Benefitting society by providing protection - how insurance works

Introduction

Our world is changing at an unprecedented speed. With this change comes opportunities for people and businesses to succeed and prosper. But the pace of change also creates new challenges as individuals and companies increasingly experience situations in which their health, property and income are not adequately protected. Protection gaps are identified.

The business of insurance companies and occupational pensions providers is to provide protection. Insurance protects people and businesses against the risk of unforeseeable events. In a nutshell, insurance is a risk transfer mechanism by which the losses of the few are paid for by the many, with the premiums based on the risk of each individual or entity.

The value of this protection - this certainty - to individuals, society and the economy is huge. Indeed, it is fair to say that modern society could not function without insurance. Many daily activities that we take for granted involve some risk of loss and might not be performed were it not for insurance.

The value of insurance for society

Insurance helps people and businesses to assess, manage and reduce their risks. It benefits people and businesses as it provides a means of turning large, unexpected costs into manageable smaller payments. Without insurance, people would be less likely to engage in many activities of modern life because the potential financial costs they would be exposed to would be too great. For example, people would be less likely to start their own business, since they would have to be entirely responsible for the cost of an accident or fire. They might also be less likely to buy their own home for the same reasons. And old age is much more comfortable if a good pension awaits you.

In a nutshell: the benefits of insurance for individuals, businesses and society as a whole are:

- **Consumer and business confidence.** Insurance provides individuals and companies with the confidence – and is in some cases even a prerequisite for them - to go about their daily life and business and to enter into transactions with others. Insurance is a safety net for economic activity and life.
- **Control of risks and promotion of safe practices.** Society in general benefits from a competitive insurance market that can use sophisticated risk pricing to encourage better risk management practices. The prospect of lower premiums can change behaviour, encouraging individuals and businesses to reduce their risks where they can by altering their behaviour or taking preventative measures.
- **Long-term investment in the economy**. Insurers invest the premium income they receive. For life insurance companies, which are large institutional investors,

the products they write are long-term in nature, and so correspondingly long-term investments are made.

- **Stable and sustainable savings and pension provision**. Insurers are significant providers of savings and pension products. The products they provide are fundamental to old age financial security, particularly in light of ageing populations.

What is insurable?

For a risk to be insurable, some prerequisites need to be in place[i]:

- **The risk must be definable and financially measurable**. Insurance provides financial compensation against a risk materialising or offers a benefit or service if that risk occurs. The risk must therefore be fully definable, in order to remove any dispute over whether the loss has occurred. It must also be possible to put a price on the cost of the loss, in order to determine the level of compensation required.
- **The risk should be random and independent**. It is not possible to insure against an event that will definitely occur, since it involves no uncertainty. In such cases there is no risk to transfer. To be insurable it must be impossible to predict if and when the insured event will occur. Also, life assurance works within this principle as, although death is certain, its timing is unknown.
- **The insurer must be able to calculate a fair premium for the risk**. Insurers use statistics from experience or knowledge of past events to make sophisticated calculations. This process — called underwriting — involves calculating the probability of the risk for each insured or category of insureds. Based on the principle of large numbers, the larger the pool of policyholders, the more accurately the probability of the risk can be calculated. The premiums charged are based on these calculations.
- **The insured must have an insurable interest**. There must be a link between the insured and the risk. Typically, such an "insurable interest" is established by ownership or direct relationship. Individuals have an insurable interest for example in their own house or car, but not in the ones of their neighbour.
- **The likelihood of the risk must be calculable.** In order to calculate a fair premium, the insurer must be able to calculate the probability of the risk. This involves calculating both the average severity and the average frequency of similar risks with some degree of accuracy. To do this requires analysis of a reasonably large claims history for the particular event, based on the insurer's own experience, industry data or other sources.
- **There should be limited risk of catastrophically large losses.** The financial impact of the loss should not be so large that the insurer could not hope to pay for the loss. For events that could result in significant losses, insurers can use techniques such as reinsurance to reduce their exposure.

Tightly worded insurance contracts – why is that?

There is a risk that the behaviour of policyholders changes once they have entered into an insurance contract in a way that increases the likelihood of the event happening, i.e. increases the risk. For example, a car owner may drive less carefully once they have insurance that passes the risk of the car being damaged on to an insurer.

This risk – also known as moral hazard - can result in more claims than the insurance company expected based on its underwriting and could result in premiums increasing for

all policyholders if it is not managed effectively. This is why it is important for the terms and conditions of insurance contracts to be tightly worded.

In other words, tightly contractual wording gives security and predictability for both the policyholder and the insurer.

The risk of adverse selection

Sustainable insurance business means that insurers must avoid situations where higher risk individuals are more likely to take out insurance. One of the objectives of underwriting is to avoid such adverse selection by identifying relevant risk factors and setting premiums to correctly reflect the risks.

For example, if smokers and non-smokers are offered life insurance at the same price, the premium will be better value for smokers — who can be expected to have a higher than average mortality rate — than for non-smokers. As a result, more smokers than non-smokers are likely to take out the insurance. The insurer will then end up with a higher than average mortality rate (and hence higher claims) than it anticipated when it was pricing the product, which will affect its reserves or the premiums it then charges. However, by taking smoking into account as a rating factor in the underwriting process, insurers can offer lower life insurance premiums for non-smokers than smokers.

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[i] These prerequisites can not be met in the context of the European Commission´s project on developping a Code of Conduct for the insurance industry regarding cancer survivors.