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Technological Innovation: Insurance Supervision and the Business of Insurance

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The Center for Economic Justice

CEJ is a non-profit consumer advocacy organization dedicated to representing the interests of low-income and minority consumers as a class on economic justice issues. Most of our work is before administrative agencies on insurance, financial services and utility issues.

On the Web: www.cej-online.org

Why CEJ Works on Insurance Issues

Essential Financial Security Tool for Individual and Community Economic Development:

CEJ Works to Ensure Fair Access and Fair Prices for These Essential Products and Services, particularly for Low- and Moderate-Income Consumers.

Primary Institution to Promote Loss Prevention and Mitigation, Resiliency and Sustainability:

CEJ Works to Ensure Insurance Institutions Maximize Their Role in Efforts to Reduce Loss of Life and Property from Catastrophic Events and Promote Resiliency and Sustainability of Individuals, Businesses and Communities.

Why is Insurance Different from Other Consumer Products?

1. **The insurance is required** – by law and by lenders requiring protection of home or vehicle collateralizing the loan. Limits normal competition.

2. **Contract is a promise for future benefits** if an undesirable event occurs. If the product "fails" – the consumer learns the insurance policy won't cover the loss – she is stuck and can't purchase another policy that would protect her against a known loss. Again, limits normal competition.

3. **Cost-based pricing is required and consumer challenges to prices are prohibited.** The requirement for cost-based pricing is to protect insurer financial condition and prevent intentional or unintentional unfair discrimination.

Insurance Innovation Different from Banking Innovation

A banking product is different from an insurance product.

Just as insurance is different from banking for capital standards, so is insurance different from banking for regulatory approaches to "innovation."

There is a big difference between an innovation for payments or hailing a taxi and an innovation for insuring a home against catastrophic risk or securing retirement income.

Insurance Supervision and Innovation in Insurance Products

Regulation and Innovation can be compatible – informed regulation can promote beneficial innovation.

Poor or misguided regulation can thwart innovation and entrench incumbents.

Regulatory innovation is needed – towards improved analytics of market outcomes and consumer experiences.

Deregulation is not regulatory innovation.

Opportunities for Innovation in Insurance Are Huge

Opportunities for beneficial innovation abound:

- to empower consumers,
- to promote resiliency and sustainability,
- to improve availability and affordability of essential insurance products.

But such outcomes are not guaranteed – indeed, we have seen "innovation" produce different and undesirable outcomes.

The Most Important Task for Policymakers and Supervisors

The most important task for policymakers is to set out goals and values for innovation in insurance:

"Before we can choose our tools and techniques, we must first choose our dreams and our values, for some tools serve them while others make them unobtainable."[1]

[1] From Tom Bender.

What Should the Values and Goals of Innovation Be?

- Honor the fundamental insurance principle of risk pooling.
- Empower consumers and communities to take action for loss prevention, resiliency and sustainability
- Promote greater availability and affordability of essential insurance products
- Provide good value in or improve the value of insurance products
- Empower consumers to improve the operation of markets and promote beneficial competition
- Promote or improve the intended operation of the product

Innovation in Insurance is Not New

Innovation has occurred for decades and regulators have responded – sometimes in good ways, sometimes in bad ways.

Historic Examples:

- Direct (without an Intermediary) Sales of Personal Insurance Products – Phone Sales
- Internet Sales of Insurance

Regulators had the tools to respond to these “disrupters.”

More Recent Example:

- Big Data Algorithms for Marketing, Sales, Pricing and Claims Settlement

Regulators are struggling to respond to these innovations with the current regulatory toolbox.

Innovations Opportunities / Regulatory Responses

Example: Auto Telematics

Opportunity: Dramatically reduce losses with real time feedback to the driver; Empower consumers with on-demand pricing.

Reality: Another black box scoring algorithm with lack of consumer data protections and portability, slow take-up because of lack of transparency to the consumer and consumer concerns about data privacy.

Regulatory Response: Protect incumbents with reduced transparency through expanded trade secret/confidentiality protections.

Example: On-Demand Insurance: Pay-By-The-Mile (Kilometer) Motor Vehicle Insurance

Opportunity: – proposed in the U.S. in the early 1990's – an opportunity to

- empower consumers to better control their insurance premium,
- to ensure universal coverage and eliminate the high costs of enforcing mandatory vehicle insurance laws.

Reality: Incumbents' opposition thwarted development

Regulatory Response: In California, emphasis on miles driven as a rating factor; elsewhere in the U.S., no response.

Example: Big Data for Sales, Pricing and Claims Settlement
Opportunity: Create new and improved interactions with consumers to promote better understanding of products, better use of products, more transparency in pricing to promote loss mitigation, more transparency in claims settlement.

Reality: Generally, more black box scoring tools for marketing, pricing and claims settlement; less transparency to consumers, lost opportunity for loss mitigation and prevention, exacerbated affordability problems from hyper-price segmentation, consumer data privacy, ownership and protection issues.

Regulatory Response: Protect incumbents with greater trade secret/confidentiality provisions and "rate stability" regulations and bulletins – allowing insurers to deviate from cost-based pricing to avoid "rate shock."

The Need and Opportunity for Regulatory Innovation:

There is great opportunity and imperative for **regulatory innovation in insurance market regulation.**

“Sandboxes” can be a regulatory innovation – if they are more than a variation of limited deregulation. Deregulation is not innovation. A “sandbox” should be an opportunity for supervisors to test new methods of interaction with consumers/innovators.

True regulatory innovation is new capability of supervisors to collect / analyze granular data on insurance market outcomes and to institutionalize greater regulatory interaction with consumers.

This regulatory innovation requires some new tools and skills to augment the existing tool box. The new tools include granular market outcome data collection, data and predictive analytics and economic analysis of markets.

Benefits of Regulatory Innovation

- Focus regulatory resources on problem companies, markets or products and let those companies with good consumer outcomes continue their positive work.

- Provide consumers and innovators with information that has never been available:
  - o information for consumers on claim settlement outcomes across insurers,
  - o targeting consumer information and education to those products and markets exhibiting poor consumer outcomes
  - o a standardized telematics database of telematics outputs, exposures and claims to encourage new entrants.

- Detailed information on a company's market outcomes can inform financial supervision of the company.

Summary

- Consumer stakeholders must be part of the policy discussions regarding innovation in insurance products.

- Insurance products are different from banking products – innovations and regulatory approaches to innovation should also be different.

- Regulation can be compatible with and encourage more rapid development and adoption of important innovations. Regulation can thwart innovation and entrench incumbents. Regulators must be able to distinguish between the two.

Summary (con't)

- Innovation should be guided by clear public policy values and goals. The most important act by a regulator is to develop and set out those values and goals for consumers and innovators.

- There is huge opportunity for regulatory innovation to move market regulation towards greater analytics of market outcomes – for consumers, markets and financial stability – with resulting improvements in efficiency and effectiveness of market regulation, financial stability and market outcomes.