The Value of Insurance to Society

by Kathrin Hoppe[+]

Insurance is of value to society in several ways but the general awareness of the contributions of insurance to the overall economy and society is low. Policymakers, policyholders and the general public only start valuing insurance once a loss has been incurred and compensation is expected from insurance.

The most significant contribution of insurance to society is the provision of risk sharing, risk pooling and risk transfer abilities and loss prevention measures, which are inherent in the insurance business model and fundamental for a well-functioning economy, but remain largely unseen.

Insurability marks the borderline between the insurers' role as a market player and the nation state's role in ensuring social welfare. Where risks are uninsurable the state has to intervene, but does not have to worry about risks that are insurable and insured.

Insurance thus works hand-in-hand with the state in loss prevention and loss compensation. The insurance business's only handicap is that the "peace of mind" it provides is an unconscious fact, which cannot be measured, unlike assets under management and insurers' contribution to GDP.

The following article highlights some areas of insurance that demonstrate its social role within society.

How does insurance help consumers, companies and society overall?

Insurers insure individuals as well as commercial entities. Private individuals choose an insurance product to avoid being confronted with a financial burden when incurring damage resulting from a certain event (non-life insurance) or when they want to build up a financial reserve for a certain project and/or seek to mitigate mortality, disability and longevity risks (life and pension insurance).

Peace of mind for individuals

The most common non-life product is Motor Third Party Liability (MTPL) insurance. If an individual causes an accident, he/she is obliged to compensate the damages which the non-liable third party has incurred. Depending on circumstances of the accident, the individual would need to pay a high amount of money (ranging from hospitals bills to loss of future income, in addition to the material damage). By taking out MTPL insurance, the individual ensures that the third party's damages are paid, while his/her financial situation is not heavily impacted.

When an individual person takes out life or pension insurance he/she saves money on a regular basis in order to build a capital stock for a certain aim, e.g. a money reserve for a certain project/risk or increased pension benefits. Generally speaking, insurance, therefore, supports the individual in keeping his/her financial situation stable. It decreases the level of unnecessary (individual) precautionary savings and enables capital to be allocated to higher-return projects. Thus, insurance stimulates investment and consumption by reducing the amount of capital bound in relatively unproductive areas. If the same person takes out a traditional banking product instead, he/she can build up a reserve and withdraw the money on demand, but he/she might not have the same access to investment possibilities as insurers have when investing as a global investor. Also if the customer chooses to invest the money in a traditional banking product, he/she might not have built a sufficient reserve to cover his/her losses following an insurable event.

An economic driver and safety net for commercial entities

Similar to individuals, commercial entities can be exposed to claims for damages following a certain event. Manufacturers, for example, can be made responsible for a defective product that caused damages to an individual. Since products are regularly sold in large quantities, a manufacturer can easily face claims from a significant number of consumers and, therefore, be required to pay large amounts in compensation. If a commercial entity were unable to transfer this risk to an insurer by taking

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out insurance, the company would need to reserve capital for potential liability claims resulting from a defective product. The company would, therefore, have less capital available to invest in new technologies and product innovation. In this way, insurance supports economic growth by taking on risks, which normally the commercial entity would need to bear.

Innovative technologies could not be commercialised and start up enterprises could not take risks without commercial insurance, Airlines could not fly aeroplanes without insurance backing, be it captives as self-insurance or commercial insurance. Only the biggest players can be self-insured and survive major losses, as was the case with BP and its Deepwater Horizon disaster—if the losses are spaced out in time.

Insurance companies also support banks in managing their risks. Consumer credit insurance, for example, is regularly taken out by consumers when taking a consumer credit. In case the consumer dies or is for other reasons not able to repay the loan (e.g. unemployment or disability), the insurance company continues to pay the instalments according to the consumer credit contract. The bank's risk of the borrower failing to pay back the loan is thus significantly reduced and allows banks to invest the capital, which they would otherwise need to hold as a precaution. Since credit insurance provides banks with more security, it facilitates not only consumer credits but also exports of equipment and other investment goods.

The insurance premiums paid by the policyholder cover the insurance company's operational costs and constitute financial reserves for future pay-outs. Since some pay-outs do not occur in the near future (e.g. long-term life or pension products), the capital obtained by insurance premiums can be re-invested in the financial market to generate investment income. Insurers are, therefore, a significant investor in the national and global economy. They make their capital available to private companies (e.g. manufacturers, energy providers, the financial industry) by investing in their shares or buying company bonds. In addition, they support national governments in funding, for example, infrastructure and other projects benefiting the economy and society, in particular by investing in government bonds.

In addition, insurance serves as a buffer in the modern economy. It allows filtering out sudden surges in financial needs linked to a disaster hitting many insured players that might otherwise be pushed into bankruptcy. Insurance allows forward planning with more certainty, avoiding or mitigating specific risks that are deemed to be threatening to the general business process.[14]

The possibility of transferring risk to the insurer provides private individuals as well as commercial entities with a safety net, which allows them to take calculated risks in their entrepreneurial decisions (e.g. product innovation, new investments) and private decisions (e.g. mortgages on homes, a second professional education, improving their quality of life).

And last but not least, insurance acts as a major employer and educator, providing skilled jobs in a number of professions.

How do insurers help to address current societal challenges?

Securing the future of ageing populations

The percentage of people aged 65 years and older in the Organisation for Economic Co-operation and Development (OECD) countries, compared to those aged 15 to 64, will have doubled between 1980 and 2040, reaching a peak of 37 per cent.[15]

The role of pension insurers is increasing in importance, particularly due to the growing elderly populations who live significantly longer today in industrialised countries, due to better living conditions and improved medical treatment. At the same time—despite the fact that a number of national governments have increased the retirement age—early retirement possibilities give people incentives to leave their active working life before the legal age limit. Only the U.S. and since 2011, the U.K. have no legal age of retirement, motivating employers and employees to develop new forms of employment as "silver workers".

[14] Liedtke, P.M. (2007) "What's Insurance to a Modern Economy?", *The Geneva Papers on Risk and Insurance—Issues and Practice*, 32(2), 211-221.

[15] Lafortune, G., Balestat, G. and the Disability Study Expert Group Members (2007) *Trends in severe disability among elderly people: Assessing the evidence in 12 OECD countries and the future implications,* OECD Health Working Papers 26, Paris.

As a consequence, retirement periods have lengthened significantly and retirees, therefore, require more savings to sustain their living standard.

While the current generation of retirees still profits from social security funds, which were largely funded when birth rates and labour market participation rates were higher, today's younger generation will have to rely to a large extent on private funds and personal savings. The existing social security funds based on the intergenerational contract have payment obligations to an increasing number of retirees and are expected to reduce benefits to future beneficiaries. In addition, an increasing number of employers shift from defined-benefit schemes to defined-contribution schemes, shifting longevity risk to their employees.

Part of this elderly generation will live the extra years of life with some level of dependency requiring the use of long-term care (LTC). LTC is a set of services provided on a daily basis, formally or informally, at home or in institutions, to people suffering from a loss in mobility and autonomy in their daily lives. Although loss of autonomy may occur at any age, its frequency raises with age. Unlike standard health insurance policies that primarily pay for the cost of health care, LTC policies are long-term contracts designed to help individuals with physical and/or cognitive impairments pay for assistance with activities of daily life.[16]

Not all national social security systems cover care and assistance costs and if they cover them, they are often not sufficient to meet the actual costs. As a consequence, individual persons have to rely on their own savings or social benefits. Again, especially for the younger generation, which has an even higher life expectancy than the current elderly generation, it is essential to take precautions.

The role of insurance, therefore, goes far beyond its role as financial investor and supporter of economic growth. Already now, but increasingly so in the future, the effectiveness of the intergenerational compact will need to rely on insurance as one of the providers of "savings products", complemented by a mitigation of longevity risk, for the retirement age. At the moment, market penetration of these products is still low so that the insurer is not only the provider but also takes a role in creating awareness of the solutions available.

Natural catastrophes and climate change

Natural catastrophes have been increasing over recent years, and the Southern Hemisphere is particularly exposed due to fragile economies and infrastructures.

The reason is not only global warming and its consequences. The reason is also the sharply increasing concentration of people and property in areas that are prone to natural catastrophes. The populations of coastal regions are increasing constantly and natural catastrophes in third world countries often hit populations living in poverty.

Micro-insurance can contribute to disaster risk management in third world countries. It has been designed to be affordable for the underprivileged and aims to support poverty-stricken households. These products are often designed to address specific natural catastrophe risk in a certain area (e.g. drought-indexed insurance schemes in Malawi, insurance for severe droughts in Ethiopia, etc.).[17]

Natural catastrophes result in ever more significant damages. Not only private and commercial property is damaged, but also infrastructure such as roads, harbours, telecommunication, water and waste water systems and electricity networks. The damaged infrastructure has an immediate effect on the economy. Insurance cover allows for quick reconstruction and reestablishment and, therefore, stabilises the economy as a whole. Interrupted business processes can be covered by business continuity insurance, compensating for the loss of income that a business suffers after a disaster while its facility is being rebuilt.

Understanding the nature and impact of climate risks in advance is extremely effective in minimising the impact of disasters. With heightened public awareness, the insurance industry is working on improving loss prevention and technology development in the areas of natural disaster risks, drawing on its vast experience and expertise acquired over the past decades. The spectrum ranges from developing digital hazard maps, hazard-resilient property to supporting public hazard mitigation programmes. Some

[16] Costa-Font, J. and Courbage, C. (2012) "*Financing Long-Term Care: New and Unresolved Questions",* in Costa-Font, J. and Courbage, C. (eds) *Financing Long-Term Care in Europe*, Basingstoke: Palgrave Macmillan.

[17] UNISDR (2011) *Global Assessment Report on Disaster Risk Reduction.* Available at *http://www.preventionweb.net/english/hyogo/gar/2011/en/home/index.html*

insurers also offer their clients specific risk engineering services which are relevant to addressing the challenge of climate change, for example property risk assessment and improvement advice, business continuity management, business interruption assessment, natural hazards assessments and total risk profiling.[18]

Insurers that are permitted to use risk-based pricing can incentivise adaption that genuinely reduces risk. Where data has a sufficient granularity, it is often possible for insurers to differentiate between risks. The presence of risk reduction methods (e.g. appropriately adapted buildings) can indicate lower damage severity and hence justify a premium reduction.

Conclusions

This article just gives a glimpse of insurers' importance for society. With society facing huge challenges, the insurers' role becomes ever more important. Traditional family structures—especially in developed countries—no longer provide a social safety net as in former times. Individuals carry the burden of loss almost entirely themselves. While insurance cannot replace social structures, it can ease the burdens. In third world countries, insurance can help prevent people in difficult living conditions from suffering additional hardship caused by natural catastrophes. Insurance cannot and should not take over the state's role of addressing societal challenges, but it can assist finding adequate solutions. It is of utmost importance that policymakers realise the potential role of insurers and take them into account when proposing new regulation for insurance and when taking post-disaster adaptation measures.

The UN Shift from Social Research to Protecting the Environment to Governance—from Stockholm to Rio 1992 to Rio+20 to the Principles of Sustainable Insurance

by Meghan Orie[+]

The foundation of dedicated United Nations (UN) programmes shows clearly the radicalisation of the thinking behind the UN outreach process.

The UN Research Institute for Social Development (UNRISD) was established in 1963 as an autonomous space within the UN system for conducting policy-relevant, cutting-edge research on social development. Its mission is to generate knowledge and articulate policy alternatives on contemporary development issues, thereby contributing to the broader goals of the UN system of reducing poverty and inequality, advancing well-being and rights, and creating more democratic and just societies.

The United Nations Development Programme (UNDP) was established in 1965 as the United Nations global development network. It advocates for change and connects countries to knowledge, experience and resources to help people build a better life. UNDP operates today in 177 countries, working with nations on their own solutions to global and national development challenges. As they develop local capacity, they draw on UNDP staff and its wide range of partners. Additionally, the UNDP works internationally to help countries achieve the Millennium Development Goals (MDGs).

The United Nations Conference on the Human Environment, held in Stockholm in 1972, was the first global environmental meeting and set a precedent for international cooperation in addressing environmental degradation. Of the then 132 UN Member States, 113 attended and agreed that they shared responsibility for the quality of the environment, signed a declaration of principles known as the Stockholm Declaration, and approved an environmental fund and an action plan. None of these documents were legally binding in international law, although they pushed for governments to implement laws, policies and strategies to protect the environment. In addition, the representatives

[18] Liedtke,P.M., Schanz, K.-U. and Stahel, W.M. (2009) *Climate change as a major risk management challenge—How to engage the global insurance industry,* The Geneva Association's COP15 Background Paper. Available at *http://www.genevaassociation.org/Portals/0/COP15_background_paper.pdf*.

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