

INSURANCE COST AND AVAILABILITY PROBLEMS
FOR SMALL INNER-CITY RETAILERS

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SUMMARY

One of the ingredients essential to reinvestment in inner-city neighborhoods is the availability of reasonably priced insurance to small retailers. In fact, the inability of small retailers to obtain reasonably priced insurance has been cited as a major cause of urban disinvestment. This paper explores the insurance mechanism as it applies to small business, examining the amount and types of coverage, the underwriting (accepting or rejecting current or potential policy holders) practices and policies and the processes of determining the costs of insurance. It explores some of the underlying assumptions which can result in inadequate coverage, or excessive costs and discusses the potential consequences for inner-city businesses and their neighborhoods.

Finally, the paper explores a range of research and strategy development efforts which, if undertaken, would help mitigate the insurance problems of small inner-city retailers. The Small Business Insurance Intervention Center, a partnership strategy involving small business representatives, insurance industry representatives, local government representatives, and the state insurance commissioner, is developed into a proposal form. It is recommended as an early step that can be taken to begin the process of solving inner-city small business insurance problems.

In the preparation of this report, no assumptions have been made regarding the policies and practices of any particular insurance company or agency. In fact, some companies appear to be taking the initiative to make insurance available at reasonable costs to inner-city businesses.

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INTRODUCTION

It has been said frequently that business would be difficult, if not impossible, without the insurance mechanism working with it.¹

Insurance contributes a number of factors essential to the well-being of the inner-city retailer. Among the most important of these are protecting the business owner from potentially debilitating losses, assistance in risk management, enabling the acquisition of credit and providing a level of psychological security. Further, through its contributions to the well-being of inner-city retail business, insurance plays a key role in maintaining the vitality of our urban neighborhoods.

The primary purpose of commercial insurance is to shield the insured from the financial losses that could result from specified types of accidents.

Insurance is a basic necessity for a property owner. By paying a premium that represents a relatively small amount compared to the value of his home or business, an owner acquires protection against the possibility that his property may be damaged or destroyed. The opportunity for every responsible individual to obtain security for his savings and investments is vital in a free society.²

This protection can allow a retailer, who might otherwise be forced out of business, be closed for extended periods or suffer other financial hardships, to recover from a loss and remain viable.

Many insurance companies offer risk management counseling to their insureds. This counseling, although generally reserved for larger

businesses, can both help prevent losses and minimize the extent of damage if a loss occurs. In recent television commercials, the Hartford Insurance Company has stressed the significance of the risk management relationship between the insurer and the insured. Loss prevention and control provides an additional layer of protection against potential financial hardship for the retailer.

Adequate insurance coverage is essential to obtaining business financing.

[Insurance] is a cornerstone of credit. Without insurance, banks and other financial institutions will not and cannot make loans. New businesses cannot be opened, and existing businesses cannot expand, or even survive.³

In a survey of financial institutions conducted in 1967 by the President's National Advisory Panel on Insurance Availability in Riot-Affected Areas and subsequently analyzed by Richard F. Syron, it was found that all but one of the institutions lending in the inner-city required fire and extended coverage on the property and 83 percent required fire and extended coverage on inventory for secured business loans. Five percent of the institutions indicated that they had foreclosed loans in 1967 due to insurance problems in "substandard" areas.⁴

The sense of security that insurance provides for some business owners should not be overlooked, even though it is impossible to measure the effects of its presence or absence. Psychologists tell us that a sense of security is one of our most basic needs and that its absence can adversely affect our performance in all

aspects of our lives, including the conduct of business.

Through its effects on inner-city businesses, the insurance industry has a major impact on the vitality of our urban neighborhoods. Thriving businesses will anchor neighborhoods and reinforce the neighborhood image for residents, lenders, city officials and other key actors. Where businesses are failing due to a lack of insurance (inability to obtain financing for repairs or improvements, expansion or purchase of a building or to maintain adequate inventories) the image of the community is adversely affected and myriad problems can ensue. The President's National Advisory Panel on Insurance in Riot-Affected Areas found that:

Insurance is essential to revitalize our cities.

Without insurance, buildings are left to deteriorate; services, goods and jobs diminish. Efforts to rebuild our nation's inner cities cannot move forward. Communities without insurance are communities without hope.⁵

Given the necessity of adequate insurance coverage for the maintenance of viable businesses and vital neighborhoods, it is the purpose of this study to explore the availability and cost problems of property, liability and crime insurance for small inner city retailers. Although the insurance problems of businesses have been mentioned in many of the reports on inner-city insurance problems, attention has generally been focused on housing and auto insurance.

There are several reasons for this lack of attention to the commercial side of the question. First, small businesses have not

been organized into politically potent groups that could bring the issues to the attention of the public and private policy shapers. The job of running a small business is often so time and energy consuming that the business owner has little choice but to suffer in silence. Second, commercial insurance is much more complex than either housing or auto insurance. There are dozens of types of retailers in different types of buildings with varying amounts of floor space and varying degrees of profitability. Furthermore, businesses are exposed to a variety of risks not experienced by homes or autos. It is, therefore, much more difficult to identify cost and availability problems of a general nature as opposed to isolated instances. Finally, the small business owner is often fiercely independent and very cautious about revealing any information which is proprietary or which could potentially be used to undermine the business.

Because these constraints have been experienced in this undertaking and because the resources were limited, the scope of this study is necessarily modest. It is hoped that this report will begin to focus attention on the critical insurance issues confronting inner-city retailers. It is our intention to raise the relevant questions and provide an initial framework within which some of the answers may be found.

Approach

This study has relied heavily on indirect methods in its attempt to get some handles on insurance cost and availability problems for small inner-city retailers. Much of the information was developed through interviews.

The author interviewed small business operators; directors of business associations, chambers of commerce and local development corporations; insurance agents and brokers; insurance company representatives (including executives and underwriters) producer trade association representatives, Illinois FAIR Plan Association staff, Metropolitan Chicago Loss Bureau staff, a representative of the Illinois Insurance Services Office, staff of the Illinois Department of Insurance and others.

The second major source of information was the literature in the field. The literature study was intensive but not exhaustive. In addition to the usual objectives of a literature study, an attempt was made to identify some of the underwriting texts widely used in commercial underwriting. Two such texts were found and the underwriting guidelines examined.

Throughout the study the author attempted to obtain statistical information - almost universally without success.

This report does not assume anything nor is it intended to imply anything about any particular insurance company, agency or small business.

COVERAGES

*Life is full of risks, avoidable and unavoidable. Risks may result in financial losses, large or small. Insurance, like prevention, is one way to protect against these losses.*⁶

There is a wide range of coverages available for the various perils which threaten the small retailer. However, the types of policies available tend to be rather uniform throughout the industry. The policy forms used by most insurance companies are developed by the Insurance Services Office (ISO), an unincorporated national organization supported by its member insurance companies. Most companies not using ISO forms develop forms largely based on ISO forms - so-called deviated forms. This product standardization is encouraged, if not mandated, by most states which require the forms to be filed and approved and require specific approval for deviated forms.

The types of coverages considered in this study are fire, extended coverage, vandalism and malicious mischief, liability and crime. The list represents a basic set of coverages offered by property and casualty insurers to acceptable applicants. Fire insurance is the oldest, most fundamental of the property insurance coverages. Fire insurance protects the insured against the damage to or destruction of his or her property resulting from a fire. A standard fire insurance policy often carries one or more endorsements (added forms altering the policy) for covering additional perils. The most common of these is the extended coverage endorsement which adds coverage for wind, hail, explo-

sion, riot, riot attending a strike, civil commotion, aircraft, vehicular damage and smoke.⁷ A vandalism and malicious mischief endorsement may be added if the policy includes an extended coverage endorsement. The vandalism and malicious mischief endorsement protects the insured against willful and malicious damage or destruction of insured property.⁸ (All of the above coverages may be applied to the building, the contents or both.)

The coverages discussed so far have all been for losses caused directly by the perils insured against. Another genre of loss is the indirect or consequential loss. Probably the most important of the consequential losses incurred by the small retailer is the loss of income, which may in fact be a greater economic loss than the direct property loss. Business interruption insurance provides the business owner with such coverage in the event that the loss of earnings is a consequence of a direct loss insured against. According to the Business Interruption Primer:

Business interruption insurance, in any of its forms, insures the money that a business makes. For that reason, it is a basic necessary coverage for most mercantile risks.⁹

The importance of business interruption insurance cannot be overstated, for it not only allows the business owner and the business to survive economically during the time the business is not able to operate, it protects the ability to obtain financing.

Even though a business is not making a profit, it is making earnings, and it is sorely in need of earnings

coverage so that its credit position - doubtful as it may be - can be maintained during a period of interruption.¹⁰

Another type of loss a business owner may sustain is a legal obligation to pay another person for personal injuries or property damages suffered as a result of the operation of the business or use and maintenance of the premises. This potential loss can be protected against by the purchase of liability insurance which covers bodily injury and property damage claims made against the business.

Crime Insurance includes coverage for losses due to robbery, burglary and theft. Robbery is "the felonious taking, either by force or by fear of force, of the property of another, commonly known as the 'hold-up'".¹¹ Burglary is breaking and entering the premises when not open and stealing insured property. Theft is an inclusive term applying to robbery and burglary as well as other kinds of stealing.¹² The role of crime insurance is self-evident.

A fairly recent addition is the multiple line or package policy. Under this concept, one policy can be issued to cover both property and liability losses with optional addition of crime coverage. Similar to the homeowner's policy, it permits the business owner to obtain a broad range of coverages relatively simply and at a discount. The most common package policy for the small retailer is the business owners policy. This policy includes man-

datory coverage of property and liability and optional crime coverage. Some companies also include business interruption insurance coverage, as well as other coverages, in the business owners policy.

Residual Market Coverage

There are two markets in which insurance is sold to consumers, the normal market and the residual market. The normal market is the mechanism through which most insurance is sold. Through the normal market the insurance companies provide a full range of products at relatively standard rates. The normal market also includes "preferred risk" insurance writers which accept only the best risks and provide their products at reduced rates.

The residual market provides insurance to those individuals or organizations unable to obtain insurance in the normal market. The residual market includes voluntary market writers, the involuntary market and government insurance. The voluntary market residual writers are the so-called substandard companies and the excess and surplus lines writers. The substandard companies are state licensed companies which provide insurance to substandard risks or risks not acceptable to standard companies. The excess and surplus writers are not licensed in the state and are therefore generally outside the regulatory reach of the state. The policies available from the voluntary residual writers often provide a narrower range of coverages than those available in the standard market.¹³

The involuntary market encompasses those insurance programs mandated by state law which requires insurance companies writing a particular kind of insurance to help provide coverage to eligible risks not able to obtain voluntary market coverage.

Involuntary market property insurance coverage is provided to eligible retailers in 26 states through state FAIR Plans (FAIR is an acronym for Fair Access to Insurance Requirements). The FAIR Plans are generally structured as insurance pools in which the losses incurred by the plans are distributed among the licensed property insurance writers in proportion to the amount of property insurance they write in the state (usually premium volumes). The commercial coverage available through the FAIR Plan in most states is very limited. Most state FAIR Plans write only a standard fire, extended coverage and vandalism and malicious mischief policy on buildings and/or contents.

The pervasive problem of coverage limitations is basic to the residual market risk and exists regardless of the mechanical format utilized by FAIR Plans. The residual market risk lacks access to the variety of the coverage forms and combinations available within the voluntary market from a variety of insurers. By virtue of his having been labeled an unacceptable risk (perhaps for no other or better reason than cancellation by some insurer of the agency contract of his agent), the residual market insured finds himself at the mercy of an involuntary market mechanism.

It can be seen, then, that the FAIR Plan insured is generally able to obtain only the barest essential fire, extended coverage and vandalism and malicious mischief insurance, and he is denied not only the additional protection provided by . . . commercial multi-peril policies but is also denied access to the more liberal policy terms, economies and avoidance of coverage gaps or duplications inherent in the packaging of coverages.¹⁴

Business interruption, liability and crime insurance are not available and in most states no involuntary market mechanisms exist through which a small retailer can obtain such coverages.

There is, however, a Federal Crime Insurance program administered by the Federal Insurance Administration, an agency of the federal government. Through this program, commercial businesses in specified urban areas are able to obtain robbery and burglary coverages if they meet the eligibility requirements (providing adequate safeguards against those perils).¹⁵ Unlike the involuntary market mechanisms, any net losses incurred by this program would be paid by the U.S. Treasury, not by insurance companies.

It is apparent that inner-city retailers who cannot get insurance in the voluntary market may be unable to obtain insurance coverages (such as liability and business interruption) that are considered by many to be essential to operating a healthy business. It is incumbent upon us then to examine the processes and criteria which are employed by the insurance industry to select those commercial risks which it will insure in the voluntary market and those it will not.

UNDERWRITING

*In insurance . . . there is one form of competition that seldom exists in the case of other products or services. That is selection competition - the ability of an insurer to affect its success, not by the price or quality of its products, but by selecting its customers in a fashion that will give it an advantage over its rivals.*¹⁶

Underwriting is the process of evaluating a potential risk to determine whether or not to provide the insurance requested and if so what type of policy to issue--and at what rates. The primary focus of underwriting is selection, i.e., the acceptance or rejection of a risk. The underwriter's job is to evaluate the level of risk involved and to determine whether the anticipated premiums sufficiently offset the risk to warrant writing the insurance. "The duty of the underwriter is to write insurance at a profit."¹⁷

The commercial underwriter has three subjects to evaluate - the business and the business owner, the property being insured and the "environment." The object of the evaluation of the business and the owner is to determine if the premiums are likely to be paid and, more importantly, if there are factors about one or the other which would increase the likelihood of a loss. The two potential hazards sought by the underwriter are the "moral" and "morale" hazards. A moral hazard is the increased likelihood that the insured will take deliberate actions which would cause or increase the severity of a loss. A morale hazard is the likelihood that an insured's indifference will increase the probability

of a loss.

If the property owner actually takes steps to destroy his own property, that is a moral hazard. If he fails to take steps that would help to protect against a loss, that is a morale hazard. [Emphasis original]¹⁸

Needless to say, these hazards are very difficult to evaluate. The core of the difficulty is that, "it is impossible to discover the thoughts of another person, certainly within the limited scope of investigation available to most underwriters." ¹⁹

In evaluating the property, the underwriter is out to determine the reasonableness of the amount of insurance being sought and the relative probability that a loss will be suffered because of characteristics of the premises. In determining the reasonableness of the amount of insurance, the underwriter wants to avoid under-insuring or over-insuring the property. Under-insuring is a problem because most losses suffered are less than total losses. The damage from a restaurant fire, for example, may be confined to the kitchen resulting in a \$10,000 loss on a \$100,000 facility. It would seem that a \$10,000 fire policy would be adequate to cover the loss. However, the insurance rates used by the companies assume full insurance (usually at least 80% of the value of the insured property), and take into account the probability that most losses will be partial. Because the premiums are predicated on full insurance coverage, the companies would lose money if a substantial proportion of their customers were less than fully insured and were paid in full for their partial losses. The underwriter, whose job it is to write

insurance at a profit, is obligated to guard against under-insurance by either rejecting the application or requiring co-insurance, an arrangement under which partial losses are paid in the same proportion as the amount of insurance carried to the amount that should be carried. In the restaurant example, the owner with a \$10,000 policy is carrying 1/8 of the coverage required for full insurance. He or she would therefore receive 1/8 of the \$10,000 loss or \$1,250.

The over-insurance problem is one in which the amount of insurance carried on the property exceeds the value of the property. This creates a situation in which the insured stands to benefit economically from destroying his or her own property - creating a potential moral or morale hazard. This problem is complicated by different values that may apply to a particular piece of property; the market value (what the property would sell for on the open market) may be substantially less than replacement value (what it would cost to replace the property if it were totally destroyed) or actual cash value (replacement value less depreciation - generally to a value of not less than 50% of replacement value). Since insurance is generally written on a replacement or actual cash value basis, a potential moral or morale hazard may exist if the market value is much lower than the replacement or actual cash value because the owner could receive more money if the business were destroyed than if it were sold.

Evaluating the "riskiness" of the property involves identifying factors which could increase the likelihood or severity of a loss. Factors such as the adequacy of the wiring, the quality of the locks on the doors and the level of housekeeping are examined.

Environmental hazards are those hazards which are beyond the control of the insured. If a shoe store is located in the same building as a bar and grill, the chance of a fire communicating from the bar and grill makes that shoe store a greater fire risk than the shoe store which is the sole occupant of a building.

The underwriters, looking at all these factors, make one or more decisions critical to the potential insured. In addition to deciding whether to accept or reject the risks, for those risks which are accepted, they decide the terms under which the policies will be written.

The underwriter then has immense power. In many cases his or her decision will determine if a business will thrive or languish (or even fail) and that success or failure can have glorious or grave ramifications for the neighborhood in which the business is located. It is important, therefore, to look more closely at the criteria or underwriting "rules" which form the basis of those decisions and look at the fairness of those rules in both an actuarial and society equity sense.

Underwriting Rules

Two circumstances make it very difficult to assess the underwriting rules applied to small retailers. First, company underwriting manuals are among the most carefully guarded materials in the industry. Second, underwriting has, until recently, been part of an oral tradition with little written about the subject.

[The approach to training new underwriters] is a carry over from the guild system used in medieval days to train craftsmen. The apprentice observed the master, learning by observation and by listening to the instructions of the teacher. This method of imparting the principals and practices of underwriting to trainees²⁰ is still favored by many experienced underwriters.

There are, however, underwriting texts and guides in print which identify rules to be used in underwriting. One can neither assume that these rules are universally employed nor that they are used by any particular company. Two such books, which will be extensively cited hereafter, appear to be widely used in the industry. The first, Underwriting Principals and Practices,²¹ was recommended by an industry representative and the second, Commercial Fire Underwriting,²² is in its ninth printing since it was copyrighted in 1969. Both are written by Robert B. Holtom, who has been called the "dean of American underwriters" by the National Underwriter - Property and Casualty Edition.²³

The impression that underwriting is the process of objectively applying a set of criteria objectively derived is greatly exaggerated. It is arguable that subjectivity plays the greater role

in both the derivation of the "rules" and their application. As stated by Michigan Insurance Commissioner Thomas C. Jones:

First, many of the underwriting 'rules' are not rules at all, but are a conglomeration of myths, notions, perceptions, and beliefs. They are often subjective, not based upon scientific, empirical fact. Second, many of the 'rules' are not put into writing and are therefore subject to inconsistent application. Third, an underwriting rule may be unduly simplistic. It is more difficult though more equitable, to find the true reasons for variations in loss characteristics, and to make individualized judgments based upon those factors.²⁴

Put another way in an underwriting text:

Sometimes [the underwriter] will let his prejudices enter in: if he does not like tire repair shops, he may look with a jaundiced eye at those whose rate differs from the norm. This is to be expected for underwriting is subjective in many respects, not just objective. If cold facts alone could determine acceptability, electronic computers would replace underwriters. The fact that this has not happened is a demonstration that the prejudices, impressions and analytical abilities of an experienced person are needed.²⁵

It is because underwriting is based in part on the underwriter's prejudices that the underwriting process becomes suspect. It prevents one from knowing the true relationship between the factors which form the basis for rejection and risk represented by those factors.

Many of the factors identified in the underwriting texts would have the effect (if not the intent) of discriminating against businesses and business owners on the basis of life style, race or ethnicity, or economic class. Not only is the application of

these factors socially unfair, it is actuarially unfair because it has not been clearly demonstrated that these factors have a causal relationship to losses.

Some examples of these underwriting factors follow. Each is considered reason enough for rejection of an application.

Not a reliable citizen of the country. Because he is not a citizen, his loyalties are suspect, and if he is not considered reliable, it is difficult to do business with him. [No definition of "reliable" is given. The application of the citizenship factor would discriminate against large numbers of inner city retailers.]

Does not own a home, or is not married. These indicate a possible lack of stability.

Does not appear to be cooperative. The insurer will need cooperation in reducing hazards which might cause losses or in settling claims. [Emphasis added]

Questionable legality or respectability of the business. The insurer might need to bare all the facts about the business in court in case of a loss. [Emphasis added. No where is "respectability" or "questionable respectability" defined. Certainly, if the business could be interpreted as illegal, legitimate grounds for denial of insurance exist.]

Has been canceled by another insurer, or has a record of many past losses. These factors tend to indicate that further experience may not be good. [There is no suggestion that the reason for cancellation be explored. Consequently, a retailer canceled by one insurer is stigmatized regardless of the loss susceptibility he or she represents. If, upon investigation, it is found that cancellation was based on sound criteria and that the factors which caused cancellation have not improved, sufficient grounds for denial may be present. One such factor might be a substantial loss history.]

. . . any applicant with a poor or questionable business reputation must be considered ineligible. Related items might also [result in ineligibility], such as the associates of the applicant and types of business conducted by neighbors and associates.

[Emphasis added. The terms "poor" and "questionable" are undefined as they apply to the applicant's business reputation. Legitimate reputation factors such as a history of bankruptcies or suspicious fires do exist, but without constraining the interpretation it is all too easy to extend the application to areas which have no effect on potential loss.]²⁶

On the basis of these factors a small retailer can be denied essential insurance. The fact that no definitions of terms or reasonable guidelines for applying these underwriting factors have been provided lends credence to the argument that commercial underwriting can be extremely subjective and unfairly discriminatory.

Underwriting on the Basis of Location

Another class of underwriting criteria used to deny or otherwise limit insurance availability for the inner city retailer is based on the location of the premises in which the business is housed. The practice of denying insurance based on location is commonly known as "redlining." An example, cited in the 1968 Meeting the Insurance Crisis of our Cities, of the use of this concept in an insurance company underwriting manual is:

A good way to keep this information available and up to date is by the use of a red line around the questionable areas on territorial maps centrally located in the Underwriting Division for ease of reference by all underwriting personnel.²⁷

This type of underwriting has been referred to as "meat ax" underwriting because of the gross generalization involved in assuming that all risks in a neighborhood are ineligible for coverage.²⁸

It would appear that the importance of the neighborhood in which the business is located to the practice of commercial underwriting cannot be over-stated. In discussing the evaluation of business potential by the fire insurance underwriter, Commercial Fire Underwriting advises the underwriter that:

A poor location can result in such poor potential that all of the other factors should be ignored, no matter how favorable they are. This illustrates how vital this factor can be in extreme cases.²⁹

Likewise, a commercial liability underwriter is advised in Underwriting Principals and Practices that a risk may be ineligible if it is:

Not in a respectable neighborhood. This fact is a clue to the respectability of the business itself. [Emphasis added]³⁰

And, in the same text, the crime insurance underwriter is told that:

Burglaries and robberies occur more frequently in some neighborhoods than others. Where these high-crime areas are too small to be rated for the exposure, an underwriter will avoid writing crime insurance there.³¹

The result is that whole neighborhoods have been "written off" by insurance companies on the basis of the perceptions of the underwriters that the neighborhood itself increases the susceptibility to losses. The fact is that "neighborhood" underwriting is a highly questionable practice both in terms of actuarial accuracy and social equity. Such practices can all too easily result in excluding from the normal insurance market those businesses which are located in neighborhoods that are predominantly minority or low

income or in which the buildings are old.

Suggestive of the kinds of reasoning which yield those results is the following statement from Commercial Fire Underwriting:

Neighborhood. The location of commercial property in relation to its neighborhood is important to a fire underwriter. This can include many considerations of both a physical and a moral nature.

Every large city has old, run-down areas. Some types of business may flourish in these neighborhoods, for example, "flop house" hotels, bars, and second-hand clothing stores, but many other businesses are marginal in such locations. As the neighborhood deteriorates, some of these marginal occupancies are forced to close. The problem of a fire underwriter is to try to avoid having the businessman "sell out" to his (the underwriter's) insurance carrier.³²

The question of the validity of neighborhood underwriting has been the subject of considerable debate within and without the insurance industry. However, even those arguing in favor of using neighborhood characteristics as underwriting factors generally stipulate that neighborhood characteristics should not be the sole factor in denying a risk and that neighborhood factors should be based on solid statistical evidence clearly demonstrating increased likelihood of loss frequency or severity. Exemplary of this school of thought is the following guideline from a major company's commercial insurance underwriting manual:

Location - Market and supply accessibility; external vandalism or arson possibilities;

Note: In evaluating location, the grading must be based on an analysis of the individual risk characteristics of the specific location, not a judgment based solely on an analyst's general perception of an area, neighborhood, or location.

The issue is further complicated by the considerable attention now focused on the arson problems of many urban neighborhoods. The difficulty is finding those factors which can reasonably predict the probability of a loss without unfairly excluding "clean" risks - and without permitting subjective denial based on a neighborhood's race, ethnicity or economic class.

The Inspector, The Reinsurer and the Producer

Three other entities participate in the underwriting process - the inspector, the reinsurer and the producer (the agent or broker). Many companies require physical inspections of certain types of risks or permit the underwriter to order an inspection. The inspection may be conducted by either in-house inspection staff or an outside inspection firm. The inspector's report is used by the underwriter as part of the evaluation of the acceptability of the risk. It is therefore possible to communicate the subjective impressions of an inspector to an underwriter. An example of this potential can be found in an inspection report filed by an outside inspection firm with a major company whose commercial underwriting staff are prohibited from underwriting on the basis of neighborhood. On the form are printed the following three items:

9. Type of neighborhood?. . . NEIGHBORHOOD_____.
10. Is neighborhood deteriorating?. . . DETERIORATING

Yes	No
-----	----
11. Subject to riot or excessive VMM?. . . RIOT or VMM

Yes	No
-----	----

VMM means vandalism and malicious mischief. The form contains no printed explanation of the criteria used to determine the answers

to those questions. There is, however, space for narrative.

The following is direct quote from a report:

Neighborhood: This building is situated at a busy intersection in this deteriorating, working to low class semi-business area which is subject to excessive vandalism and high crime.

The relevance of the neighborhood being "working to low class" is not explained and no evidence in support of the contention that the area is subject to "excessive vandalism and high crime" is provided. This report was prepared in mid-1979. It should be noted that fire insurance on the subject property was written by the company which ordered the report.

It should also be noted the same company's internal inspection report form contains the following item.

10. Desirable neighborhood? Y N

It fails to define "desirable."

Reinsurance is a mechanism through which part or all of a risk is passed on to another insurer, often a company that writes only reinsurance. The contract between the primary insurers and the reinsurer is known as a reinsurance treaty. These treaties generally contain the underwriting parameters within which the reinsurer will accept some or all of the risk, generally identifying specific types of risks that the reinsurer will not accept, and the primary insurance underwriter is bound by those underwriting restrictions. ³³

The insurance producer also performs some underwriting functions. Through both formal and informal mechanisms the producer learns which risks are likely to be acceptable to a given company and which are not. The prudent producer soon learns to screen the applicants before forwarding the applications to the company.

Under current company underwriting restraints, producers know there are certain types and locations of risks that their insurers will not accept, or which will be accepted only in limited numbers, regardless of merit. If a producer violates this unwritten rule by submitting too many unwanted risks, he can anticipate cancellation of his agency relationship with the insurer.³⁴

Agency cancellation is an extreme practice that has been used by some companies to eliminate policy holders in "undesirable" neighborhoods from the company's book of business. The effects of cancelling agency contracts are far more serious and long term than terminating individual policies. The agent is the point of entry into the insurance market for most businesses. The absence of an agent in the neighborhood licensed to write in the voluntary market means that many businesses will not have full access to the voluntary market and will either be uninsured or forced into the involuntary market. Those businesses which have policies canceled or non-renewed because the agent lost his or her contract are unable to obtain insurance from those companies which categorically deny insurance to anyone who has been terminated by another insurer. Other agents, knowing that agents who had written substantial amounts of business in a neighborhood had lost their contracts, are likely to be hesitant to write insurance

in those neighborhoods. Thus, businesses operating in those neighborhoods become stigmatized as poor risks for reasons over which they have no control and which have nothing to do with the real risks involved.

Insurance underwriting may involve practices which result in unfair discrimination against business owners who are powerless to alter the factors which result in their inability to obtain insurance, factors which, in many cases, have no apparent relationship to actual or potential losses. These practices must be examined and re-examined from within the industry and from outside, and where the relationship to actual or potential losses is too weak or non-existent they must be cast aside. That process will benefit not only the small business operators who have been unfairly discriminated against but also the prudent insurers which will be earning the premiums.

COSTS

*The perfume of the premium hides the odor of the risk.*³⁵

The costs of insurance are of critical importance to the small retailer because the amount of earnings which can be contributed to insurance is often quite constrained. High insurance costs may necessitate a condition of being under-or uninsured, even among otherwise healthy businesses. On the other hand, a small retailer that must carry high cost insurance may find that the premiums impose serious cash flow problems and threaten the viability of an otherwise healthy business.

The annual cost or premium of a given coverage is a function of the amount of coverage, the rate, the size of the deductible, after charges or surcharges and package discounts. The rate, usually expressed as a certain cost for each one hundred dollars of coverage, is the company's expression of what it perceives to be the probability of loss as well as administrative costs and profits. If, for example, the fire insurance rate on a given commercial risk is one dollar for each one hundred dollars of coverage, the premium for a \$50,000 policy would be \$500.00.

Several factors can modify the rates. The size of the policy affects the rates with larger policies generally receiving discounts because many of the administrative costs are nearly the same whether it is a \$1,000 or a \$1,000,000 policy. The size of the deductible also affects the rate - the larger deductible

means the insured will cover his or her own small losses saving the insurer both loss payments and administrative costs. Also, the moral and morale hazards are felt to be reduced because the insured has retained part of the risk. Package discounts are generally applied to the rates for each of the coverages in a multi-peril policy such as business owner's insurance. Because administrative costs are reduced by providing several lines of insurance in one policy, and because premiums from less risky lines can help cover the loss of the more risky lines, a discount of up to fifteen percent is often given.

Finally, a company may apply penalties, in the form of surcharges or after charges, for factors which it feels makes the probability of a loss greater than the rate implies. The surcharge involves an increase in the rate, whereas an after charge is a flat amount added to the premium. In the example used above, in one company an underwriter may apply a ten cent (or ten percent) surcharge to the rate because an inspection report indicates that there is trash stored under a staircase. Another company's underwriter might apply a fifty dollar after charge to the annual premium for the same reason.

Rate-Making

Rates are established by class or by schedule. "Class rates are used for large groups of homogeneous risks - that is risks that have similar characteristics." [Emphasis original]³⁶ Schedule rates are used to rate each risk individually. The rate is derived

by evaluating each of a predetermined set of characteristics and assigning a point value for each characteristic from a table or schedule. The accumulated points are then converted to a rate using another schedule.

Schedule rating is commonly used with commercial fire risks rather than class rating because frequency of loss is low but severity of loss is high. Each risk is compared on a number of factors, all of them physical, in order to determine the modification to be made in the rate. Rates for each individual risk are then published or otherwise made available.³⁷

There is a movement in the industry to use class rates more extensively in rating commercial fire risks. Since August 1979 class rates are being used for most small commercial fire risks (7,500 square feet or less) in Illinois.³⁸

"The nature of the insurance industry is that price-fixing is an integral part of the business."³⁹ Most insurers use rates established by rating bureaus, non-profit organizations supported by member and subscriber insurance companies. The justification for industry-wide use of bureau rates is the statistical necessity of basing loss projections on large numbers of similar risks. Bureau companies either use the bureau rates directly or modify them, so-called deviated rates. Some companies, particularly very large companies, develop their own rates which are based on their loss experience with a large number of risks.

Commercial fire insurance rate-making in Illinois differs from the practice found in most states because Illinois has no rate

law. The Insurance Services Office of Illinois (ISO) feels that because Illinois has no rate law, the industry could be subject to antitrust suits if the companies used common rates. Therefore, ISO provides member and subscriber companies with a figure known as a "loss cost factor" which the insurers use as the basis for establishing their own rates. The loss cost factor represents the average projected loss for each one hundred dollars worth of coverage. Each company then applies a multiplier to that factor to derive its rates. In the example used above, if ISO indicated that the loss cost factor for that business is .50 and the company uses a multiplier of 2.0 to derive its rate, the rate would be \$1.00 for each one hundred dollars worth of coverage. The multiplier can represent both the company's administrative costs and profits and its loss experience with that class of business.

Although rate-making is highly centralized, nationally coordinated and very sophisticated, it is not necessarily objective. The Assistant General Counsel of INA Corporation said:

Often statistics do not exist or are not credible and informed judgment has been accepted. Look, for example, at the grouping of occupancies in a commercial fire classification system. There are an almost infinite number of differences and distinctions of this nature.⁴⁰

Given the question of the credibility of both the statistics and the "informed judgment" involved in rate-making, one has to wonder about the actuarial fairness of the resultant rates. In

fact:

A study of loss experience in retail establishments found that existing classification systems could explain 12.5% of actual losses. The variables examined in the study were geographic location, fire protection, exposure and type of construction.⁴¹

The doubt that has been cast on actuarial fairness compounds the question of social fairness. The industry argues that it would be unfair to require standard risks to pay higher rates which would in effect subsidize those risks which are grouped in a higher rating class (substandard risks) on the basis of factors which are beyond their control (location, for example). A cogent counter argument has been provided by former Massachusetts Insurance Commissioner James Stone. Although his comments are directed at auto insurance, they are equally applicable to other forms of insurance, including business insurance.

[Commissioner] Stone argues that all insurance is a subsidy, since drivers without accidents subsidize those with accidents, and he insists that his rating system is a fairer subsidy. Through their class-pricing, he argues, insurers force accident free drivers in high-rated groups to subsidize accident prone drivers in those groups rather than spreading that burden more evenly throughout society. Stone insists that insurers grossly overcharge the 90% of good drivers in the youthful urban group in order to cover the risk of the 10% of bad drivers in that group who will have accidents. His system underprices insurance for 10%, at least until they actually have an accident, but, by making a large group of suburban and rural drivers pay a little more, it avoids the heavy penalty on the 90% of good youthful drivers. "There are flaws in both systems," he argues, "but at least the flaws in mine are based on the notion that you should not be penalized until proven guilty."⁴²

The changes in the premiums in the normal market would be very small if this approach were adopted.

The Involuntary Market

Those risks which are unable to obtain insurance at any price in the standard market are relegated either to being uninsured or to the involuntary residual market, i.e., the FAIR Plan or Federal Crime Insurance. The costs in the involuntary market, predicated on the assumption that those insureds relegated to the involuntary market represent greater risk than the voluntary market insureds, are generally substantially higher than in the voluntary market.

Once a risk, even a loss-free risk, is forced into a FAIR Plan, it may be subjected to various penalties not shared by similar loss-free risks which are not forced into the plans. Where, because of syndication or otherwise, self-rating procedures of a plan impose upon these loss-free risks rates which are higher than those for risks outside the plan which are indistinguishable, objectively. There is, in fact, price discrimination even if such discrimination is not defined as illegal by statute.⁴³

Similarly, Federal Crime Insurance is higher priced than comparable voluntary market coverage and is available only as monoline coverage (not available as part of package insurance). Federal Crime Insurance adds another cost burden to the business owner in that very specific measures to protect the premises from illegal entry must be taken before the business is eligible for coverage.

Thus, insureds who may have been unfairly denied coverage in the voluntary market may be unfairly charged higher rates in the involuntary market; in addition to which they will have higher administrative costs and higher rates because of their inability to avail themselves of the package discounts and administrative simplicity of the multi-peril policies.

INSURANCE INDUSTRY UNDERWRITING CYCLES

*The cyclical nature of the property/casualty business in the United States has been observed for many decades. The underwriting loss cycles are fairly predictable; they come regularly after two or three years of a profit cycle.*⁴⁴

In order to understand the property and casualty insurance situation, it is important to be aware of the underwriting cycles experienced by the industry. The industry had underwriting loss cycles (earned less premiums than its combined expenses for writing insurance and paying losses) in 1956-58, 1963-65, 1968-1970 and 1974-76. In 1979 it began another loss cycle.⁴⁵

These cycles are created, in large part, by industry practices. During profit cycles, fierce competition among companies for policies leads to substantial rate cuts, expanded coverages and slackening of the underwriting standards. After two or three years the premium volume is below the level needed to cover loss claims and the industry enters a two or three year underwriting loss cycle. In order to restore itself to a position of underwriting profitability, companies raise rates, constrain coverage, tighten underwriting standards and terminate potentially unprofitable insureds through cancellation or non-renewal. One of the quickest ways to shed policies is to cancel contracts with agents who either have a record of underwriting losses or produce policies in an area the company considers "undesirable." When the agent is canceled, all the policies he or she has written are canceled

as well.

The most recent underwriting loss cycle, 1974 to 1976, was considered to be one of the worst in recent history. The underwriting losses sustained throughout the industry were substantial and some companies were even threatened with insolvency. As a result many inner-city and minority producers lost company contracts and large numbers of inner-city risks were terminated.

Several questions have been raised about the validity of the industry profitability position and the practices used to improve the position. The profitability issue centers on the fact that, although the industry did suffer underwriting losses during those three years, the industry had net profits due to return on investments.

In the area of property and liability insurance, more than 2,800 companies collected almost \$60 billion in premiums in 1976 alone, earning approximately \$1.3 billion (2.4 percent of premiums earned) in profits (these figures are after taxes). The industry did experience losses on its underwriting operations for 3 consecutive years beginning in 1974, reaching a total of \$780 million in losses in 1976. It is important to note, however, that only \$66 were paid out in losses for every \$100 of premiums earned in 1976. The net underwriting loss also includes commissions, administrative expenses, and other costs incurred by the industry as part of its underwriting operations. Despite these underwriting losses, the industry still showed a net profit, resulting primarily from a \$2.8 billion return on its investments.⁴⁶

The fact that the industry remained profitable during the period of underwriting losses seriously challenges the economic neces-

sity of utilizing the wholesale cancellation of agent contracts to terminate policies. It is, furthermore, unclear that the terminated policies had a significant impact on the underwriting losses suffered. It may well have been that rates cut too low in the heat of competition were the primary cause of losses. If the average rates were eight percent higher during the worst year in the cycle (1975) the industry would have shown an underwriting profit.

Not all lines of property and casualty insurance were unprofitable during that period. According to Best's Review, an insurance trade publication:

Straight fire insurance. . . constantly returns an underwriting profit; over the past 10 years it has shown the largest underwriting gain of any line of insurance. The last time the industry showed an underwriting loss was 1968, the year of the enactment of FAIR Plan legislation.⁴⁷

Commercial multiple peril continues to be one of the most desirable lines of business despite a slight increase in the pure loss ratio in 1978. The line has turned in a combined ratio in excess of 100% only once in the last 10 years, and that was a quite safe 101.6%. The pure loss ratio last year was 44.4, a rise of 1.5 points from 1977, which was the best year ever for this line.⁴⁸

The continuing profitability of these lines makes the indiscriminate termination and declination of inner-city business especially difficult to understand.

The years 1977 and 1978 were the property and casualty insurance industry's most recent profit cycle. An analysis of the profits earned in 1977 by Business Week stated that:

Coming out of a three-year period that was the worst in their 200-year history, property-casualty insurers in 1977 posted a 21% return on net worth. Never before had the industry come even close to that level of prosperity.⁴⁹

So high are the industry's new profits that they are reminiscent of the embarrassment of riches that faced the giants of the oil industry four years ago when the Arabs quadrupled the world price of oil.

. . . property-casualty insurers were the recipients of what can only be called a windfall.⁵⁰

Nineteen seventy-nine was the first year of a new underwriting loss cycle. There are serious concerns about how well inner-city business will fare this time around.

CHICAGO

*There is an old adage that men with little money need insurance more than those with plenty, and it applies to businesses as well.*⁵¹

There are some indications that many small retailers, particularly in minority and low/moderate income neighborhoods, are suffering from insurance availability and cost problems. Industry representatives insist that there are no cost/availability problems based on questionable underwriting criteria such as the neighborhood in which the business is located; and if there are problems, the situation has been greatly improved over the last couple of years due to the improved underwriting profitability throughout the property and casualty insurance industry.

The difficulties involved in obtaining reliable data on costs and availability of commercial property and liability insurance inhibit the ability to define conclusively these problems or their magnitude and forces reliance on secondary and even indirect sources of information.

Availability

One thing is clear: there is substantial demand for commercial property and crime insurance in the city of Chicago that is unmet by the voluntary market. Nearly 16,000 commercial policies were written or renewed by the Illinois FAIR Plan in 1979. That represents an annual premium volume of \$11,000,000.⁵²

From June through December, 1979, the Federal Insurance Administration marketed Federal Crime Insurance (FCI) in five cities including Chicago. Over ninety percent (368) of the inquiries in Chicago were from individuals inquiring about commercial crime insurance (most of the remainder were for residential crime coverage).⁵³

It is not clear, for either type of coverage (FAIR Plan or FCI), what types of businesses are involved or where they are located. The commercial business in the Illinois FAIR Plan includes not only large and small retailers but multi-family residential, as well. FAIR Plan staff were unable to provide information that would indicate the location or type of business of commercial insureds in 1979. FAIR Plan statistics for 1977 show that 56% of the commercial fire insurance premium volume was for coverage of mercantile risks. FAIR Plan staff also indicated that it would not be unreasonable to assume that the FAIR Plan commercial risks are concentrated in the same communities as FAIR Plan residential risks. Acceptance of this assumption would support the contention that commercial insurance availability is adversely affected by location since FAIR Plan residential risks are highly concentrated in minority and low and moderate income neighborhoods, particularly on the city's west and south sides.

This contention is reinforced by conversations with producers. The minority producers interviewed indicated that there are substantial problems with shortages of agents in minority neighbor-

hoods and that it is very difficult for minority producers to secure agency contracts with major companies. One agent said that it is not uncommon for a company to tell a producer seeking a contract that his premium volume is too small and that he should come back when it reaches a specified level. The producer returns in a year or two, having reached the specified level, and the company identifies several other demands with which the producer must comply (some of which approach impossibility) before a contract can be written. The producer never gets the contract.

Another agent told of a downtown agent who had been able to secure only one company contract over a period of years. In frustration he moved to a suburban location and companies were lining up to offer contracts to his agency. However, because of the competition among agents in his area he was having difficulty writing enough policies to meet the contract terms, a problem never encountered in the city.

The Independent Insurance Agents of America concurs with the contention that a major cause of insurance availability problems in the inner-city is the lack of agents. IIAA General Counsel Jeffrey M. Yates at the 1979 annual meeting of the National Association of Insurance Commissioners in Chicago said the key to resolving the redlining problem:

is the appointment by companies of more agencies in inner-city areas. There will be large scale increase in the availability of insurance in the inner-city areas.⁵⁴

The other problem identified by a Chicago agent is the company's subtle discouragement of agents submitting insurance from particular neighborhoods. According to this agent, "A company representative might tell you, 'We've noticed that you have had some claims on policies you have written in this neighborhood. We want to help you maintain a good book of business.' Nothing more needs to be said."

It appears then that in Chicago, as in other cities, companies, by failing to have agents in certain neighborhoods, are able to deny insurance to small retailers because of their location without having to underwrite on that basis.

Industry representatives insist that availability is not a problem for small retailers in Chicago. They correctly point out that the commercial business in the FAIR Plan has decreased. In fact, the number of Illinois FAIR Plan commercial policies declined by almost 47 percent from fiscal year 1977 to fiscal year 1979.⁵⁵ The reasons for the reduction are not known, however. The types and locations of the businesses no longer in the FAIR Plan are likewise unknown. One hopes the industry representatives are correct in their assumption that the reduction represents the voluntary market taking "clean" mercantile (and other) risks out of the FAIR Plan regardless of location.

Cost

Cost problems in the voluntary market are even more difficult to

identify than availability problems. Risks located in Chicago do pay higher fire rates than similar risks in the remainder of the state according to the Illinois Insurance Services Office. ISO insists, however, that within the city the location of the risks makes no difference. This contention was supported by an examination of a Chicago rate manual for a major insurer.

However, the Illinois FAIR Plan rates are substantially higher than voluntary market fire rates. FAIR Plan staff felt the rates were about 50% higher on the average. They may be even higher. An ISO representative suggested that the average voluntary market multiplier was around 2.0 whereas the FAIR Plan multiplier for Chicago is 3.5, 75% higher than the voluntary market estimate. A business owner who had changed from the FAIR Plan to the voluntary market stated that fire insurance premiums on his contents (around \$1100 per year) were less than half what he had to pay for similar coverage under the FAIR Plan (over \$2500 per year).

Small businesses (all businesses for that matter) are further plagued by the fact that Illinois State laws now provide little, if any, protection from insurance problems. As one industry representative said, "What you have to understand is that insurance redlining is not illegal in Illinois when it comes to commercial risks." In fact, the Illinois FAIR Plan commercial fire insurance is predicated not only on the legality of geographic discrimination but on the legitimacy of it. The fourth principle derived by the Department of Insurance from the Illinois statute establishing the

FAIR Plan is:

Geographic discrimination, as practiced by private insurers so as to avoid insuring essentially unpredictable or incalculable risks, would not be considered an illegitimate underwriting practice. [Emphasis original]⁵⁶

Further, Illinois retailers are unprotected when it comes to rates.

Former Illinois Director of Insurance Richard Mathias stated:

The Illinois Insurance Department is the only department in the nation which has no authority to review and disapprove rates which property and casualty insurers are charging consumers.⁵⁷

Not only does the Department have no role in setting rates, it is virtually powerless to intervene in even the most egregious rate situations:

Illinois has no standards whatsoever by which the department of insurance can judge rate adequacy or inadequacy. The Illinois department has no legal power to investigate insurers to determine if the rates they are charging are excessive, inadequate or unfairly discriminatory and, once having found the rates to be excessive, to disapprove those rates.⁵⁸

In many ways the fate of the small inner-city retailers is left entirely in the hands of the insurance companies.

Crime

A major factor in the entire insurance problem is the industry's perception of potential crime. The moral hazard is really the fear of arson in the case of fire insurance or fraud in the case of liability insurance. Arson can be caused by owner (so-called

arson-for-profit) or by others (generally vengeance). Statistics from the Metropolitan Chicago Loss Bureau for the Chicago Metropolitan area for 1979 show the same number of probable commercial arsons in both the FAIR Plan and the voluntary market (106 each); however, loss claims in the voluntary market were over five times those in the FAIR Plan (\$9,891,350 for the voluntary market and \$1,880,429 for the FAIR Plan).⁵⁹ Further, analysis by the Bureau indicates that in the voluntary market five out of six incendiary fires are arson-for-profit whereas in the FAIR Plan only one out of six appears to be arson-for-profit.

With regard to liability coverage, a producer claims that insurers feel that fraudulent liability claims against store keepers are more likely to occur in low income and minority communities than others. No evidence to support this contention has been made available.

The threat of crime causing crime insurance losses is self-evident. Again, it is felt that the risks are greater in low income and minority communities. As one producer put it:

Low income people are more likely to commit crimes than people with higher incomes because their needs are greater. It is easier to talk a poor person into doing something like sticking up a store than it is someone with money. Besides in poor neighborhoods you have the dope problem and those people will do anything for money. And most minority neighborhoods are poor. You know an agent doing business in (he named a low income black community in Chicago) is not going to make a profit.

These kinds of assumptions can determine the fate of small retailers in Chicago.

CONCLUSION

Because of the nature of this study no hard and fast conclusions can be drawn. Certainly no assumptions are made or intended about the policies or practices of any particular insurance company. Further, there are indications that the insurance industry is making efforts to correct problems which may have existed and to prevent them from occurring in the future.

There are, however, some critical concerns which have emerged in the course of this study. First and foremost are the underwriting guidelines and the underlying assumptions contained in some of the prominent underwriting training materials. The open or tacit use of many of these guidelines would result in the denial of normal market coverage to small inner-city retailers on the basis of neighborhood, race or ethnicity, economic class, or life style. Further, these guidelines have not been shown to have any relationship to actual risk.

A related concern is the apparent absence in inner-city neighborhoods of qualified agents with contracts with major insurance companies. The lack of agents greatly limits the accessibility of small inner-city retailers to the voluntary market. In some instances this appears to be an underwriting decision.

One company executive, who asked not to be identified, said that companies do not have a problem with the agent, but with the area in which the business is written. Insurance companies are conservative, he said, and they prefer writing business in traditional areas where they are comfortable.⁶⁰

When insurance is unavailable or unaccessible in the voluntary market small inner-city business are either forced into the residual markets with less coverage at higher prices or to be uninsured.

Consequences of Insurance Problems

The consequences of being unable to obtain adequate insurance coverage or of having to pay excessively high rates can be devastating to both the owner of the business and the neighborhood where the business resides. The business that is uninsured or underinsured may be forced out of business by a loss. If a fire has been suffered, the owner may be unable to afford to repair or replace the building. The business which carries full coverage at high rates may have insufficient cash flow to carry a full line of goods, hire needed additional employees or obtain financing necessary to remodel the store or expand the business. The fact that a business is covered by the FAIR Plan may cause difficulty in obtaining financing because the business is stigmatized as a poor risk.

One retailer in a minority neighborhood suffered a major fire loss on his six story building which was covered by the FAIR Plan. He approached several banks, including the one where he had done all his banking business for years, to obtain temporary financing until his insurance claim was paid. According to the owner, the conversations were always abruptly ended when he stated that his insurer was the Illinois FAIR Plan. His bank even called his mortgage, preventing him from rebuilding. The building stands today - a

burned out hulk on a busy commercial strip.

Even in areas where FAIR Plans provide essential coverage at affordable rates, redlining has stigmatized healthy neighborhoods as second class areas. This impacts negatively on investment and reinvestment opportunities for these reasons.⁶¹

The consequences extend beyond the individual insureds to affect adversely all aspects of neighborhoods. The initial impacts are probably felt most strongly in the economic life of the community.

As the inadequacy of the insurance mechanism inhibits the ability to expand, remodel, rebuild, or finance inventory, job opportunities are lost. Neighborhood residents may begin to seek more attractive shopping areas or stores with better selections. It becomes more difficult to attract new businesses and vacant stores go unfilled. The self-image of the neighborhood suffers as its once vital shopping strip shows obvious signs of deterioration. Stores close earlier and earlier to cut operating costs. The commercial street becomes empty in the early evening hours. Residents become afraid to venture out alone because there are no longer "eyes" on the once busy street. A once vital neighborhood is in decline - and all aspects of neighborhood life suffer.

The lack of affordable business insurance is clearly not the only cause of neighborhood disinvestment, but is a major factor and in some communities can be the linchpin that begins a cycle of disinvestment.

Creative solutions to cost and availability problems can help preserve and restore the health of inner-city neighborhoods. This can in turn increase market opportunities for insurers and through strengthening urban economies improve the profitability of the industry.

NEXT STEPS

*As the old farmer remarked when asked the way to a distant town,
"If I wanted to get there, sir, I would not start from here." 62*

The seriousness of the insurance cost and availability problems apparently suffered by small retailers in urban neighborhoods requires that two major areas of activity be undertaken both simultaneously and sequentially. Because the body of knowledge concerning urban business insurance problems and their consequences is so limited, it is critically important that major research efforts be undertaken to increase our understanding of the causes of the problems, the nature of the problems and the ramifications of the problems for the businesses themselves, the neighborhoods and municipalities in which they reside, and for our nation as a whole. The gravity of the problems, though, behooves us to move forward in developing and implementing solutions to the problems without waiting for the research to be done. As the research progresses, solutions can be modified or new solutions developed to address the problems.

Research

Any serious research efforts promise to be most challenging. Access to current reliable information is probably the major hurdle. Insurance companies, anxious to protect their competitive positions, are not eager to share their underwriting manuals, rate books, or locations of policy holders and agents. State regulators may or may not have usable information depending upon the

legislative context, the regulations, enforcement and the effectiveness with which the information is handled. These problems are multiplied by the complexity of commercial insurance. These challenges, however, can and must be met.

Four general types of research efforts would substantially increase the quantity and quality of information available on the insurance problems of inner-city businesses. The first is the kind of research which has been conducted by community groups studying homeowners insurance availability. Careful documentation of problems experienced by specific businesses is essential to understanding the problems and their ramifications at the local level. These efforts could be undertaken by local chambers of commerce, local development corporations, community organizations or municipalities. These efforts could contribute to the understanding of the actual costs, coverage and technical problems experienced by local businesses, their effects on the health and conduct of the business and the secondary effects on the commercial strips and the neighborhoods and the difficulties experienced by insurance companies in relating to inner-city risks.

A second type of research needed is the examination of the industry. A model for this kind of research is the study conducted by the Illinois Department of Insurance documented in An Investigation of Discrimination in the Sale of Homeowner's Insurance in Illinois - commonly known as the Valukas Report. This investigation had five components. The first was company examinations.

Department examiners collected information on the locations of new business, terminations and declinations; reasons given for terminations and declinations; ages of buldings; inspections; and use of deductibles and surcharges. The examiners obtained lists of active agents and recently appointed or terminated agents by agency locations. They also obtained underwriting manuals and related materials.

The second component was an evaluation of complaints by insureds and community groups. A "hotline" telephone was established and publicized to facilitate complaint filing.

The third component was the test call project which involved calling agents in an attempt to obtain insurance on test homes. These calls were followed up by "off-the-record" interviews with selected agents, the fourth component of the investigation.

The fifth component was interviewing company underwriting representatives to obtain explanations of company policies and practices as well as reactions to evidence uncovered during the investigations.⁶³

An investigation of this magnitude involving sensitive company information can probably be conducted only by state insurance departments or similar regulatory agencies. It may well be the only effective way to obtain a full understanding of insurance company policies and practices affecting inner-city businesses.

A third area of research needed is that of statistical analysis of business insurance problems and their causes and effects at the neighborhood, city and metropolitan area levels. These studies would look at relationships between and among factors such as insurance availability and historic losses and other socio-economic characteristics, such as the availability of capital and credit, etc. An example of this type of research is the statistical analysis of the correlations among homeowners fire and crime insurance availability and fire and theft losses, minority composition, age of housing and income conducted by the Midwest Advisory Committee to the United States Civil Rights Commission.⁶⁴ A wide variety of actors could be involved in these types of studies including: public agencies, community-based groups, research organizations and universities.

A fourth type of research that would be of great value is research conducted by the insurance industry itself. The industry contends that its underwriting and rating practices and policies are based on statistical analyses of objective data, and yet the companies have been reluctant to release these studies. Industry research would also enable the insurance industry to take the initiative in finding ways to improve the availability and cost situation for inner-city retailers - demonstrating its often stated concern for solving these problems.

Strategy Development and Implementation

The development and implementation of solutions to the inner-city

business insurance problems cannot wait until "enough" information is available; it must start from "here" with whatever resources are at hand. An initial list of some of the types of efforts which need to be considered follows.

- ° Business owners and managers insurance education programs designed to help them understand what their insurance needs are, what products are (or ought to be) available, what typical costs are and how to meet their needs.
- ° Insurance industry education programs designed to help company executives, underwriters and actuaries, as well as agents and brokers understand inner-city businesses and reassess underwriting and actuarial assumptions.
- ° Offering multi-peril commercial insurance in the FAIR Plan at voluntary market rates.
- ° Developing programs to shift "clean" commercial risks out of FAIR Plans and Federal Crime Insurance into the voluntary market.
- ° Increasing the appointments of inner-city and minority agents by property and casualty insurers. This could be done through voluntary efforts by the industry to train and finance inner-city and minority agents (as well as appointing already qualified agents) or through legislative mandates.

- ° Changing company underwriting policies and practices to increase actuarial and social fairness. This could be accomplished through industry initiative or legislative mandate.
- ° Changing company (and bureau) rate making policies and practices to increase actuarial and social fairness. Again, this could be accomplished through industry initiative or legislative mandate.
- ° A citizen's task force on small business insurance established by the insurance commissioner to investigate small business insurance problems and develop legislative and regulatory proposals to solve them. The Task Force would be composed of representatives of small business, community organizations, the insurance industry and city and state government.
- ° Develop alternatives to traditional insurance mechanisms such as municipal insurance or self-insurance through small business cooperatives.

This list is but a point of departure in the search for solutions to the inner-city commercial insurance problems. The vitality of our cities depends upon the creation of solutions as yet untried

or even unimagined. The development and implementation of those solutions requires the kinds and levels of commitment and creativity the public, private and voluntary sectors have applied and are applying to problems of credit availability and home and auto insurance availability.

SMALL BUSINESS INSURANCE INTERVENTION CENTER

*We are living in a time of transition. The winds of change have blown away one age of underwriting. A new age is just emerging.*⁶⁵

An important early step in solving the insurance problems for small inner-city retailers is getting the relevant actors together in a forum in which they can discuss needs and problems and design and implement appropriate solutions. One approach, which will be discussed here, is to establish a Small Business Insurance Intervention Center (SBIIC) governed by representatives of all the relevant sectors.

Purpose and Functions

The purpose of the SBIIC would be to serve as an intermediary between the insurance industry and the small businesses and commercial strips experiencing insurance problems. The goals for a SBIIC might look something like the following:

1. Increase the sensitivity of the insurance industry to the needs of inner city small businesses.
2. Provide greater accessibility to voluntary insurance markets.
3. Depopulate residual market plans where feasible and prudent.
4. Bridge the communication gap between industry and small businesses.
5. Improve the small business operator's knowledge of insurance products and the insurance industry.
6. Promote the image of the insurance industry as a sensitive industry responding to a difficult problem.

7. Promote self-policing of the industry.
8. Assist small businesses in reducing risks - increasing insurability, primarily through low cost measures.
9. Assist in increasing the number of competent inner-city agents.

The SBIIC, as envisioned here, would perform five basic functions: Information and referral; intervention; insurance education for small business operators; risk management assistance; and training and placement of inner-city agents.

Information and Referral

A primary activity of the SBIIC will be providing information to small business operators who call, write or visit the office. A small business insurance hotline could be established and the number widely publicized. Trained staff would presumably be able to answer most questions immediately. There would, however, need to be a back-up pool of industry specialists upon whom staff could call in cases where additional information is needed. In addition, a referral mechanism would be in place through which the staff would be able to refer small business operators to three or four agents willing to service the businesses in those locations. An effective follow-up system would need to be in place to insure that the callers' needs were adequately met.

Intervention

Another critical ingredient in a successful SBIIC is the ability to intervene with insurance companies on behalf of small businesses

experiencing insurance problems which their agents have been unable to resolve. In order for this function to be successfully carried out, it will be essential for all participating companies to designate one or more key contacts that SBIIC staff can call upon to help resolve the problems.

Education

In order for the small business operators to utilize the insurance mechanism effectively, it is important that they understand it. Consequently, it is important to have an on-going educational component in an effective SBIIC. The education programs would consist of neighborhood seminars, conferences, published materials, and informative articles in city and neighborhood periodicals.

Agent Training and Placement

Since, in many urban neighborhoods, the presence of competent agents is a critical factor in solving the insurance availability problems, an inner-city agent training and placement function is essential to effective operation of SBIICs. The training and placement would be conducted by insurance companies and producer trade associations. The SBIIC would assist in finding candidates, would provide an internship program and would identify target communities for agent placement.

Structure

The SBIIC would represent a partnership among the interested parties in the small business insurance mechanism. In order to insure the

responsiveness of the SBIIC to the needs of the inner city small business community it is essential that a majority of each governing board represent that community. At the same time, it is critical that the other actors be adequately represented. The board should be small enough to be able to respond quickly and flexibly to needed policy changes. The composition of such a board might be as follows:

- 8 members elected by neighborhood chambers of commerce and business associations;

- 1 member representing the city economic development entity;

- 2 members selected by insurance companies;

- 2 members selected by producer trade association(s) (at least one of which would represent minority producers);

- 1 member appointed by the state FAIR Plan; and

- 1 member appointed by the state insurance commissioner.

Some SBIICs may also benefit from including representatives from other entities such as the Small Business Administration, the banking industry, the Federal Crime Insurance Program, and other city departments or commissions.

Participant Roles

The city can play a key role in serving as the catalyst in establishing an SBIIC. The city can bring together the other actors to discuss the insurance need of inner city small businesses and begin the process of establishing an SBIIC. The city can also help by providing data, technical assistance and operating support. Further, the city may provide services such as inspections, garbage

collection, demolition of hazardous adjacent buildings, and arson prevention programs. The city may also be able to assist by making city loans and grants available to qualified small businesses in need of financing to correct potentially hazardous conditions (e.g., faulty wiring). In return, the city could benefit from an improved business environment in inner-city neighborhoods which could in turn improve the tax base, increase employment opportunities, and reduce crime.

The insurance companies can make a variety of contributions to an effective SBIIC - most important, perhaps is their expertise. Insurers could train SBIIC staff, help prepare printed materials, staff neighborhood insurance seminars for small business operators, designate key contacts for providing information and addressing specific insurance problems, and train agents. In addition they could promote the SBIIC by including flyers in bills and mentioning the SBIIC hotline in local advertising. Further, the insurers could provide data, computer resources, administrative assistance and operating funds to the SBIIC. Finally, the insurers could, either directly or through pools, provide equity and debt financing for new agencies in inner city communities. In return the insurance companies would get substantial public relations benefits, increased knowledge and skill in writing good risks in inner-city neighborhoods, new profitable inner-city business, competent inner-city agents, reasonable return on prudent investments in new inner-city agencies and possible prevention of undesirable legislation and regulations.

Producer Trade Organizations can help identify agents able and willing to service businesses in underserved inner-city neighborhoods and provide agent lists for each neighborhood. In addition, the trade organizations can supply data and provide information and referral back-up for SBIIC staff. The trade organization can help identify potential trainees and participate in the training process. They may also be able to provide some operating support. The trade organizations would benefit from improved public image, increased member ability to write good inner-city risks, possible increased potential to secure company contracts, new profitable inner-city business and new potential members.

The state FAIR Plan could potentially contribute both operating support and staff, a risk management specialist for example. The FAIR Plan could supply SBIIC staff with copies of applications and inspection reports for new and renewal business. In addition, the FAIR Plan could inform all appropriate insureds of the existence of the SBIIC. The FAIR Plan could provide data and information and referral back-up. The potential benefits to the FAIR Plan would include depopulation (taking out and keeping out good risks) and improved relations.

The primary contributions of the business associations and local chambers of commerce would be promoting the program, and promoting the concept of risk management among their members. They could also assist in organizing seminars for their members. The return would be increased knowledge of the insurance mechanism and more

accessible/affordable insurance for their members.

Staff

The composition of the staff of the SBIIC would depend upon the size of the small business community and the magnitude and nature of the insurance problems in the given city. A typical staff might include a director, a secretary-receptionist, an intervention specialist, a risk management specialist and two agent trainees.

The director would be responsible for management and operations, fund raising, public relations and implementation of board policies. The secretary-receptionist would receive clients, screen telephone calls, and handle all secretarial responsibilities for the program.

The intervention specialist would respond to requests from small businesses including the provision of information, referrals to agents, and insurance problem solving assistance. When appropriate, the intervention specialists will intervene with agents and companies on behalf of the small business operators. They will be responsible for follow-up with the clients and with agents and companies within a reasonable time frame to insure that appropriate action has been taken.

The risk management specialist will focus on assisting small businesses in reducing risks through preventative actions. The risk management specialist will be a field person working with individual business operators and business associations on identifying and

implementing risk reduction measures and conducting prevention seminars. Examples of the kind of activities a risk management specialist might engage in are:

- ° helping a shop keeper find better ways to store hazardous materials;
- ° assisting in getting an adjacent burned out building demolished;
- ° helping a building owner obtain financing (subsidized if necessary) to install new wiring;
- ° helping reorganize a stock room;
- ° helping a chamber of commerce design a night time commercial strip security program;
- ° conducting a business association housekeeping seminar; and
- ° assisting in establishing a neighborhood arson watch program.

The risk management specialist would work with small businesses and business associations requesting assistance and with clients referred by the intervention specialists, insurance companies, agents and the FAIR Plan.

The agent trainees would be part time in a training program and part time on the staff of the SBIIC for the duration of the training period. Part of their time would be spent assisting the intervention specialist and part of their time assisting the risk management specialist. The work program and supervision would be designed to maximize both the learning opportunities and the productive contributions of the trainees.

Budget

The budget would vary according to local conditions, the nature of the local program and the ability to obtain in-kind services, staff, space and equipment and furniture. A possible budget for the programs and staff outlined herein is presented on the following page.

Annual Budget

SALARY AND BENEFITS

Director	\$20,000 to \$25,000
Secretary/Receptionist	10,000 12,000
Intervention Specialist	16,000 20,000
Risk Management Specialist ¹	16,000 20,000
Agent Trainees	10,000 12,000
Benefits @ 15%	11,000 16,000

\$83,000 to \$102,000

ADMINISTRATIVE

Rent and Utilities	\$ 5,000
Xerox	4,000
Printing ²	1,500
Telephone	750
Office Supplies	500
Office Equipment and Furniture ³	2,500
Local Travel	1,500
Periodical Subscriptions	250

===== \$ 16,000

TOTAL BUDGET

\$99,000 to \$118,000

¹ The risk management specialist may be a donated FAIR Plan staff member as part of a depopulation program.

² The printing may be donated by insurance companies or the city if they have in-house capability.

³ The office equipment and furniture would be primarily a first year expense which could be offset by in-kind contributions from insurance companies.

FOOTNOTES

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- 6 Ibid., p. 18.
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- 30 Underwriting Principals and Practices, p. 340.
- 31 Ibid., p. 342.
- 32 Commercial Fire Underwriting. p. 3.
- 33 Underwriting Principals and Practices, p. 128.
- 34 Full Insurance Availability, p. 11.
- 35 Underwriting Principals and Practices, p. 565.
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- 37 Ibid., p. 165.
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