Insurance and its continued benefits to the economy and society

As a timely reminder, we bring you this focus by **Dr Christophe Courbage** of the **Geneva School of Business Administration** (HES-SO), listing the numerous benefits that insurance offers, including providing security for the continued progress in technology and finance and various other areas.

Insurance, as we know it today, encompasses the three main activities of risk transfer, indemnification and investment. These three core activities of insurance each benefit the economy and society in many aspects.

Insurance promotes financial stability and facilitates entrepreneurship

Insurance through indemnification improves the financial stability of households and firms. Indeed it allows households to return to their former financial position after a loss occurs. They can then maintain their financial security. In that way, they are less likely to seek public assistance or welfare benefits.

In the same way, indemnification to firms helps them to remain in business and employees to keep their jobs. It therefore limits negative spillover effects such as higher unemployment, customers being deprived of the firms' products or services, suppliers losing business, and government tax revenues decreasing.

By providing security to both individuals and firms, insurance makes it possible for both to engage in risky undertakings that they would otherwise not engage in. Insurance may even be a condition for engaging in a particular activity. For instance, without access to product liability insurance, firms, particularly, pharmaceutical, would be unwilling to develop and market highly beneficial products. In that sense, insurance facilitates innovation in the economy by offering to underwrite new risks. Ford, Rockfeller and others would not have taken the investment risks they did without the possibility of sharing them with insurers.

A related argument is that insurance helps the development of markets for luxury goods, such as cars, by offering risk-averse individuals the possibility to transfer their risk. Indeed this encourages individuals to make purchases that they would not otherwise have made. In the same spirit, in the case of health insurance, insurance gives individuals access to healthcare that they would not otherwise be able to afford were they not insured.

Insurance encourages prevention and mitigation

Insurers, based on their own information about the risks of the insured, differentiate premiums on a risk-adjusted basis. When aggregating many similar individual risk exposures, insurers rely on the law of large numbers which allows them to make reasonably accurate estimates as the risk group's overall expected loss. The role of insurance is therefore to identify groups of individuals with similar risk profiles and to establish a premium for this risk.

When the premium reflects the risk associated with an individual or a firm, it produces an incentive to that individual or firm to reduce the risk in order to reduce their premium. Risk-based premiums incentivise prevention activities, reducing the risk faced by individuals and firms which benefit the society as a whole.

In addition, risk-based pricing benefits society since it sends pricing signals that fuel many public debates on safety, leads to more risk-resilient behaviour on behalf of consumers, and encourages broader and better legal standards such as improved safety performance requirements for cars, fire alarms and sprinklers or security systems for homes and businesses, building codes to protect against earthquakes, floods or high winds. A corollary of having access to such information is a reduction in the number of unproductive investments, for instance such as building in an avalanche zone.

In relation to limiting carbon emissions, or taking action related to climate change, insurance companies can play various roles, as stressed in various publications of The Geneva Association.

This can take the form of insuring new technologies so as to speed up their commercialisation and transfer to the market place. Another possibility is illustrated via existing insurance policies that allow policyholders to offset their travel at the point of purchasing motor insurance.

In the same way, the pay-as-you-drive policies that have recently became available in various countries also help with mitigation as they encourage less driving. Finally, the insurance industry can guide and engage customers and suppliers on alternatives in claims-handling that are more climate-friendly and weather-proof.

Insurance advances the financial intermediation of services

The insurance industry further advances the development of financial services by facilitating credit transactions and bank intermediation.

Non-life insurance in particular collateralises credit for consumer goods and business operations, eg providing banks with security in the event of bankruptcy of the policyholder, thereby reducing a bank's risk exposure and encouraging further loans. This reduces the market cost of capital for companies and influences economic growth by creating further demand for financial services.

Also, insurance, and in particular life insurance, enhances the individual's credit. Insurance makes a borrower a better credit risk because it guarantees the value of the borrowers' collateral or gives greater assurance that the loan will be repaid. In various countries, when a house is purchased, the lending institution normally requires property insurance for the house or life insurance for the buyer before the mortgage loan is granted.

Insurers as investors improve corporate governance and promote economic growth

Along with investment funds and pension funds, insurers are the world's largest institutional investors. They invest heavily both in equity markets and fixed income markets.

In that way, they can have an active participation in corporate governance. They can avoid investing in companies that are not behaving correctly. For instance, in the case of environmental risk, they could avoid investing in companies that are major carbon dioxide emitters.

Even more efficient, insurers can use their voting rights at general assemblies and engage with the boards of companies in which they invest to foster more sustainable business models. Insurance companies can also invest in and finance clean energy projects and offer eco-friendly funds. Additionally, they can monitor firms and individuals to encourage them to act in their best interest and not engage in unacceptable risk-increasing behaviours.

The development of insurance activities, in particular life insurance companies, can promote stock market development by investing funds raised through contractual saving products in stocks and equities. These funds are typically invested in shopping centres, hospitals, factories, housing developments, etc. The investments increase society's stock of capital goods, and promote economic growth and full employment.

Source of risk management services

In addition to risk coverage, the insurance industry is a valuable source of risk management skills and information that benefit society as a whole.

Because of the very nature of its business, the sector needs to gather a large quantity of research on what constitutes and contributes to risk in many areas and across a broad spectrum of disciplines such as construction, geography, geology, demography, health, finance, etc.

Insurers have the analytical expertise to help insureds prevent and reduce losses. They have obvious economic incentives to encourage loss mitigation through various avenues, for example by offering loss control programmes such as on fire prevention, occupational health and safety, industrial loss prevention and reduction in automobile property damage, theft and injury.

While insurance has long been part of the economy, its contribution to the development of countries is largely underestimated. Better communication on these benefits would be a good way for the insurance industry to enhance its image.

Woody Allen, in one of his movies, once said that "there are worse things in life than death. Have you ever spent an evening with an insurance salesman?". We would like to think that if Woody Allen had understood the benefits of insurance to the economy and society, he would have found a way of making spending an evening with an insurer much more attractive.

Highlights

- By providing security to both individuals and firms, insurance makes it possible for both to engage in risky undertakings that they would otherwise not engage in;
- Risk based pricing sends pricing signals that fuel many public debates on safety and numerous other activities that ultimately benefit the society; and
- Insurers are some of the world's largest institutional investors and in that way, they can have an active participation in corporate governance.

Dr Christophe Courbage is Professor at the Geneva School of Business Administration (HES-SO) and external collaborator at The Geneva Association.