Summary of the 11th Joint Conference of EALE and The Geneva Association on Risk Classification and Public Policy

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This article was published in Insurance Economics No. 52, July 2005

The 11th Joint Seminar of the European Association of Law and Economics and the Geneva Association was held on 16th and 17th of June at German Institute for Economic Research (DIW) in Berlin. Its main theme was “Risk Classification and Public Policy”, focusing on the economic effects of banning information on age, sex or genes for the purpose of risk classification in insurance contracts. It also touched upon legal issues of non-discrimination in the EU and in Canada.

The economic background of the debate was summarized by leading international expert Michael Hoy from University of Guelph (Ontario/Canada). Based on rigorous microeconomic models he looked into the questions: Why do insurers need immutable individual characteristics as risk classifiers, how will a ban on the use of this information affect the insurance market, and how will it affect social welfare? As an important result he found that restrictions on risk classification will unambiguously reduce social welfare if the fraction of high risk types in the population exceeds a critical level. However, if the fraction of high risk types is sufficiently small, then it is possible that banning risk classification can even enhance social welfare under a veil of ignorance inspired by the social welfare approach. This occurs because a single premium policy provides an insurance against premium risk. A balanced empirical approach is therefore required. However, a presumption can be made that negative social welfare effects will be more likely for a ban on gender and age (which affect large groups of insureds) compared to genetic tests (which affect small groups of insureds).

Michael Faure of the University of Maastrich and Yves Thiery of the University of Leuven (joined by Caroline Vanschoubroek) looked into the legal and political aspects of the current non-discrimination legislation of the EU. They introduced the concept of “risk solidarity” (to be differentiated from “distributive solidarity”) in an attempt to bridge the thinking of legal scholars and scholars from insurance economics. Guy Thomas continued with critical comments as to the empirical effect of banning risk classification and its adverse selection impact. He suggested looking at the factual loss coverage effects of single premium rates instead. Michael Wolgast of the German Insurance Association (a sponsoring organization of this meeting jointly with The Geneva Association and DIW Berlin) highlighted the practical importance of risk classification for the insurance industry and the need to separate public policy objectives (such as redistribution) from the underwriting practice to maintain “good economic order” – following the German economic policy approach of “Ordnungspolitik”.

The second day of the seminar was devoted to the practical and empirical aspects of this debate. It looked into different branches of insurance. Irene Luperto and Donatella Porrini of the University of Lecce introduced a business economics view to the risk classification schemes used in the Italian automobile insurance market: What are the benefits of using insurance history and other “dynamic” individual factors for risk classification of drivers; can a double moral hazard arise from agent based underwriting; what are the premium effects of the de-regulation of car insurance tariffs in 1994?; Norma Nielson of the University of Calgary (in a joint paper with Mary Kelly) followed this line by looking into the empirical evidence on age and auto insurance. She showed striking evidence that age is an important factor to determine the frequency and severity of auto accidents (though not in a causal relationship) and
discussed the effects of using alternative variables such as number of years licensed, driving record, and insurance scores. None of these other variables is able to capture the real difference in the population of insureds as well as age does. Yet their use can reduce or minimize the cost of banning age as a classifier to a considerable extent if that decision were to occur for other social reasons. Chwen-Chi Liu from the Feng-Chia University of Taiwan (in a joint paper with Chu-Shiu Li and Jia-Hsing Yeh) examined the empirical relationship between the decision to obtain insurance and the resulting classification under the heavily regulated rating system in Taiwan. He showed evidence of a “reactive” or learning behaviour of insureds based on past accidents. Oliver Riedel of the University of Giessen studied the individually optimal co-insurance under different premium-refund systems in German health insurance and Susanne Pech of the University of Linz looked at the possibility of collecting risk-type information from consumers buying individual versus joint life annuities. Angus Macdonald of Heriot Watt University of Edinburgh, quantified the underwriting financial impact of using genetic information in health and life insurance in the U.K. He argued that genetic epidemiology is not yet at a stage to reliably identify risk classes for an important set of diseases. Its future lies in an enhanced medical understanding of multifactorial disorders. He showed: The actuarial impact of using genetic information - in its current state - is limited, the empirical adverse selection effects of not using this information are unclear. Roger van den Bergh of the University of Rotterdam (jointly with Michael Faure) completed the review of different branches by elaborating on legal and economic justifications for a Private-Public-Partnership system of compulsory flood insurance within the EU’s framework for competition in non-life insurance.

All in all, this seminar took a very tempered approach to an issue that usually lends itself to heated disputes. This success was achieved partly by avoiding some of the more controversial issues of this debate (such as finding a shared definition of social welfare) and partly by taking on the ‘bridging attitude’ that also characterized previous joint meetings of lawyers and economists in this seminar series. The proceedings of the seminar will be published in *Etudes et Dossiers* and selected papers in the Issues of Practices line of the *Geneva Papers* sometime in next year.