

*Patent Pending*

## **Transurance: Managing Moral Hazard, Adverse Selection, and Fraud**

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When an insurance company considers underwriting a new type of policy, two issues that are foremost in its considerations are how it will manage the potential for moral hazard and adverse selection. While Transurance gives insurers the opportunity to write more premiums at substantially less expense, insurers must understand these issues and deal with them appropriately.

### **Moral Hazard**

Insurers must guard against providing coverage to undesirable policyholders and the possibility that the insurance policy will induce some insureds to change their behavior in ways that increase the probability and severity of loss. In the area of personal lines insurance, moral hazard is an extremely important underwriting consideration because the beneficiary of the insurance recovery is the same person whose behavior may be affected. Insureds know more about their potential actions than insurers, and the relatively small amount of premium involved makes it uneconomic for insurers to spend much effort investigating policyholders.

Moral hazard is less significant for larger businesses because changing the behavior of many people takes more effort, requires more time, and is more observable. Furthermore, the adverse economic consequences of suffering an insurable loss for most businesses are significantly greater than the amount that is likely to be recovered from insurance.

Thus, it is fair to say that an insurer should be very concerned about the potential moral hazard that may result from writing Transurance on personal policies or for small businesses. Where Transurance is provided to large businesses, this hazard is not nearly as significant.

For large businesses, it is reasonable to believe that Transurance will increase moral hazard but only minimally and at the margins. Some insureds that were already susceptible to these hazards will become more susceptible with Transurance. Nevertheless, the vast majority of large companies are not prone to moral hazard. Consequently, the provision of reasonable amounts of Transurance will have little adverse impact.

In order to minimize the potential for moral hazard, Risk Innovations is limiting the amount of Transurance that its licensees can offer and limiting the provision of this type of coverage to very large companies. However, it is ultimately up to the insurers that are writing this coverage to ensure that the amount of coverage they provide is reasonable.

### **Adverse Selection**

The more important question facing insurers is whether they will be adversely selected against by businesses that are more prone to bad loss experience. For this to happen, Transurance would have to be very attractive to companies that are likely to have unfavorable loss experience and unattractive to most other companies.

Generally, when insurance people talk about adverse selection they are describing a conscious decision to buy insurance knowing that one's loss experience is likely to be worse than average. Like moral hazard, Insurers are generally much more concerned about adverse selection when it involves personal lines insurance or insurance for small businesses. This concern is well founded because individuals and small businesses may know their potential for loss better than an insurance company. Given the relatively small amounts of premiums involved in these policies, it is not economically feasible for insurers to do very much investigation into these types of policyholders.

Adverse selection is not usually a significant concern for large companies because they are too complicated for any one person or even a small group of people to adequately understand. Large organizations are an agglomeration of unique risks composed of many disparate parts that are constantly changing. Additionally, the premium amounts are large enough so that insurers can spend meaningful amounts of time and money attempting to understand the risks of these entities. As a result, it is unreasonable to believe that large companies with large retentions would have enough of an informational advantage over insurers to be able to adversely select against them.

Adverse selection typically occurs when a product has a weak value proposition to the average buyer, so that only buyers who know they are worse than the average risk contemplated by the insurer's underwriting model apply for, and ultimately purchase, coverage. A product like dental insurance is a good example of this. Given the high cost of this product relative to the coverage that is provided, dental coverage is much more attractive to people who know that they will need dental work. Given how strong the value proposition is for Transurance, it is unlikely that this issue will be an important cause of adverse selection.

The strong value proposition of Transurance and the lack of informational advantage that large companies have over large insurers all but eliminates the possibility for adverse selection because of some conscious decision that insurance buyers make. However, insurers must still guard against the possibility that they will end up with a bad portfolio of risks. To this end, insurers must apply their underwriters so as to select the best risks or at least, adjust the price of the coverage to take into account the insured's potential for loss.

### **Fraud**

It is important to distinguish moral hazard and bad loss experience from fraud. With moral hazard, an insurance company underwrites insureds that are careless or indifferent to loss experience. With adverse selection, insureds are merely using their superior knowledge to take advantage of an attractive insurance rate. This is very different from insurance fraud, where an insured tries to deceive its insurer into paying for a loss that is not covered by its insurance policy. For example, an insured may purposefully cause a loss and then seek an insurance recovery, as if it were an accident.

As with moral hazard and adverse selection, fraud is a much greater problem for insurers that offer coverage to individuals and small businesses. This is because the span of control is small enough so that a fraud can be carried out by an individual or a small group of individuals relatively easily. Insurance fraud by a large organization would typically require far more people to carry out and would be much more observable. Also, the large amounts of the loss involved would prompt a serious investigation by the insurance company.

### **First Defense**

The Transurer's first line of defense against moral hazard, adverse selection, and fraud are the measures that the primary insurer takes to guard against these problems. Given the greater amounts of limits that they are providing, the primary insurer has much more reason to be concerned about these issues than the Transurer.

Assuming that the insurer is comfortable with the customer's character and its loss potential, the insurer will then attempt to structure a policy that balances potential for loss and premium. This involves structuring the policy's deductibles, retentions, co-insurance, limits, and coverage terms so as to guard against moral hazard and setting a price that will provide an adequate return on the capital that it must have to support the risk.

After the policy has been written, the insurer will have proportionately much greater interest than the Transurer to review any claims that may arise. The insurer will take all steps necessary to determine if the cause of loss is covered by the policy and to determine how much of a payment should be made to the insured. To the extent that there are any reasons to suspect fraud, the insurer will conduct an investigation.

### **Second Defense**

Assuming the Transurer trusts the insurer's ability to underwriting and adjust losses, the Transurer can follow the insurer's underwriting. In this case, it will be happy to offer Transurance to any of that insurer's customers and price its coverage at the same rate (e.g. 30% proportional Transurance will be offered for 30% of the underlying premium).

However, the Transurer may not feel comfortable enough to rely on the work of the insurer. The insurer's pricing, its risk selection, coverage terms, or its loss adjustment processes may be suspect in the eyes of the Transurer. In this circumstance, the Transurer must first decide if it wants to take that particular exposure. Assuming that the exposure is desirable, it must decide how much Transurance it is willing to offer and how much it will charge for the coverage it provides.

Like any insurer, the Transurer can guard against the potential for adverse selection, moral hazard and fraud via a prudent risk selection process. If they do not like a particular risk, they are not under any obligation to take it. Like traditional insurance, the Transurer can also minimize these issues by limiting the amount of coverage that they are willing to provide. Also, the Transurer can increase the price of the coverage it provides. This may make sense if the Transurer is concerned about the loss adjusting practices of the primary insurer.

### **Summary**

The Transurer has the same tools available to it that any insurer does with respect to preventing moral hazard, adverse selection, and fraud. It can decide against covering a particular risk, it can limit coverage, and it can increase the price of the coverage that it provides. However with Transurance, all of these tools are supplemented by the underwriting and loss adjustment work of the primary insurer. Given the small size of the Transurance coverage in relation to the traditional insurance coverage, the primary insurer has much more financial incentive than the Transurer to ensure that its underwriting and loss adjusting are top notch.