Legal Principles in Risk and Insurance

Week 8

Betting on the lives of strangers!

1980’s
a significant number of AIDS-afflicted men...had life insurance policies and needed financial resources
also, there were investors willing to provide immediate cash

Life insurance policies, pay sum of money on death

Policy Begins

Death

Payout to Insured’s Estate

1974 Life Assurance Act (England)

• prohibited the making of any policy on the life of a person by anyone with no interest in the insured life or for gaming or wagering purposes
• Prevent wagering on the life of the insured

“So far as reasonable safety permits, it is desirable to give to life policies the ordinary characteristics of property. To deny the right to sell except to persons having such an interest is to diminish appreciably the value of the contract in the owner’s hands.”
Justice Holmes, US Supreme Court
Grigsby v Russell, 1911

...a life insurance policy is private property
Betting on the lives of strangers!

- A secondary market for life insurance emerges as patients sell life insurance policies to pay for medical costs.

1980’s Late 1990s 2001 2005 Today

- Senior citizens discover a new option to sell unused life insurance policies in the secondary market.
- The purchase of life insurance policies from senior citizens becomes known as "Life Settlements." Industry is at 2 Billion.
- The life settlement industry continues to grow at a rapid pace. Sophisticated investors and banks enter the marketplace.

Definition of a Life Settlement

- The FASB defines a life settlement contract as: [A] contract between the owner of a life insurance policy (the policy owner) and a third-party investor (investor) [that] has the following characteristics:
  
a. The investor does not have an insurable interest (an interest in the survival of the insured, which is required to support the issuance of an insurance policy).
  
b. The investor provides consideration to the policy owner of an amount in excess of the current cash surrender value of the life insurance policy.
  
c. The contract pays the face value of the life insurance policy to an investor when the insured dies.

In Europe there are legal and ethical issues around the life settlement business.

- Ethical considerations
  - Investors have a financial interest in seeing the people from whom they have purchased life insurance policies die sooner
  - Sick people can be manipulated to accept a price that is too low.

- Legal considerations
  - The principle of insurable interest

Insurance Law

Indemnity Subrogation

Principles

Insurable Interest

Utmost Good Faith
Principle of Insurable Interest

The insured must stand to lose financially if a loss occurs

• Purpose:
  – To prevent gambling
  – To reduce moral hazard
  – To measure the amount of loss

• When must insurable interest exist?
  – Property insurance: at the time of the loss
  – Life insurance: only at inception of the policy

Principle of Indemnity

The insurer agrees to pay no more than the actual amount of the loss

• Purpose:
  – To prevent the insured from profiting from a loss
  – To reduce moral hazard

Principle of Indemnity

In property insurance, indemnification is based on the actual cash value of the property at the time of loss

• There are three main methods to determine actual cash value:
  1. Replacement cost less depreciation
  2. Fair market value is the price a willing buyer would pay a willing seller in a free market
  3. Broad evidence rule means that the determination of ACV should include all relevant factors an expert would use to determine the value of the property

Principle of Indemnity

• There are some exceptions to the principle of indemnity:
  – A valued policy pays the face amount of insurance if a total loss occurs
  – Some regions have a valued policy law that requires payment of the face amount of insurance to the insured if a total loss to real property occurs from a peril specified in the law
  – Replacement cost insurance means there is no deduction for depreciation in determining the amount paid for a loss

• A life insurance contract is a valued policy that pays a stated sum to the beneficiary upon the insured's death.
Principle of Subrogation

Substitution of the insurer in place of the insured for the purpose of claiming indemnity from a third person for a loss covered by insurance.

- Purpose:
  - To prevent the insured from collecting twice for the same loss
  - To hold the negligent person responsible for the loss
  - To hold down insurance rates

Principle of Subrogation

- The insurer is entitled only to the amount it has paid under the policy
- The insured cannot impair the insurer’s subrogation rights
- Subrogation does not apply to life insurance and to most individual health insurance contracts
- The insurer cannot subrogate against its own insureds

Principle of Utmost Good Faith

A higher degree of honesty is imposed on both parties to an insurance contract than is imposed on parties to other contracts

- Supported by three legal doctrines:
  1. Representations are statements made by the applicant for insurance.
     A contract is voidable if the representation is material, false, and relied on by the insurer
     An innocent misrepresentation of a material fact, if relied on by the insurer, makes the contract voidable
  2. A concealment is intentional failure of the applicant for insurance to reveal a material fact to the insurer
  3. A warranty is a statement that becomes part of the insurance contract and is guaranteed by the maker to be true in all respects
     - Statements made by applicants are considered representations, not warranties
Requirements of an Insurance Contract

- To be legally enforceable, an insurance contract must meet four requirements:
  - Offer and acceptance of the terms of the contract
  - Consideration – the values that each party exchange
  - Legally competent parties, with legal capacity to enter into a binding contract
  - The contract must exist for a legal purpose

Distinct Legal Characteristics of Insurance Contracts

- **Aleatory**: values exchanged are not equal
- **Unilateral**: only the insurer makes a legally enforceable promise
- **Conditional**: policy owner must comply with all policy provisions to collect for a covered loss
- **Personal**: property insurance policy cannot be validly assigned to another party without the insurer's consent
- **Contract of adhesion**: since the insured must accept the entire contract as it is written, any ambiguities are construed against the insurer

Law and the Insurance Agent

- An agent is someone who has the authority to act on behalf of a principal (the insurer)
- Several laws govern the actions of agents and their relationship to insureds.
Law and the Insurance Agent

- **Waiver** is defined as the voluntary relinquishment of a known legal right
- **Estoppel**
  - e.g. applicant tells agent of a health problem
  - agent assures applicant that it need not be stated in application
  - Insurer could be estopped from denying benefits

Read

- Chapter in Textbook, "Fundamental Legal Principles"
  - p. 144-158

Risk Preferences, Risk Perceptions and the Demand for Flood Insurance

- Major Risk
  - Public & Private Risk Management

• Severe flooding in Dublin
• Revealed underinsurance
• Demands for government agencies to make up deficiency
Risk Preferences, Risk Perceptions and the Demand for Flood Insurance

- 1998-2004, 100 major floods in Europe
  - 2002: catastrophic floods along the Danube and Elbe

- Since 1998, floods in Europe have caused
  - Over 700 deaths,
  - the displacement of about half a million people, and
  - More than €25 billion in insured economic losses.

What should be the role of government?

What drives the demand for flood insurance?

EU Directive
- requires Member States to assess if all water courses and coast lines are at risk from flooding,
- to map the flood extent and assets and humans at risk in these areas and to take adequate and coordinated measures to reduce this flood risk,
- this Directive also reinforces the rights of the public to access this information and to have a say in the planning process.

Risk Preferences, Risk Perceptions and the Demand for Flood Insurance

- Why do people live on flood plains?

- Related Risk Research
  - choice of households to locate near hazardous material sites;
  - perceived mortality risk from transporting radioactive water;
  - perceived health risks associated with arsenic contamination of drinking water;
  - consumers’ stated preferences for genetically-modified foods;
  - farmers’ risk preferences to explain crop insurance choice.
Risk Preferences, Risk Perceptions and the Demand for Flood Insurance

- What drives the demand for flood insurance?
  - Well-informed, rational, risk-averse individuals will purchase full insurance.
  - Loading factors in insurance premiums (to cover administrative and capital costs) reduce the demand for insurance cover.
  - While a subsidized premium will lead individuals to demand cover that exceeds the expected loss.

- Assumption
  - Subjective Loss Probabilities = Objective Loss Probabilities

Risk Preferences, Risk Perceptions and the Demand for Flood Insurance

- Expected benefits of insurance cover depend upon the perceived likelihood of loss and the size of the conditional loss.

- Individuals often do not protect themselves prior to a disaster because they underestimate the likelihood of a future disaster, often believing that it will not happen to them.

- The perceived likelihood of disaster assistance may act as a substitute for formal flood insurance.