The Protection Gap – New Challenges for Insurers and Consumers

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The Property Insurance "Protection Gap:" Definition and Measurement

The Global "Protection Gap," the difference between Economic Losses and Insured Losses generated by catastrophes, is growing

$Billions, in 2016 dollars
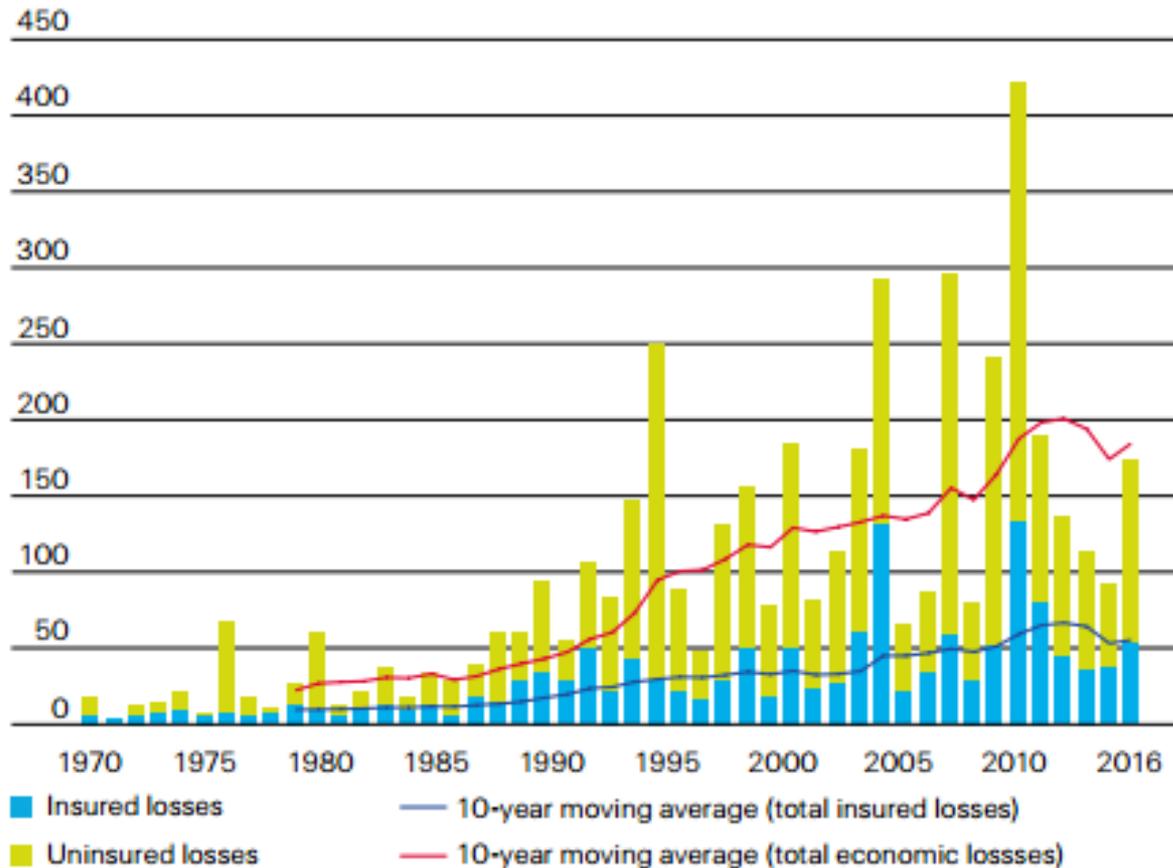
In terms of 10-year rolling averages, between 1991 and 2016, insured losses grew by 4.6% per year but economic losses by 5.6% per year.
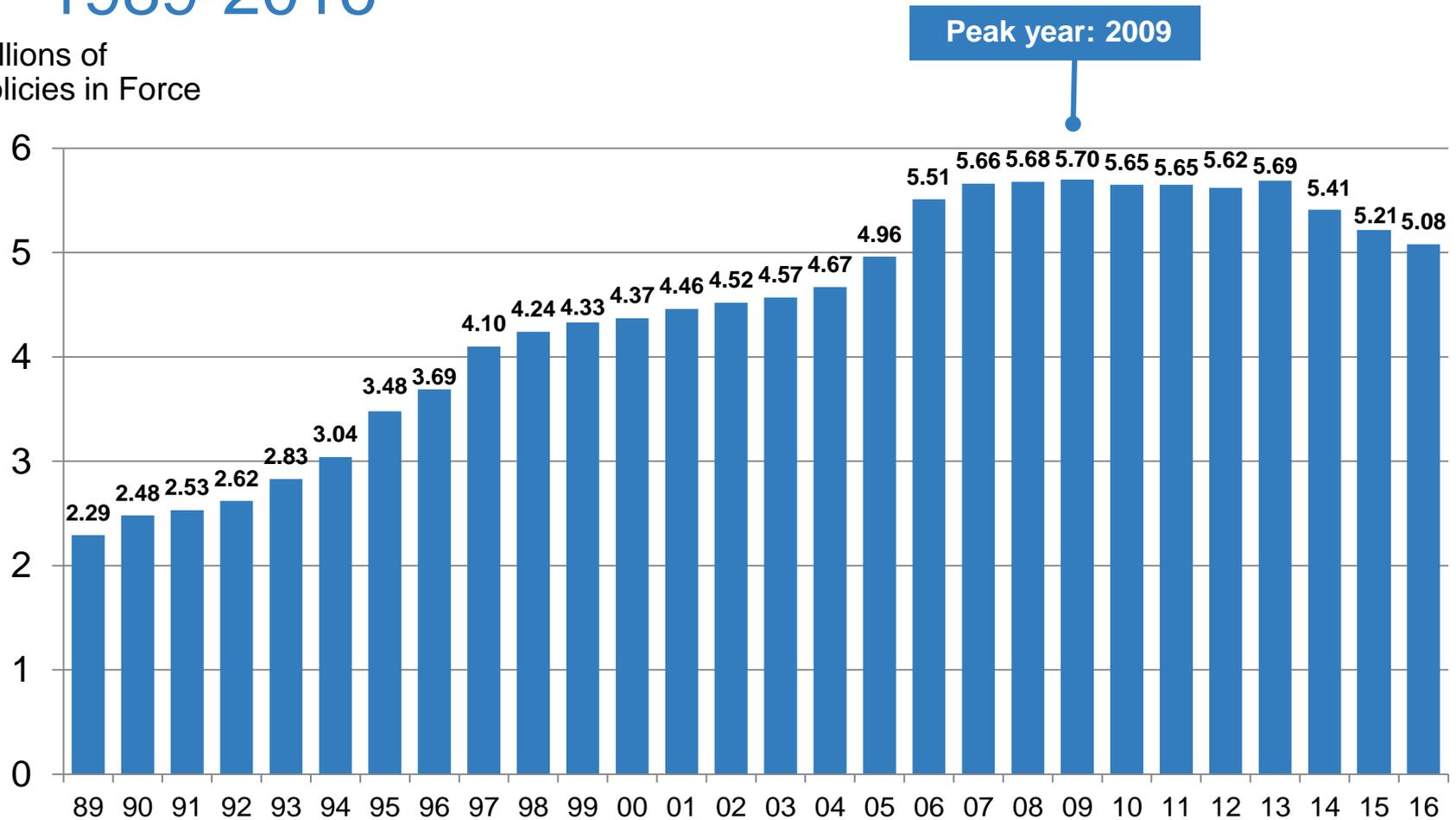
Legend:
- Insured losses
- Uninsured losses
- 10-year moving average (total insured losses)
- 10-year moving average (total economic losses)

Economic losses = insured + uninsured losses

Source: Cat Perils and Swiss Re Institute.

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U.S. Flood Insurance Policies In Force, 1989-2016

Millions of
Policies in Force

Peak year: 2009

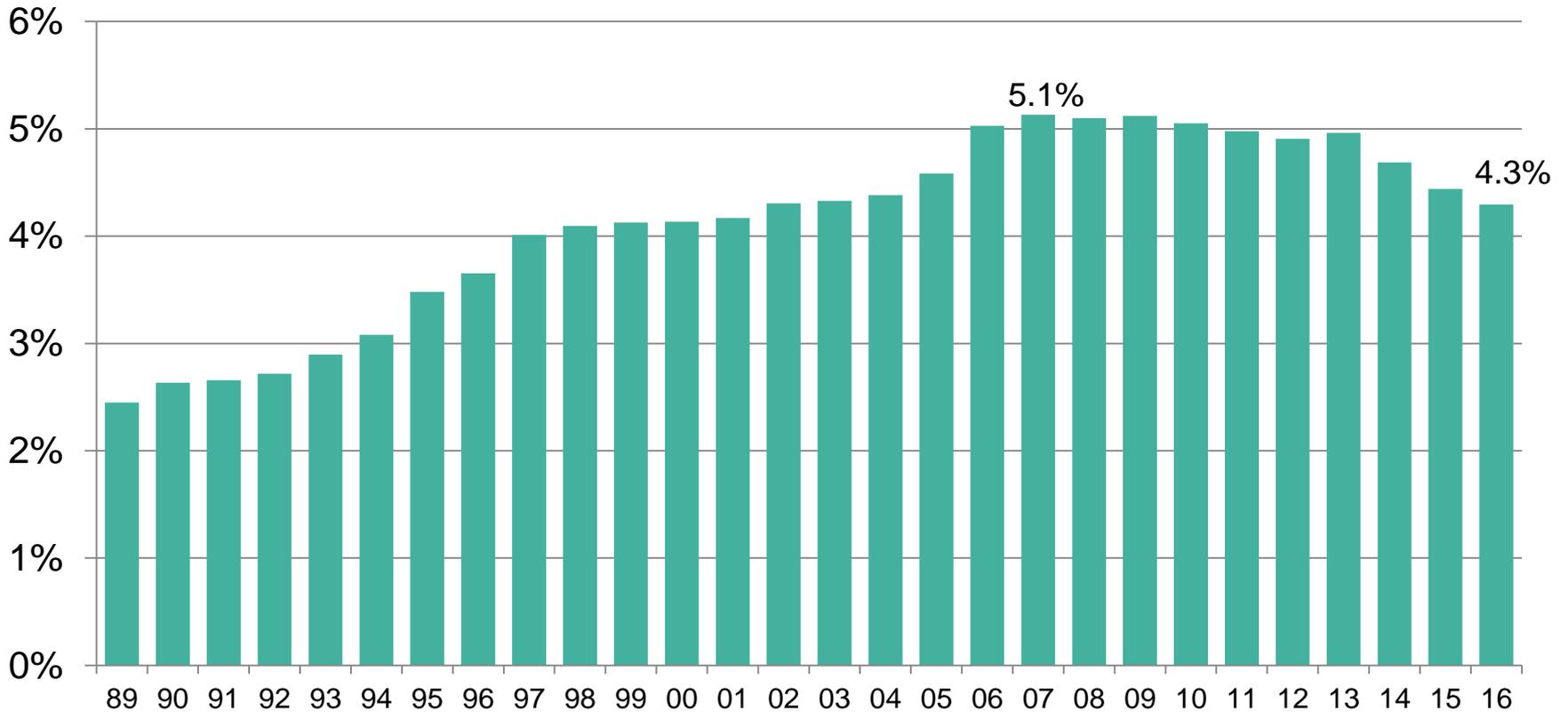| Year	Policies (millions)
89	2.29
90	2.48
91	2.53
92	2.62
93	2.83
94	3.04
95	3.48
96	3.69
97	4.10
98	4.24
99	4.33
00	4.37
01	4.46
02	4.52
03	4.57
04	4.67
05	4.96
06	5.51
07	5.66
08	5.68
09	5.70
10	5.65
11	5.65
12	5.62
13	5.69
14	5.41
15	5.21
16	5.08

The number of NFIP policies in force grew every year during the two decades from 1989 through 2009 but was essentially flat through 2013 and declined in 2014-2016.

At Peak (2007), Only 5% of Occupied Residences Had an NFIP Flood Insurance Policy In Force

5.1%

4.3%

| 89 | 90 | 91 | 92 | 93 | 94 | 95 | 96 | 97 | 98 | 99 | 00 | 01 | 02 | 03 | 04 | 05 | 06 | 07 | 08 | 09 | 10 | 11 | 12 | 13 | 14 | 15 | 16 |

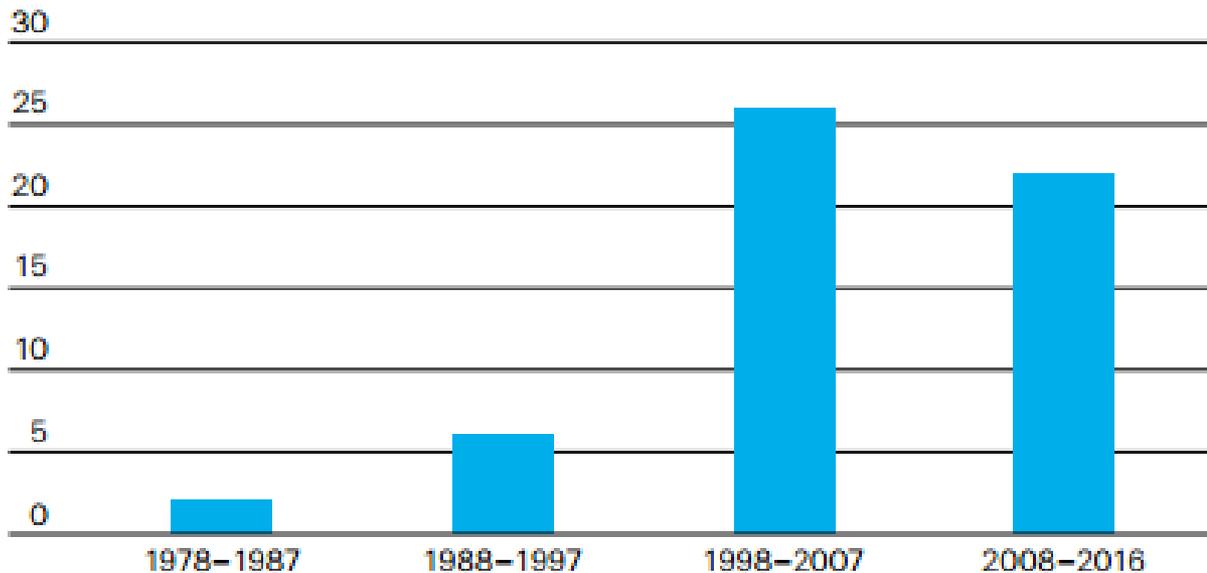**Since 2007 the number of occupied residences has grown by 7.25% but the number of flood policies in force fell by 10.25%.**

The Drop in Flood Coverage Isn't Due to Lower Insured Flood Claims Payments

US Insured Flood Losses, $Billions

- In 2016 there were 4 separate multi-billion-dollar inland flood events – the highest number in a single year since 1980.

Source: NFIP.

The $10 Billion Flood Protection Gap: What Can We Do?
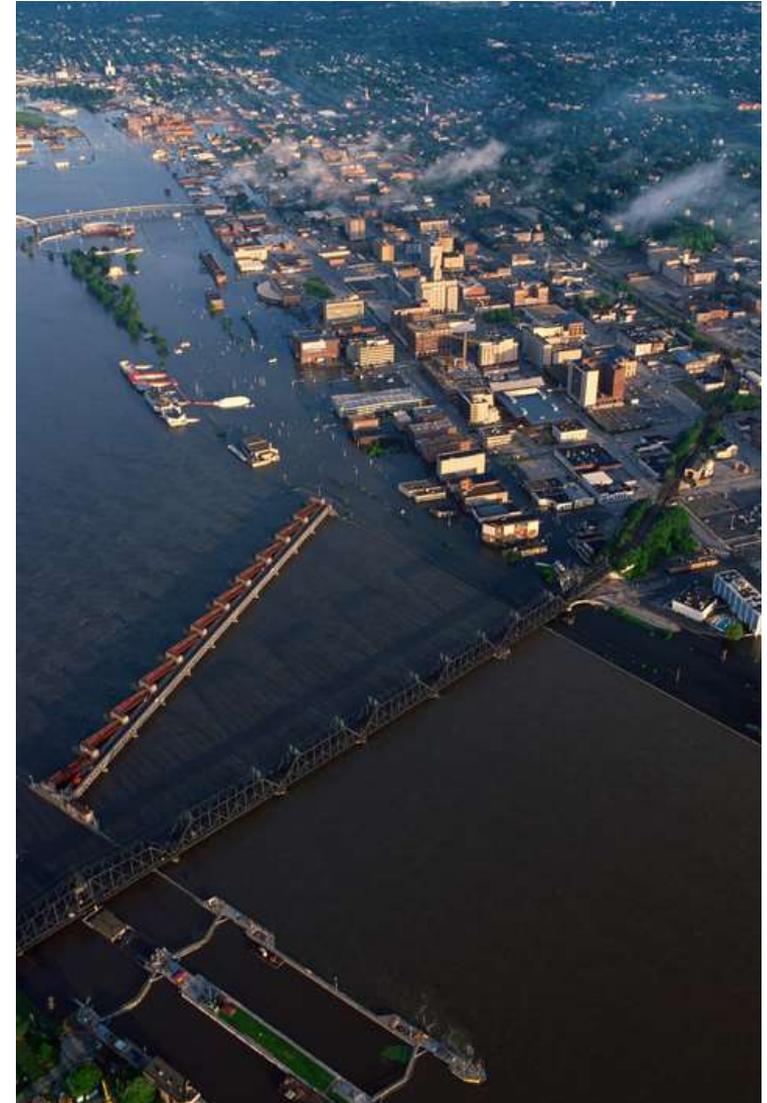

Risk awareness

Simple insurance products (flood endorsement policies)

Continue to improve risk assessment tools

Public/private partnerships that support financial resilience

Source: SwissRe/III webinar, April 27, 2017.

Financial Literacy: A 3-Question Test

This test has been administered world-wide to provide a rough indicator of financial literacy among many populations.

The First Financial Literacy Question

If you had $100 in a savings account with an interest rate of 2 percent per year, after 5 years, how much do you think you would have in the account if you left the money to grow?

a. More than $102
b. Exactly $102
c. Less than $102
d. Don't know
e. Refuse to answer

The Second Financial Literacy Question

If the interest rate on your savings account was 1 percent per year and inflation was 2 percent per year, after 1 year with the money in this account would you be able to buy

a. More than today
b. Exactly the same as today
c. Less than today
d. Don't know
e. Refuse to answer

The Third Financial Literacy Question

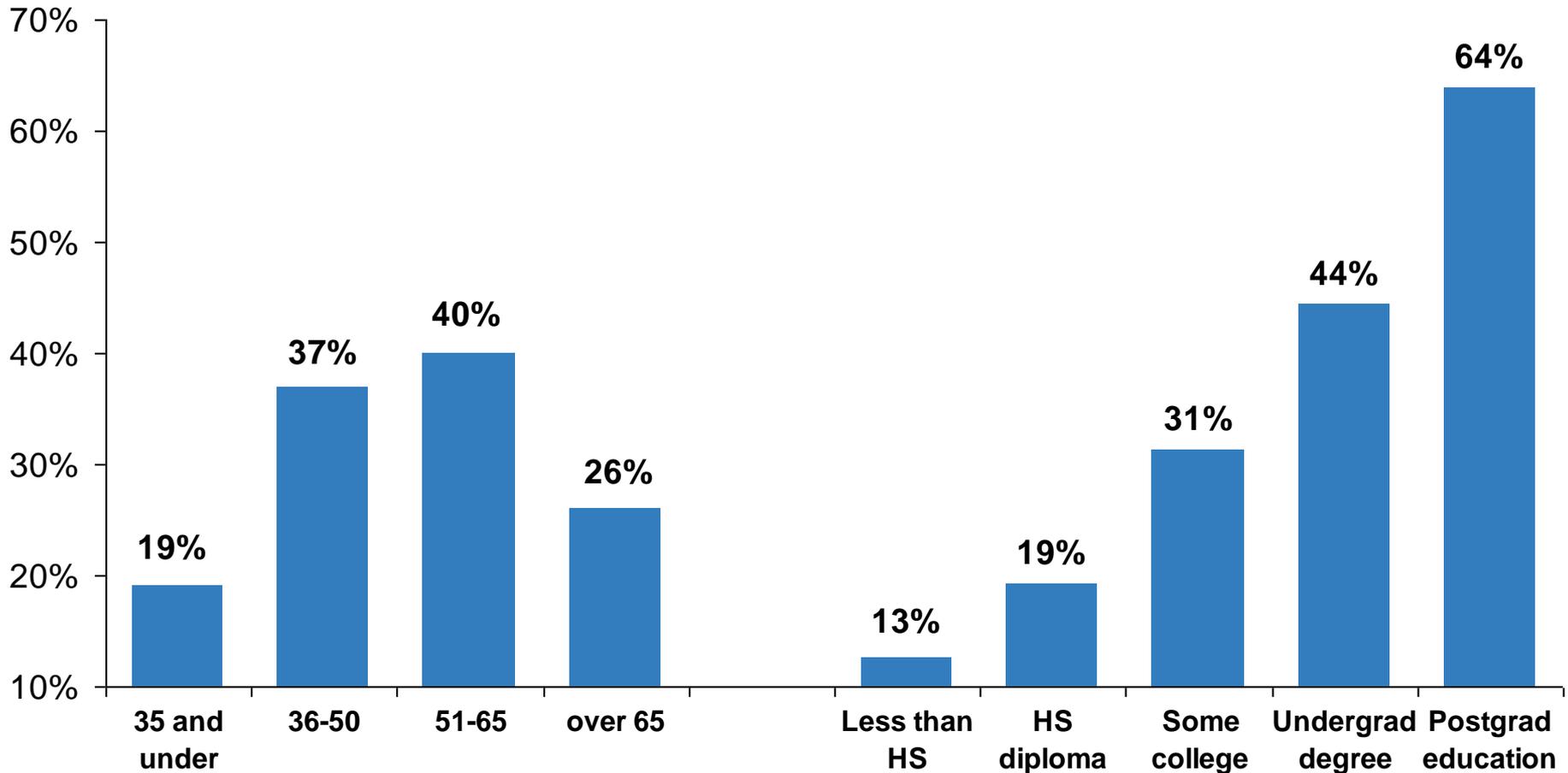"Buying a single company stock usually provides a safer return than a stock mutual fund." This statement is

a. True
b. False
c. Don't know
d. Refuse to answer

Financial Literacy by Age Group and Education

Percent answering all three questions correctly

*The questions ask about interest rates, inflation, and risk diversification (comparing individual stocks vs. stock mutual funds). The details are on page 10 of the cited article and in other articles cited by the authors.

Source: Lusardi and Mitchell, "The Economic Importance of Financial Literacy: Theory and Evidence," *Journal of Economic Literature*, 2014 (pp. 5-44).

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Why Is This Important?

To make good decisions regarding the types and amounts of P/C insurance to buy, consumers should understand

- The types of losses/claims that they might sustain

- The likelihood/probability of those various kinds of losses/claims—what we call "frequency"

- The potential severity of those losses

Do Financially Illiterate People Make Worse Financial Decisions?

How Do Economists Determine Whether a Person's Financial Decisions Are Good or Bad?

Economists: Good Decisions Are Consistent Decisions

<u>The Concept</u>: If your decisions are consistent, they're likely based on an underlying and well-understood view of financial choices—in short, they're "rational."

- For example, it a policyholder chose similar low deductibles for auto and HO, that's consistent and could reflect little liquidity

- But if the policyholder chose a small deductible for one policy and a large deductible in another, we suspect that the policyholder isn't choosing based on his/her circumstances or preferences.

<u>The Finding</u>: Consistency in financial decisions is highly correlated with wealth, education, income, youth, and financial literacy.

Sources: S. Choi, S. Kariv, W. Muller, and D. Silverman, "Who is (More) Rational?" *American Economic Review* 104(6) [June 2014], pp. 1518-1550, and J. Brown, A. Kapteyn, E. Luttmer, and O. Mitchell, "Cognitive Constraints on Valuing Annuities," Pension Research Council PRC WP 2014-21; Insurance Information Institute

Financial Literacy and P/C Insurance

A Low Level of Financial Literacy is Probably At Least Partly Responsible for a Number of Policyholder Problems

Why Renters
Don't Have Renters Insurance

Is this an important reason for why you don't have renters insurance?

Legend:
- Yes
- No
- Don't know / refused

Percentage Of People

Reason	Yes	No	Don't know / refused
Your landlord has insurance	43%	37%	19%
Renters insurance is too expensive	45%	42%	13%
Your home has good security	59%	37%	4%
You don't have enough property to insure	42%	53%	5%
You don't know where to get renters insurance	20%	75%	5%
You don't understand how renters insurance works	27%	66%	7%

Source: Princeton Survey Research Associates International, January 2015

insurance Quotes

The Top Purchases Millennials Won't Make Without User-Generated Content
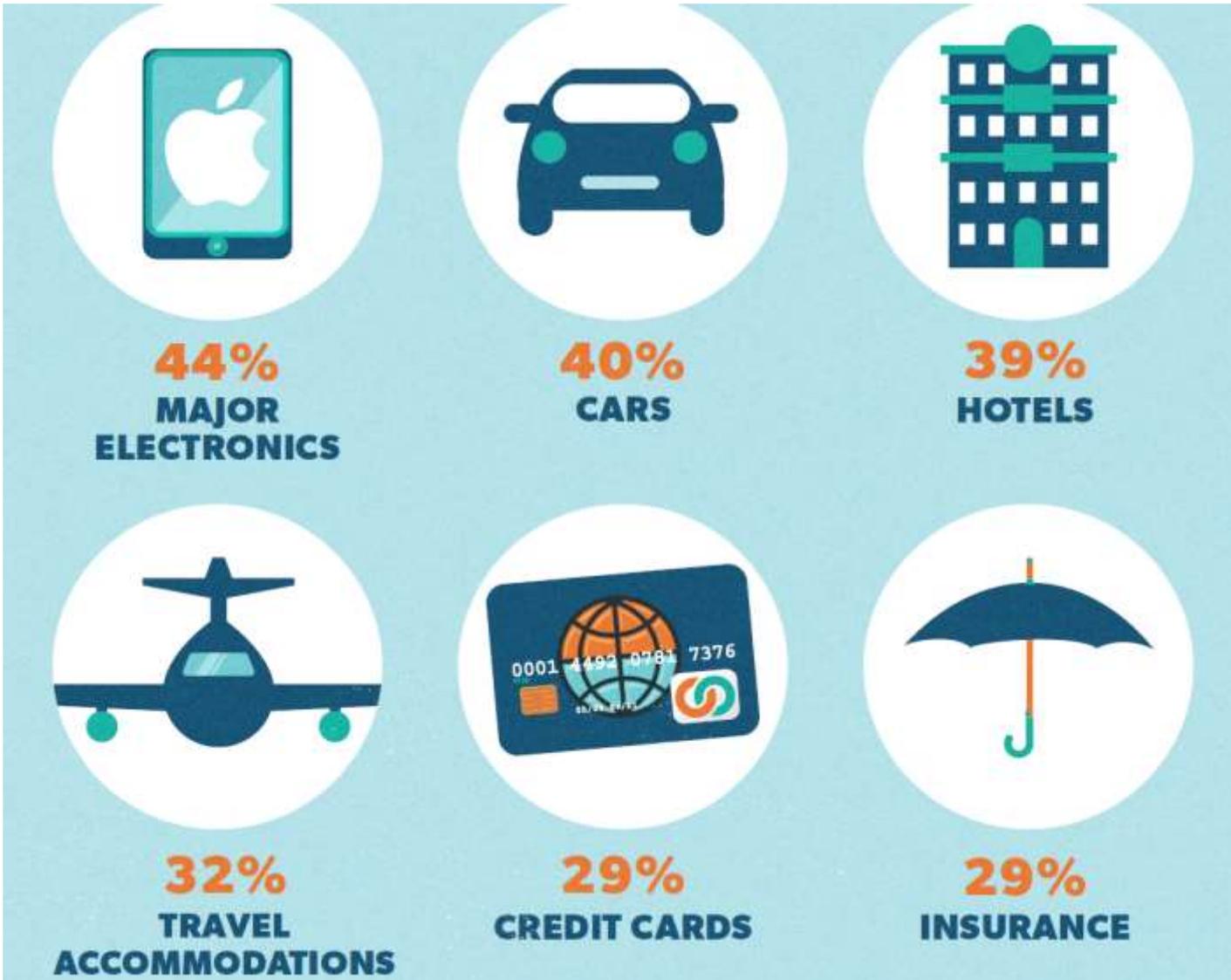
44% MAJOR ELECTRONICS

40% CARS

39% HOTELS

32% TRAVEL ACCOMMODATIONS

29% CREDIT CARDS

29% INSURANCE

Insurance Coverage by Age Group

Compared to older generations, millennials are underinsured.
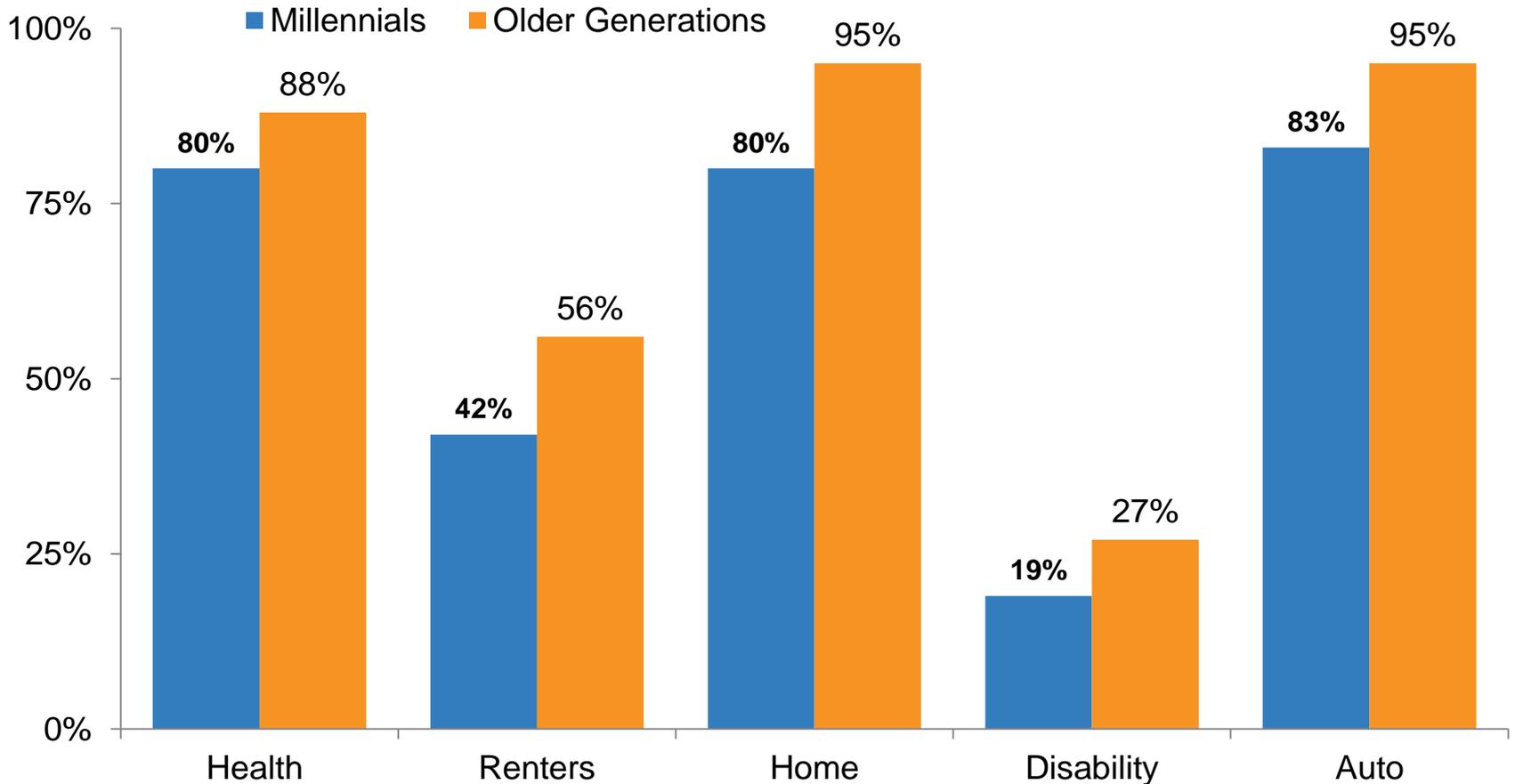
Source: IA Magazine, May 2017, p. 16, citing a study by Vertafore; Insurance Information Institute.

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Consumer Understanding of Home and Flood Insurance: **Good News and Bad News**

The good news

The bad news

Key Findings

Two broad conclusions can be drawn from the I.I.I.'s survey. First, **the majority of homeowners _do_ understand the basics of their homeowners policy.** They recognize that they will be covered if their house is damaged by a fire, if property is stolen from their home or if someone is injured on their property (Fig. 1).

But second, **homeowners have gaps in their knowledge of their coverage.** For example, many policyholders do not recognize that most flood damage is not covered by their basic homeowners insurance.

Fig. 1

Homeowners Understand the Basics

Percentage of homeowners who knew key perils are covered

91% Fire damage

79% Theft from house

69% Medical costs for someone injured on property

Misunderstanding of Flood Damage Coverage

43% of homeowners **incorrectly** believe damage from heavy rain flooding is covered under their standard insurance policy

Most homeowners understand the basics in a home insurance policy. But many don't understand its water damage and flooding coverage.

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One More Hurdle: Loss Aversion

What is Loss Aversion and How Does it Affect Insurance Buying?

▲ **Loss aversion** refers to people's tendency to prefer avoiding losses to acquiring equivalent gains
  - ◆ one who loses $100 will lose more satisfaction than another person will gain satisfaction from a $100 gain

▲ Research shows that people tend to consider a premium payment as a guaranteed "loss" and the rare receipt of an insurance claims payment—even of a much larger amount—as a less valuable gain.
  - ◆ This might help explain why why many people and businesses don't buy various types of insurance

A Famous Loss Aversion Experiment

◢ Imagine you are a physician in an Asian village, and 600 people have a life-threatening disease.

◢ Case 1. Two treatments exist: Treatment A will save exactly 200 people. With Treatment B, there is a 1/3 chance to save all 600 people and a 2/3 chance that you will save no one. Which treatment do you choose?

◢ Case 2. Two treatments exist: With treatment C, exactly 400 people will die. With Treatment D, there is a 1/3 chance that no one will die, and a 2/3 chance that everyone will die. Which treatment do you choose?

◢ In Case 1, the vast majority choose Treatment A. In Case 2, the vast majority choose Treatment D.

Insurance Literacy

Why the Issue of Financial Literacy Is Important for P/C Insurance

- Increasingly severe weather increases the likelihood that policyowners will have a significant loss that could be insured.
- Research shows that financially literate people are more likely to act, while less-financially-literate people procrastinate and often don't act
  - This might help explain why so few people have flood insurance
- When new types of exposures arise, financially-literate people are more likely to buy insurance against them

Why the Issue of Financial Literacy Is Important for P/C Insurance

▲ People who don't understand their policies—or the events they insure against—are likely to blame, or be antagonistic to, insurers and agents

- ◆ Legislatures might create organizations like the federal Consumer Financial Protection Bureau to "protect" unsophisticated policyowners
- ◆ Growing numbers of policyholders will be age 80 and over. Many will have cognitive limitations and might become financially illiterate even if they were previously financially literate. Agents and insurers will have to develop strategies for dealing with these people.

P/C Insurance Implications of Financial Illiteracy

▲ It seems likely that financially illiterate people are…

- ◆ Less likely to buy and renew P/C insurance when they are not required to do so
- ◆ Less likely to buy and renew P/C insurance even when they are required to do so
  - – Low financial literacy might help to explain high percentages of drivers who don't have auto insurance
- ◆ Less likely to buy appropriate policy limits
- ◆ Less likely to understand policy terms and features (e.g., hurricane deductibles)
- ◆ More likely to focus on price (because they don't understand other aspects of the P/C insurance relationship)

Insurance Literacy:
A Proposed 3-Question Test

This test has never been administered to anyone but if it were it might provide a rough indicator of property/casualty insurance literacy.

The First Insurance Literacy Question

▲If you had $500 deductible in your insurance policy and you had $2,000 of damage covered by the policy, how much would the insurance company pay?

◆$2,000

◆$1,500

◆$500

◆Don't know

◆Refuse to answer

The Second Insurance Literacy Question

▲ If your insurance policy had a policy limit of $50,000 and you had $80,000 of damage covered by the policy, how much would the insurance company pay?

◆ $80,000

◆ $50,000

◆ $30,000

◆ Don't know

◆ Refuse to answer

The Third Insurance Literacy Question

▲ "Insurance policies usually cover several different types of losses in a single policy." This statement is

- ◆ True
- ◆ False
- ◆ Don't know
- ◆ Refuse to answer

Questions?

Thank you