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Insurance Protection Gaps: Examples and Case Studies

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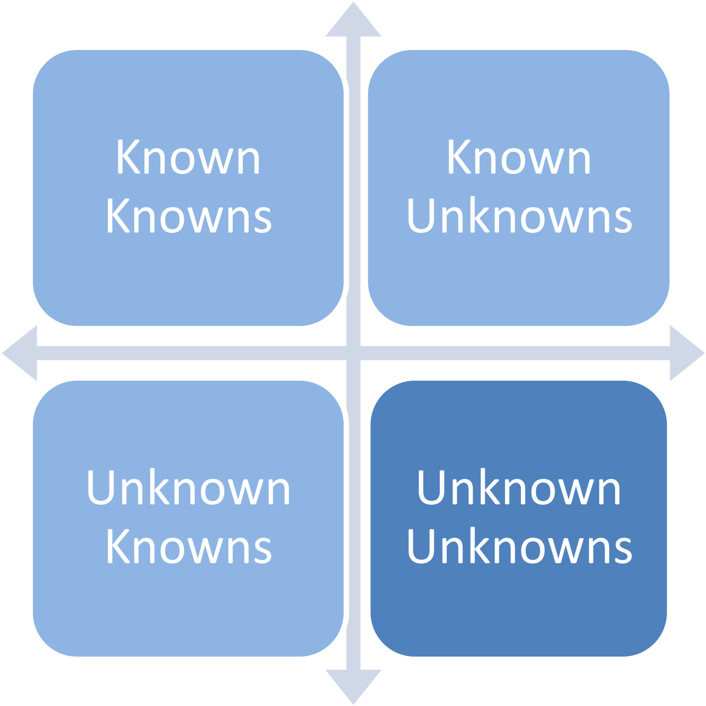
In keeping with the non-partisan, non-advocative mission of The Griffith Foundation, I will keep my comments and contributions to today's program unbiased and purely educational.

Unknown Unknowns

Last week, we discussed the following coverage gaps:

- Insured Value
- Liability Limits
- Uninsured Motorist
- **Cyber Threats**
- **Home-based Business**
- **Home Host Business**
- Ride-share
- **Wildfire**
- Domestic Employees



Economically Viable Insurance

For insurance to be economically viable, it must:

- Price for **moral hazard**
- Anticipate **adverse selection**
- Achieve **actuarial equity**

Moral Hazard

An example of **information asymmetry**

- One party (agent) has information the other does not have (principal)
- It is costly for the principal to observe the agent
- Principal assumes that agent will act in their own best interest
- Insurance prices reflect assumption that insured will not take care
- Certain perils are excluded to prevent moral hazard

Adverse Selection

Another example of **information asymmetry**

- The agent (insured) knows (approximately) their risk level
- The principal (insurer) can only guess based on information provided
- If the insurer cannot segregate risks, they could charge a premium that covers risks *on average*
- High-risk consumers will purchase insurance (appears “cheap”)
- Low-risk consumers will reject insurance, unless they are especially risk-averse (appears “expensive”)

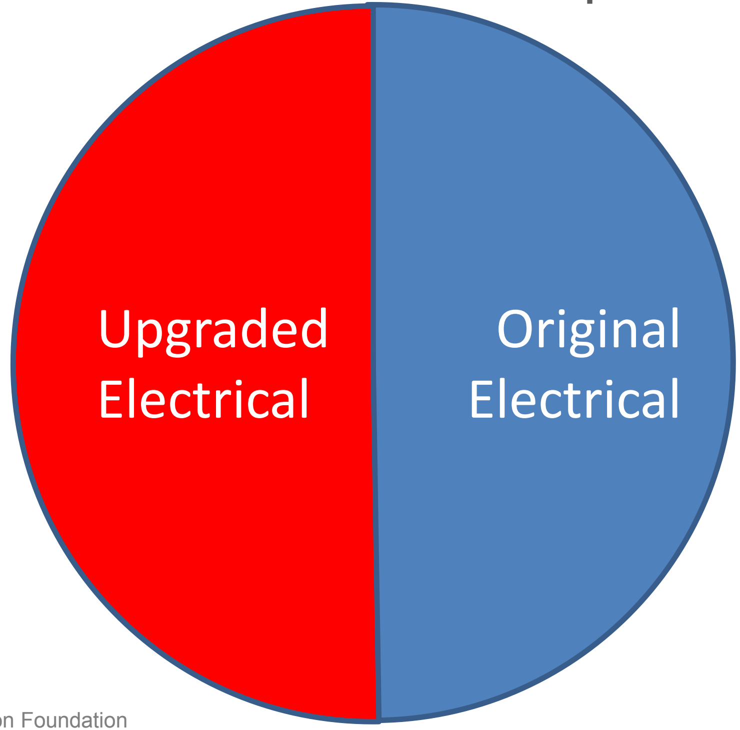
Case Study

Consider this group of properties:

50 year-old homes

Case Study

This group of homes is divided into two parts:



Case Study

Upgraded electrical (200 amp service, breakers):

- Wiring rated for modern appliances
- Grounding where appropriate
- Expected loss $1,000

Original electrical (100 amp service, fuses):

- Wiring may not be sufficient for current needs
- Owner likely to bypass fuses
- Grounding protected defeated
- Increased fire risk
- Expected loss $2,000

Adverse Selection

- Insurer can charge average premium: $1,500 (plus loading)
  - Fewer low-risk (upgraded) consumers will purchase insurance
  - Most high-risk (original) consumers will purchase insurance
  - Expected loss for insurer > $1,500 per customer
  - Original customers have little incentive to upgrade
  - Insurer loses money, possible financial distress
- Insurer can charge high-risk premium: $2,000 (plus loading)
  - No low-risk consumers will purchase
  - Original customers have little incentive to upgrade
  - Social equity is not achieved

Segmentation

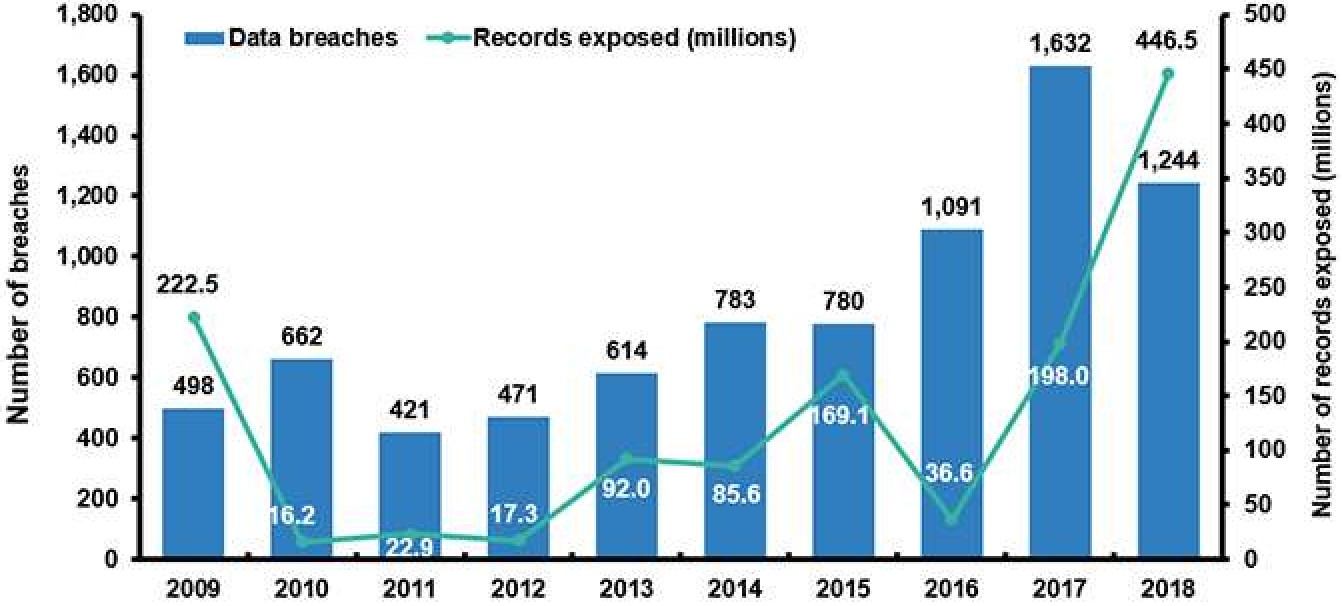
- Insurer can inspect
  - Inspection costs $100, passed on to consumers
  - Low-risk customers pay $1,100 (plus loading)
  - High-risk customers pay $2,100 (plus loading)
  - High-risk customers may have incentive to upgrade (or find another carrier)
  - Inspection imposes dead-weight loss
- Insurer can impose/increase deductible
  - Insured has more skin in the game
  - High-risk customers may have incentive to upgrade
  - Social equity is not achieved (no one has the amount of coverage they desire)

Exclusion

- Insurer can exclude electrical fires
  - Insured may not be aware of exclusions
  - Endorsement can reinstate coverage at a higher cost
  - Informed insured can achieve optimal coverage
  - Insurer remains solvent
  - Social equity is achieved for informed insureds
- Coverage gaps result from:
  - information asymmetry
  - lack of awareness

Cyber Threats (Coverage Gap)

1. Identity theft is a growing problem



Source: Identity Theft Resource Center, *2018 End of Year Data Breach Report*.

Cyber Threats

- Emerging Cyberthreats:
  - Vehicles linked to phones and internet
  - Autonomous vehicles communicate with each other
  - Wireless vehicle diagnostic systems can be infiltrated
  - “Smart” home devices subject to hacking
  - Touchless payment methods (RFID wallets)
  - Home security systems

Identity Theft Coverage

1. Homeowner policies pay small amounts for theft or unauthorized use of credit cards
2. Coverage for break-in theft in homeowner policies (subject to deductible)

Theft, including attempted theft and loss of property **from a known place** when it is likely that the property has been stolen.

3. Identity theft coverage is available at an additional charge.
   a. Counseling
   b. $30,000 for lost wages and attorney fees
   c. No recovery of lost money

Other Cyber Threats

1. Under most home policies, there is no coverage for losses from connected device infiltration
   a. Refrigerator (shutdown resulting in spoilage)
   b. Laundry (flooding)
   c. HVAC
   d. Telephones
2. These items remain low probability losses, but could be high severity
3. In most cases, insurance policies will provide no coverage
4. Extensive terms of use exempt providers from liability

Home-based Business

1. What is covered:
    a. Personal property on residence used at any time or in any manner for any for any business purpose (limit: $2,500)
    b. Personal property used off residence for any business purpose (limit: $250)
2. What is not covered:
    a. Other structures used in whole or part for business
    b. Other structures rented for anything but a private garage
    c. Business data
    d. Vegetation grown for business purposes
    e. Liability arising out of business operations by insured

Addressing Home Based Business Gaps

1. Business Owners Policy:
    a. Personal liability for customers in home
    b. Data loss coverage
    c. Equipment excluded under homeowners policy
    d. Endorsements to extend coverage
2. Risk Management:
    a. Compliance with municipal codes
    b. Duplication strategies to limit risk of loss
    c. Contingency plans to handle claim period

Homeshare Host

1. “Host Guarantee” Coverage:
    a. Up to $1,000,000 for damage caused by a guest above the security deposit
    b. Excludes cash, securities, collectibles, rare artwork, jewelry, pets, personal liability, wear and tear

> The Host Guarantee is not an insurance policy. To the extent you desire protection beyond the Host Guarantee, [service] strongly encourages you to purchase insurance that will cover you and your property for losses caused by guests in the event your loss is not within the terms of the Host Guarantee.

2. May be a significant delay in payment
3. Work with guest to adjudicate claim

Homeshare Host Protection

1. $1,000,000 limit for:
    a. Legal liability due to host negligence
    b. Claims settled through network, not underlying insurer
2. Excludes:
    a. Host property damage
    b. Communicable disease
    c. Electronic data
    d. Liquor liability
    e. Punitive damages

Natural Disaster

1. Insurance availability following natural disasters creates a coverage gap
2. Insurance policies give broad rights to cancel within 60 days of inception
3. Insurers can non-renew policies with 45 days notice and specific cause
4. Some states provide a residual market for homeowners insurance (such as FAIR in California)
5. FAIR plans typically only provide property damage coverage

Residual Markets

1. To promote social equity, regulators provide residual markets
   a. Insurers operating in a state must agree to accept “last resort” insurance to a portion of the market in proportion to their share of voluntary business (assigned risk)
   b. The state or industry can set up an insurer or group to assume involuntary risk (joint underwriting association)
   c. The state can partner with industry or federal government to provide coverage

FAIR Plans

1. Fair Access to Insurance Requirements
    a. Homes in high risk areas (windstorm/wildfire risk zone)
    b. High risk homes (older mobile homes)
2. In California:
    a. All admitted insurers must be members of the FAIR plan
    b. Profits and losses are shared by members in proportion to property market share
3. Require or highly recommend regular shopping
    a. Licensed agents in California can provide a FAIR quote alongside other plans
    b. Rates must be actuarially sound
    c. Often provide property only coverage; insured must purchase liability on the open market

FAIR Plan Penetration 2018

State	Residential Policies	Total Exposure	Premiums Written
Florida	452,526	$109 billion	$868 million
Massachusetts	230,828	88 billion	307 million
California	119,570	50 billion	82 million
North Carolina	177,002	20 billion	94 million
Texas	104,165	15 billion	96 million
All others	254,913	42 billion	246 million
Total	**1,339,004**	**$325 billion**	**$1.7 billion**

Source: Property Insurance Plans Service Office

Beach and Windstorm Plan Penetration 2018

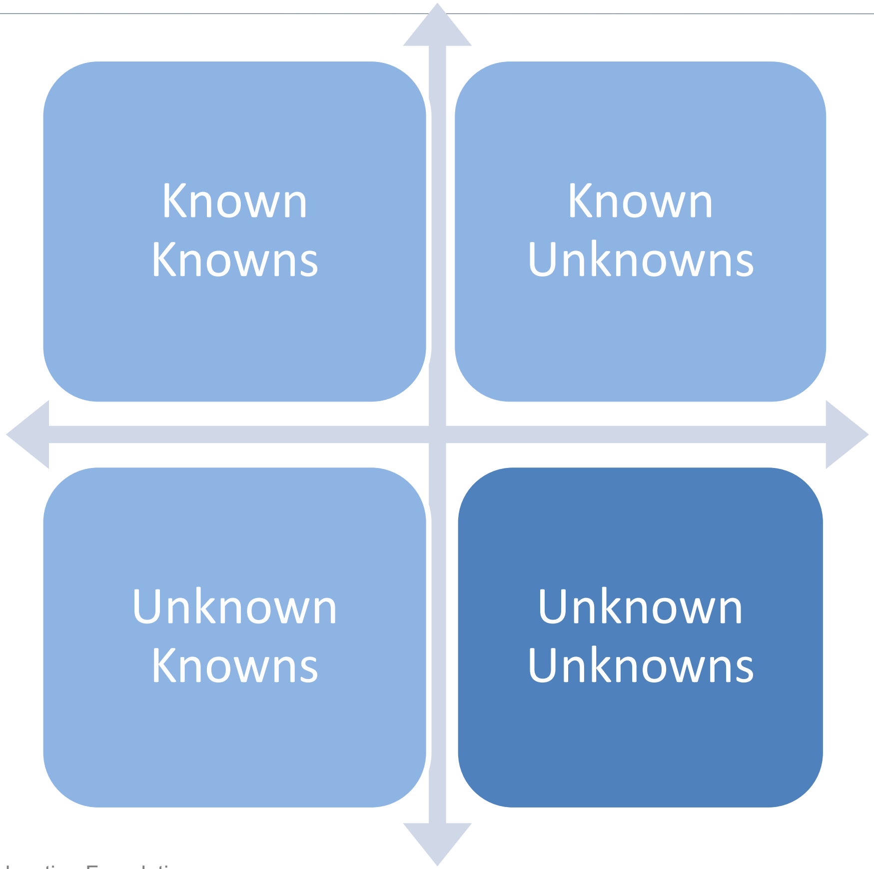
State	Residential Policies	Total Exposure	Premiums Written
Texas	202,710	$58 billion	$396 million
North Carolina	199,392	75 billion	330 million
South Carolina	21,055	7 billion	41 million
Alabama	20,910	6 billion	26 million
Mississippi	20,660	3 billion	35 million
Total	**464,727**	**$149 billion**	**$829 million**

Source: Property Insurance Plans Service Office

Conclusion

1. Insurance must make economic sense
2. Exclusions and deductibles increase access to insurance
3. Increased access requires increased awareness of gaps
4. Gaps exist particularly in these areas:
   a. Cyber and identity theft
   b. Home-based business and homeshare host
   c. High risk catastrophe area
5. Most of these gaps can be covered through endorsements or in the residual market

Questions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