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When is insurance not insurance?

Insurance laws and regulations govern the activities of those who distribute, underwrite and in some instances service insurance products. A key provision of these laws is the definition of what is insurance or what constitutes doing the business of insurance. In the US, a typical definition of insurance is found in section 1101 of the New York Insurance Law. It reads:

(a) In this article: (1) “Insurance contract” means any agreement or other transaction whereby one party, the “insurer”, is obligated to confer benefit of pecuniary value upon another party, the “insured” or “beneficiary”, dependent upon the happening of a fortuitous event in which the insured or beneficiary has, or is expected to have at the time of such happening, a material interest which will be adversely affected by the happening of such event.

(2) “Fortuitous event” means any occurrence or failure to occur which is, or is assumed by the parties to be, to a substantial extent beyond the control of either party.

This is an incredibly broad definition of insurance. On its face it covers “any agreement” conferring “pecuniary value” dependent on a “fortuitous event”. But there are many products and services that cover potential financial loss that are not treated as insurance, e.g., credit default swaps, many product warranties, home warranties, collision damage waivers in car rental agreements, etc. Some of these activities are specifically excluded by law or by administrative or judicial rulings. E.g., section 1101 of the New York Insurance Law goes on to say:

“(3-a) Notwithstanding the foregoing, the marketing, sale, offer for sale, issuance, making, proposing to make or administration of a service contract pursuant to article seventy-nine of this chapter or warranty, service contract or maintenance agreement conditioned upon or otherwise associated with the sale or supply of heating fuel shall not constitute doing an insurance business in this state.” (Emphasis added.)

Similarly, section (7)(A) says:

“Notwithstanding the foregoing, the making of a swap shall not constitute doing an insurance business in this state.”

As business activities expand and innovate the ability to model, understand and assume risk moves beyond the purview of traditional insurers, we are coming face to face with the fundamental question of “when is insurance not insurance”? This is not an academic question for falling within or outside the definition of insurance can have a profound impact on the activities of those involved. And for reasons discussed below, I think this issue will have a significant impact on how we close many of the protection gaps that currently exist.

As examples of how new products and services may bump up against definitions of an insurance business, consider the following:

1. A car manufacturer includes in the price of its self-driving car repairs of physical damage to the car from any accident—even if the owner is driving manually at the time. The manufacturer may offer this because it has substantial data showing the driving performance of technology that controls their cars and the driving performance of those who own their cars. With this, they just include the cost of these potential financial obligations in the base price of the car. (Just as car manufacturers today might include roadside assistance/ repairs in the event of breakdown of the car.)
2. The seller of seed for crops includes in the price of the seed a promise to replace the seed at no cost, in the event the crop fails.
3. A data security firm agrees to indemnify a customer for any cyber breaches.
4. The builder of a home agrees to replace the roof in the event of physical damage—from wind, falling trees or other causes. Or the builder of next generation flood resistant houses—using the latest flood mitigation materials and engineering advancements agrees to cover any flood damage.

There are many such examples, and the purpose of this note is not to dissect and analyze these, but to suggest that we need to begin to think about the issues raised by these agreements which cover potential financial loss (aka conferring pecuniary value) from fortuitous events, but where the protection is embedded in the price and the perceived value of the product.

There are obvious potential benefits in permitting these transactions. They will insure more people are covered from loss. They will permit those with specialized knowledge of the risk (and the ability to mitigate it) to provide this service. And with embedded protection, there is an antidote to one of the key contributing factors to many protection gaps that exist today, that is the human behavioral tendencies (biases) that cause people not to buy insurance protection or to under insure even in the face of well-known dangers. These biases include the tendency to over value short term benefits compared to long term benefits, to underestimate their exposure to loss, to procrastinate, or fail to take any steps when faced with complex multiple choices. These are well-known characteristics that are addressed in the fields of social sciences, behavioral economics, and psychology—but are only just beginning to be addressed within the insurance sector, as it addresses the vexing question of why there are significant, persistent protection gaps, even in high income economies.

Of course, there are countervailing considerations regarding embedded insurance as well. These include consumer protection concerns and wanting to ensure that the vendor has the financial strength to perform on its promise. These concerns need to be considered but I suggest that these considerations should not lead to the conclusion that we need to treat all of these products as the sale of insurance, rather than the sale of a house which will not flood or a car that you know will be repaired if it is in an accident. And indeed, as noted above, there are many products or services that are today exempted from the definition of insurance, even though they provide pecuniary value dependent on a fortuitous event.

As risk management and risk assessment capabilities evolve and technology and data analytics change the nature of goods and services that are offered for sale, it is important for insurance laws and regulations to evolve as well. Would not a better focus for insurance regulation be on products that transfer risk to a third party (i.e., the insurer) in exchange for a specified payment (i.e., premium) and not on commitments made by a party that can inherently manage the risk related to such commitments (such as the car manufacturer in the example above)? As with all forms of regulation, there is a balance to be struck.



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