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Insurance is the Harbinger of Repricing Risk

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Just as markets are the crowdsourced wisdom on values, insurance is the crowdsourced wisdom on risks. Rail as much as you will against the 'unfairness' of spiking insurance costs, you must nevertheless use the news: your risks having been repriced unerringly means you have business practices you should seriously rethink.

Newly perceived risks are scary, even terrifying (think COVID), but familiarity with risks breeds contempt for them, and as a result people usually underrate steadily rising risks until after they happen catastrophically. The world's first insurance company, the Fire Office, was founded 14 years after London's Great Fire of 1666 (itself brought on in part by London's depopulation in the 1665 Plague Year), because:

> There's nothing like a giant, city-destroying conflagration to get people thinking about better fire safety and measures to pay for repairs.

Risk is both an abstract and a commodity – abstract because it lies in the future and cannot be directly observed, and a commodity because it can be assumed and transferred. Risk also has a negative value, so when policyholders sell risk, they pay the insurers premiums to buy it. (The insureds also take back counterparty risk, but they don't think of that until the claims adjuster shows up after the risk has come true.)

Risk is a condition with three distinct dimensions:

- **P**robability of Event. What are the chances the thing you fear will come true?
- **L**oss given Event. If it does come true, how painful or costly is it to you?
- **C**ost of Reducing Risk. What can I do now that lowers either the Probability or the Loss? (Samuel Pepys' 1666 diary records that oil and tallow kept in London's warehouses "had been a major accelerant in the Great Fire.")

Probability is unprovable. Loss is personal because it has an external component and an internal one, and everyone values the external and the internal differently. Cost is contextual based on who you are and what you can do. Out of these endlessly kaleidoscopic perceptions arise the insurance markets.

Insurance is a product with three dimensions, each of which we capitalize because when it comes to insurance, the claims are judged by what was written in the policies, where words mean what they have been defined to mean:

- Covered **E**vents. What defines the event causing loss? Enumeration is incomplete (any list is finite), whereas categorization always creates boundary issues. (In Hurricane Katrina, for instance, some hurricane carriers argued they were not liable because the *hurricane* had not destroyed the homes, it was the flooding that ensued when the levees burst.)

- **P**remiums. For risks that endure (for example, nearly anything to do with health), how much of the risk is consumed or abated every month or year?
- **D**eductible. Not only do deductibles reduce the administrative burden on the carrier for not having to investigate trivial claims, but they also motivate policyholders to avoid foolish risks.

Shifting who pays after the event also shifts who should mitigate the risk before, away from the insured and onto the insurer. This obvious misalignment creates moral hazard and has spawning plot lines galore for noir movies:

> "We were talking about automobile insurance, only you were thinking about murder."

Conversely, the act of writing policies against covered events motivates the insurers to set up their external strategies to mitigate their contractually defined risks:

By 1700, companies had realized that it would probably be cheaper to put out the fires more effectively than pay for rebuilds.

> "Insurers employed] their own fire brigades and created 'fire mark' plates to identify which houses were insured by each company when the fire brigades arrived. Insurance companies often had reciprocal arrangements with each other, so that if a fire brigade put out a fire at a house insured by another company, then the brigade's company would be reimbursed."

Good insurance adds value to the insured: people sell risk when they have less financial wherewithal to absorb the loss if it happens. That's why many mortgage lenders insist that borrowers buy the insurance as part of the overall financial product. The constant nudges—or, in times of disruption, big shoves—in insurance prices and terms (events, premiums and deductibles) interactively create a complex ecosystem, from which information is always flowing.

As such, risk evaluation is the only way that's market-real – by what people will sell or buy it for:

- The price isn't what that risk *actually is*.
- The price isn't what *expert bystanders think* that risk is.
- The price is what the *market demonstrates:* what one group will pay to sell that risk while another group will be paid to buy that risk.

In such a system, risk migrates to the party best able to evaluate, control, manage and bear it – and that includes judging which preventive measures lower risk enough to justify the cost of implementing them. Such ecosystems also self-organize to reduce risk collectively:

Before long the major insurers realized it would be more efficient to have single, unified force to watch over London. In 1833, the London Fire Engine Establishment was created, with constant "attendance day and night" across 17 key locations across the City, and three 'floating engines' on the Thames, to extinguish fires in the docks.

Where risk trades in the market spotlights where the market is going. Sometimes, the market is 'wrong,' in that a specialized activity may, in fact, be less risky than broadly realized. Then, the captive insurance company, invented in the 1950s, emerged, and today, it is a staple of affordable housing, both nationally and in high-cost states, such as New York.

Like 'insurance for insurance companies,' reinsurance began in post-Great-Fire London, in 1688 at Edward Lloyd's coffee-house. It is the business of selling a piece of an insurance contract, such as a Black Swan event (very low probability with very high loss given default), from a less-capitalized insurer to a more-capitalized one. Most importantly for the 21st-century world, in any money-based society, the ultimate reinsurer is the sovereign government itself, because ultimately, the denomination of any insurance contract is in money, and money is itself a commodity whose value depends on who or what stands behind it. In affordable housing, as in many other fields, the government is a third-party beneficiary of good insurance because otherwise, the government owns the liability even if it often tried to distance itself from it: just ask Fannie Mae or Freddie Mac.

As the ultimate reinsurer, the government also takes unto itself the role of ultimate risk manipulator. Via monetary policy, tax policy, laws pertaining to legal liability (e.g., in health insurance) and especially in insurance policy (e.g., the Affordable Care Act), the government can change market dynamics by imposing its proxy judgment of future risks versus present costs. If you think any particular type of insurance costs too much, examine how the financial consequences of different risks have expanded or transmogrified over the years, whether in the courts, the legislatures, or the administrations. All of these bodies make rules that assign particular costs, in which public choice theory shifts moral hazard by paying for *today's* mandates out of the wallets of *tomorrow's* voters and taxpayers – even if those future voters are merely aged versions of current voters who want.

Stare long enough and you will see that insurance and reinsurance are a maze of mirrors with the government standing at the center and moving the walls. *That's* why insurance repricing today reflects the government's self-fulfilling prophecies about tomorrow. When today's insurance rises in cost, we are wise to act as if this means the real risks have become more expensive, because even if they haven't yet, they will all too soon.

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