The Tides of Hazard

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Insurance companies feel misunderstood. They state their beliefs and are judged tedious. They shut up and are judged secretive. Journalists poke fun at them. Regulators chase them about.

Insurance companies and human beings indeed can have a strained relation. They are not, after all, brought together in life's happiest moments. They trade in fear and grief, in ashes, blood and money.

The strain is natural. But it is unfortunate and unnecessary. Of all our great business institutions, insurance is perhaps most intimately involved with people individually and with people as a society. Both society and the insurance business affect how well the other functions. Crucial to both is that they have complementary objectives.

Insurance is involved with society in many ways, but three are fundamental to whether insurers will prosper and be useful and content.

First, the business of insurance works best when the insurance bet that an unfortunate event will not happen is supported by private and public decisions that the event should not be allowed to happen. Insurers assist society's effort by making visible the costs of the event, and they benefit as the event is brought under control.

Second, insurance works worst when it is betting against society's efforts. That can happen with the insured event itself, but these days it is more common when society sets out to shift the cost of the unfortunate event from the victim to others and insurers stand against the trend.

Third, private insurance can end up working not at all when the insurance mechanism itself becomes the main object of society's efforts to deal with the costs of unfortunate events.

Let's look at those three kinds of social involvement one at a time.

When society is trying to suppress the insured event, the reasons insurers tend to do well is simple. Insurance prices begin with a reckoning of past insurance losses. If society succeeds in its efforts, then losses, measured against the values or activities insured, will decline over time. The losses of the future will be lower than the losses of the past. Prices will consistently exceed the related costs, which lie in the future. The difference will be profit, capital generation and the desire to write more insurance.

The trend which matters here is in insured loss costs compared to the economic value of the property or activity insured. When losses in that sense are declining, doing an insurance business will resemble what is known in the computer business as riding the downward cost curve.

Such changes will occur over long periods of time. They may be likened to tides. Insurance cycles, like waves, will come for other reasons regardless of which way the tides are moving.

There is quite a record of these tidal trends in insurance losses and of their effects and causes. Here are some examples.

Life insurance is the clearest and best known. For three hundred years rates have been based on tables of past mortality. Meanwhile, lifetimes have lengthened due to better diet, public hygiene, medical care and working conditions. From time to time the mortality tables have been made more recent, but it has never been their function to anticipate.

The fortunes made in life insurance in the nineteenth century are often described as triumphs of salesmanship. They were that, but it is important that what was so expertly sold was also so consistently overpriced.

The examples are less obvious but no less real in property and casualty insurance.

The oldest line of insurance is ocean marine. Nineteenth and twentieth century improvements in ship design, navigation, seamanship and the stowage of cargo made voyages safer and safer. Ocean marine rates tended, therefore, to be too high. Insurers prospered, as they did later when insuring aircraft.

In fire insurance, rates proceeded from an astute judgment a hundred years ago about burning costs. For a long time thereafter rates were not modified by experience at all.

Construction improved, with fire resistance prescribed by law. Supplying water and fighting fires became duties of government. Fires happened less often and were less severe. By habit and agreement, rates stayed the same. Money was made.

When workers' compensation was introduced in the early twentieth century, its mysteries called forth a new statistical science. Doctrines of credibility required much past experience for making future rates.

Meanwhile, industrial safety improved. The number and severity of injuries went down. As long as benefit schedules and claim attitudes remained the same, the effect was to bring insurance losses down too. Credibility theory stayed the hand of the rate cutter. Experience in workers' compensation was favorable for many, many years.

The pattern holds in the largest property and casualty line of all. Since the first world war, automobile insurance losses, in relation to the number of vehicles and miles driven, have been going down.

The reasons were better roads, better cars, two wars, a depression and an assimilation of the car to our national character so complete that it became the only appliance to be taught in the public schools.

As the unit cost of auto accidents came down, so did insurance rates. With perfectionist actuaries and imperfect competition, the decline was unhurried.

This happy condition endured until the breakup of the pricing cartel and the price pressure of the direct writers took out of automobile insurance the general or sociological profits. Getting back on the downward cost curve through exquisite rate classification, tried at one time or another by all types of companies, has not been as easy as it looked.

Yet even here the problem is economic. The physical trend is still probably favorable.

This survey of downward loss trends leads to the question why they occur, why the insurance bet and the social resolve so often support each other.

The question leads back to the observation we started with. Insurance is an intensely social institution, reflecting what people do and make, own and think.

The same events and worries which call an insurance into being and make people want to buy it may also animate people in other ways.

People may demand other protection from what they fear, be it sickness, death, injury or the destruction of property. They may move government and other institutions to protect them. When that happens, the same alarm which created the insurance will have started a greater effort to control the insured event.

The effort may be public or private, coercive or voluntary, coordinated or diffuse. It may involve penalties, subsidies, warnings, encouragement, prohibitions and the whole regulatory array. When a private misfortune becomes a public concern, society has a lot of resources.

Insurance, in turn, helps society by informing it in advance of likely future costs and savings. The record is long—iron hulls and safe stowage, sprinklers and fire alarms, guarding machinery and rehabilitating the injured, safer grain dryers and safer cars.

The insurance business benefits from society’s effort to control the insured event. The business assists the effort by making the cost of the event clear in advance. The relationship is symbiotic and stable, pleasant and profitable. It belongs in every glorification of free enterprise.

Not all insurance loss trends, however, are downward. Tides can run both ways. Here is the second engagement of insurance and society—opposition.

Sometimes the problem is just that coverage is so designed that costs go up instead of down as society achieves its goals. Obsolete mortality tables have done little for annuity companies and pension systems except cause trouble.

But there is a more complex, expensive and, thus far, intractable example of the second or adversary involvement of insurance with society. It is where society is trying to reallocate costs through the insurance mechanism and the insurance business, rather than staying neutral and just holding the stakes, is trying to stop society from doing so.

Exactly that has happened in the last ten or twenty years in liability insurance. The immediate cause is not, as is commonly supposed, the ingenuity and aggressiveness of the plaintiffs' bar. Plaintiffs' lawyers have been trying to broaden the rules of recovery from time immemorial. What is new is that in the last couple of decades they have begun to succeed in a big way.

The deeper reason is that, in liability insurance, not one but two social forces are at work. As far as insurance is concerned, in recent years the two forces have contradicted each other, and lately the second has overwhelmed the first. Here's how.

Insurance losses involve an event and its financial consequences. Typically the event is physical—the blast, crash, fire or death.

In some classes of insurance, the event is connected to its financial consequences only by contract, the insurance policy. That contract is the decisive social arrangement. Changes in interpretation will tend to be gradual, because society has an important interest in consistent and predictable enforcement of what people agree to.

Where the link between event and consequence is simply contractual, long trends in losses will depend mainly on the physical event. As society controls the event, the benefits will flow directly into the insurance system through declining losses. That is true today in life, health, property and marine insurance and in bonding.

But in the liability classes, the event is connected to its financial consequences not just by contract but also, and more importantly, by the system of civil legal liability or tort.

In the United States, with much individual freedom in personal and economic behavior, the tort system is an important way of allocating costs and limiting behavior. Like our other social institutions, the tort system will change over time in response to the citizens who operate it and to pressures from outside.

Where the tort system connects the physical event and the financial consequence, society can modify not just one but both steps in the insurance loss. It can suppress the event and it can make the tort law link more or less generous.

As long as the tort rules remain the same, regardless of their level of generosity, insurers can stabilize and cover their costs. The benefits of society's control of the insured event can flow unimpeded into the insurance system just as in first party lines.

The conventional statutory, contractual, underwriting and rating techniques for stabilizing and covering liability costs were developed at just such a time, one when the rules did remain the same.

Yet the very apprehension and sympathy which created the demand for insurance and moved society to control the insured event can lead to an expansion of the ability to shift losses. That has happened in recent years and it continues. The tort law link becomes more generous.

Consistent and predictable interpretation of the insurance contract gives way to society's stronger need to fund the changes in the tort system. Brushed aside is the legal artistry of the insurance contract, now seen as printed by the strong for the weak to sign.

Part of our problem with the tort expansion is psychological. In the past, we not only allocated costs but we also understood the rules of allocation and even had substantial influence over what the rules were. We wrote the insurance contracts and, by and large, the courts respected them.

Now society has taken over the design of the cost allocation rules. It does so by uneven judicial decisions. We insurers still pay under the allocation rules, but we no longer make those rules or even know what they are.

Suddenly powerless and frustrated, but still quite human, we lash out. We identify as the problems society's effort to shift accident costs away from initial victims and society's effort to internalize to economic activities their accident, health and environmental costs. We change from society's stakeholder to its opponent.

Opposing such tidal change with the conventional legal and pricing techniques developed in calmer times has cost the insurance business a lot of money. Society wants to shift more, not less, of the costs of the unfortunate event, and betting against its ability to do so has about as much chance of success today as betting in favor of fires would have had a hundred years ago.

Futile perseverance in the second, or adversary, relationship with society sooner or later leads to the third—where insurance itself becomes the main social or political issue.

Recently we have seen it happen in property insurance in central cities, health insurance for the elderly, surety bonds for minority contractors, liability insurance for physicians and automobile insurance for people rated up for reasons beyond their control.

What those instances have in common is sudden change and a public view of insurance as an unsympathetic but not inaccessible part of the problem. Their common danger is that society will go feverishly to work, not on the insured event but on the insurance mechanism.

The debate can shift away from the cost and control of hazardous behavior and toward questions of who wins and who loses and who gets to make the big decisions.

Once society's concerns take that form, it is rare indeed for private insurers to come out ahead.

The best hope for private insurers is that the social debate never center on them. Avoiding the third involvement with society depends on success in the other two, on being recognized as naturally supportive of what society is trying to do about unfortunate events and their costs.

The three powerful social forces—to suppress the insured event, to transfer its costs, and to compel insurers to spread them strangely—spring from similar human concerns. They come together intricately, changeably and with great impact on insurers.

Let's turn again to examples.

In automobile insurance, for over forty years critics have been asserting that insurance has no role in suppressing the insured event, and that shifting its costs through the law of negligence is inefficient and unfair. The proposed change has usually been to omit shifting the costs notionally to another individual before spreading them through insurance. Ten years ago it looked as though society was marching that way. Now the question is back in doubt and, ominously, society's attention has turned to the practices of insurance companies.

In fire insurance in central cities, just over twenty years ago experts looked to the high cost and limited availability of coverage as a useful spur to owners to fix up their buildings. Insurance was to be used to price the insured event out of the market. A decade later, urban riots and a different way of looking at urban decay made insurance itself the central issue. Insurers were forced to spread the costs, to make property owners elsewhere subsidize them and, one may suspect, to encourage them to happen.

Today, the kinds of insurance in which the interaction of the three forces is most confused and the outcome most in doubt are both commercial casualty lines—professional malpractice and product liability.

The setting is not auspicious. In commercial casualty insurance in recent years, money has been made not by the bearers of risk but by those who distribute it. For the insurer assuming exposures on a net basis, even the investment income on the longer asset float has not overcome underwriting losses, let alone generated capital to support growth.

Instead, profits have gone to brokers, whose commissions have risen in proportion to premiums, and to insurers with books of business balanced between primary exposures and reinsurance. Both have achieved entrepreneurial stability, while actuarial stability has eluded everyone. Perhaps it is a sign that a business is both exciting and unsound when all the profits are made by arbitrageurs.

Yet in malpractice and product liability, everything seems to be happening at once. Society is awakening to the prevalence of the insured event and setting out to suppress it.

Society is also encouraging the transfer of costs from victims to perpetrators. At the same time society is inclining to look upon insurance itself as part of the problem.

We insurers are not strong enough to resist any one of the three powerful social forces converging on the more troubled parts of liability insurance. Fortunately, all we need is a little inventiveness and an ability to assess how the forces will come together, for given a correct assessment we can relinquish our partisanship about the outcome and get on with the business we know—accepting risks which all can see but only we can bear.

What once upon a time we insurers found in property insurance, we must now create in casualty. For if we can just solve the riddle of how to insure expanding liabilities for contracting events, we will add them to the pleasures of the downward cost curve. Conversely, if we do not figure out how to write liability insurance in a way that assures stable markets for our customers and generates capital fast enough to support our exposures, we cannot expect forever to remain independent of either our customers or the government.

In summary, insurance made its first money in natural harmony with social progress, helping man tame hostile nature.

Then came accidents and questions of blame. We admit with small grace the inevitability of accidents—in the car, home or factory. But to get the kind of society we wanted, we made a tacit decision for accidents.

So insurance the adjutant of progress became also insurance the harbinger of the unmentionable costs of progress.

Caught between the America of the strong arms and the America of the huddled masses, how could insurance not itself at times become the issue?

All three trends, the ones we like and the ones we do not, are parts of the same society. We cannot take one without the others.

Nor can we demean our problem as nostalgia or futurism. Certainly some losses came down because American at one time let nothing stand in the way of economic growth. Certainly some have gone up in the interest of fairer allocation of resources now viewed as finite and only slowly growing. But the insurance business, inventive as it is, need not be just the messenger and victim of such obvious historical changes. If we can think, we surely have the freedom to act. We are not on, and do not belong on, the hidden agenda of any utopian socialist.

To succeed, to get back on the side of history, we insurers need first to acknowledge how very social an institution we are. Our problems and uncertainties are social. The gravity of our condition is not physical. The physics of our condition are not grave.

Once we understand who we are, and see both the greatness and the smallness of our role, we will find ourselves moving with the most powerful tide of all. It is the great effort by our society to reduce the unfair risks of living, to reduce the harm done by those risks, and constantly to broaden the concept of what risks are unfair.

Once back where we belong, we will be in funds and be in grace, and we will find that our most basic and most successful bet was to take civilization as our partner.