sound underwriting. If the variable associated with loss has no intuitive relationship to the actual cause of loss, particularly if that variable is something over which the insured has no control, then there is no incentive for responsible behavior.

In fact, just the opposite might be the case. If a driver believes his or her rates will be determined, even just in part, by education, occupation, credit score, or some other factor that has no common sense relationship to the cause of loss—and is something they cannot readily control anyway—no additional positive incentive is provided.

It is precisely the use of such factors that sends a blurred, garbled and perhaps lost message to most policyholders.

Use of such criteria is particularly problematic in the current economy, with many people losing their jobs. Now in addition to losing their income, health insurance and often their very sense of identity, they will also suffer the indignity

of higher insurance premiums.

Does the industry really want to be viewed as piling onto vulnerable populations, particularly at a time when they are most vulnerable?

There are racial implications as well. Even assuming education and occupation predict loss, there cannot help but be an adverse disparate impact. In 2007 among people 25 or older, 28 percent of whites were college graduates compared to 17 percent of blacks and 12 percent of Hispanics. And any other education level or occupational index will yield a similar pattern.

This current debate reflects longstanding controversy over the question of race, ethnicity and socio-economic status in the pricing, underwriting and marketing of property insurance. It is long past time for the industry to provide a level of transparency that the mortgage lending industry has provided for more than 30 years.

Insurers should be required to publicly disclose the race, gender and income of applicants and the disposition (such as approved or denied) of those applications. Given the importance of location in most underwriting schemes—and the close association between race and place as well as poverty and place—the geographic location of where insurers are writing, renewing, nonrenewing and cancelling policies should also be disclosed.

Through the Home Mortgage Disclosure Act mortgage lenders have been doing this for decades without revealing the identity of any individuals or families or any trade secrets of any lender. Confidentiality has been maintained. And it has worked.

Douglas Duncan, senior vice president for research and business development and chief economist with the Mortgage Bankers Association, recently told the House Subcommittee on Financial Institutions and Consumer Credit: "MBA uses HMDA data to assist its members in analyzing the industry's performance in serving the nation and identifying new markets and investment opportunities...The data fairly

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P-C SURPLUS DROPS

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cutting measures, such as higher retentions and lower limits, the report said.

As the falloff in demand produces a top-line premium drop across the industry, the economic crisis will also directly impact the incurred losses due to fraud, increased professional liability lawsuits and higher workers' compensation payouts.

But in the current depressed economic environment, increased losses will not drive premiums up until policyholders' surplus "becomes more drastically reduced," Advisen predicted. "Such loss increases will merely serve to strain insurance companies' balance sheets through at least mid-2009."

NOT THE GREAT DEPRESSION

Mr. Hartwig drew his own analogies to the Great Depression but easily pushed aside direct comparisons by presenting some historical numbers.

Although 2007 and 2008 did indeed mark the first consecutive years of negative premium growth since 1930-1933, he said estimates from I.I.I. indicate that premiums written fell by a staggering 35 percent over a four-year span from their 1929 peak through their 1933 trough.

In addition, during the Great Depression policyholders' surplus fell by an estimated 37 percent, contrasting the 12 percent dip of 2008.

"The bottom line is that the impact of the current financial crisis on p-c insurance, as bad as it is, is not even remotely close to the impacts experienced during the Great Depression," he said. "Indeed, premiums, surplus and assets will likely return to their pre-crisis levels within a few years, [while] it took 10-to-12 years (i.e., until 1939, 1940 or 1941) for these same financials to recover in the wake of the Depression."

Likewise, Advisen expects a quicker recovery. When policyholders' surplus as a percentage of GDP is declining, "supply is shrinking relative to demand and a hard premium market usually follows," the Advisen report said.

While both policyholders' surplus and GDP have been dropping, the level of decline in the GDP is becoming "less dramatic" than policyholders' surplus, "and continual large declines in GDP are unlikely to persist beyond midyear," the report said. ■

FORMER CEO BANNED

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Mr. Vukelic was CEO from August 1997 until October 2002. During that time Mr. Vukelic was responsible for overseeing and structuring three different transactions that were designed to allow the client insurance companies to hide very significant losses in their accounts, the FSA said.

Mr. Vukelic, according to FSA, knew that the deals were not genuine reinsurance transactions and that they could be used to mislead the clients' auditors.

It noted that two of the three client insurance companies subsequently collapsed with wide-ranging consequences.

The Tribunal found that Mr. Vukelic had "turned a blind eye" to the true nature of the contracts and was "reckless as to whether they were intended to mislead auditors and others."

Margaret Cole, FSA director of enforcement, said in a statement: "This case has been fought every inch of the way by Mr. Vukelic. We are determined to take whatever action is necessary to ensure that individuals should not avoid the consequence of their actions. The Tribunal rightly criticized his persistent failure to recognize his shortcomings.

"Those carrying out senior functions in regulated firms need to be clear that the FSA will hold them to the highest standards of behavior and will take action against those who fall short. There is no place in financial services for the sort of behavior demonstrated by Mr. Vukelic."

FSA said Mr. Vukelic ceased to be an approved person for the industry in July 2005.

He is the second executive connected to a Gen Re subsidiary against whom the FSA has taken action in the past two years.

INSURERS ADD TO HARDSHIP

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present a picture of the industry's work, offering information to further effective investment and, where appropriate, provide flags for further regulatory review."

Federal Reserve Board Governor Mark Olson told that same subcommittee: "The data prompt discussion, investigation, analysis and research that may deepen our understanding of why these patterns occur and allow us to increase fairness and effi-

In 2006 John Byrne, a reinsurance specialist with Cologne Re, was prohibited from working in the industry for five years.

Separately, in the U.S. District Court in Hartford, Conn., on April 2, Judge Christopher E. Droney's sentence for Ms. Monrad was the fourth sentence he has handed down to executives for the roles they played in a sham insurance scheme involving American International Group.

In addition to the prison term, Judge Droney sentenced Ms. Monrad to three years probation and fined her \$250,000.

Ms. Monrad was found guilty in February of last year of conspiracy, securities fraud, making false statements to the U.S. Securities and Exchange Commission, and mail fraud.

Ms. Monrad and four others were convicted of creating two sham insurance deals. The deals increased AIG's loss reserves by \$250 million in the fourth quarter of 2000 and \$250 million in the first quarter of 2001. An investigation forced AIG to restate its earnings in 2005, costing shareholders more than \$500 million.

Others sentenced in the case were Ronald E. Ferguson, Gen Re's former chief executive officer; Christopher P. Garand, former senior vice president and chief underwriter of the company's finite reinsurance operations in the United States; and Christian M. Milton, a vice president of reinsurance at AIG.

Mr. Ferguson was sentenced to two years in prison and fined \$200,000. Mr. Milton was sentenced to four years in prison and fined \$200,000. Mr. Garand received a year and a day in prison and was fined \$150,000.

The fifth defendant, Robert D. Graham, formerly Gen Re senior vice president and assistant general counsel, is still awaiting sentencing. ■

ciency in the home loan market."

Loss costs, of course, are central determinants of the pricing and underwriting of insurance. Loss information should also be publicly disclosed so it is clear for all to see why insurance availability and pricing take the patterns that they do.

Simply asserting that risk, and risk alone, accounts for the pricing and underwriting of insurance is not sufficient.

It is time for the property insurance industry to finally step out of the shadow and let the sun shine in. ■