



**The benefits of insurance**

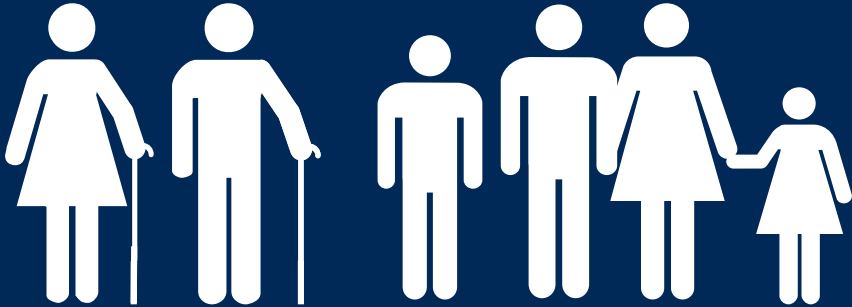
### **About Insurance Europe**

Insurance Europe is the European insurance and reinsurance federation. Through its 34 member bodies — the national insurance associations — Insurance Europe represents all types of insurance and reinsurance undertakings, eg pan-European companies, monoliners, mutuals and SMEs. Insurance Europe, which is based in Brussels, represents undertakings that account for around 95% of total European premium income. Insurance makes a major contribution to Europe's economic growth and development. European insurers generate premium income of more than €1 100bn, employ almost one million people and invest over €8 500bn in the economy.

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# Introduction — meet the family



We live in challenging times. Europe faces significant economic headwinds, demands on strained public finances are higher than ever and the impact of natural catastrophes is rising.

Faced with such uncertainty, policymakers are seeking answers to difficult questions:

- With more people entering retirement than ever before, how can they provide for their old-age, without increasing the strain on already stretched public finances?
- Where will Europe find the investment it needs to create and support jobs, and economic growth?
- How can we better protect our society against unexpected and extreme events?

While these questions often require complicated answers, the end result boils down to the everyday lives and businesses of people like Maxine and her family.

## Meet the family

Maxine's family is made up of three generations: two grandparents, Maxine and her husband, and their two children.

Like most people they have straightforward desires. They want a degree of certainty and financial security for them and their loved ones, protection of their assets and possessions, and an economic environment that offers the opportunity to gain meaningful employment.

The grand parents

- Both have saved well for their retirement.
- They own a house, which is in a low risk area and is insured.
- They both own a car and their premiums are low, due to their age and responsible driving.

Maxine and her husband

- They have begun saving for retirement.
- They are looking to buy a new house, but are wondering whether the cost of their insurance will increase because the new property is located in a flood plain.
- They both have life insurance. Maxine's husband smokes, so his policy costs more than hers.

- They both own a car, and have reasonably low premiums due to their age and lack of claims.
- Maxine's husband has a job and she runs a successful business, which is also well insured.

#### The children

- They have a daughter aged 14 and a son aged 18. The son has a car, with higher insurance premiums than his parents and grandparents due to the higher risk associated with drivers of his age. He has recently begun studying abroad and so has taken out car insurance to cover him in the country where he is studying.

**How can a family  
protect its prosperity?**



We often cannot prevent events such as the death of a loved one, a car accident or extreme weather from damaging our homes and disrupting our businesses. These are part of the uncertainties of life. Steps can, however, be taken to mitigate the consequences of such events.

By pooling the risks faced by policyholders like Maxine's family, insurers spread the financial impact of an event that could be disastrous for one policyholder across a wider group, where it is more easily absorbed. Pooling in this way also allows insurers to combine different risks to reduce their exposure to any one risk in particular, which in turn allows them to keep the price of policies at reasonable levels.

### **Quick fact**

Millions of individuals, families and businesses across Europe benefit from insurance. In 2013 European insurers paid out €952bn in benefits and claims. That is equal to €2.6bn being paid out to people and businesses every day.

While Maxine's family and many others benefit from having comprehensive insurance cover, there is still much more to be done to extend this protection to the millions of others who are not yet adequately protected.

From an economic perspective, insurance provides people and businesses with financial protection, so that when something bad happens they can maintain a certain standard of living and public finances need not be so burdened. It, therefore, makes sense for policymakers to enable as many people and businesses as possible to take out suitable insurance cover.



## **How can we further reduce uncertainty for our society?**

### **Do's**

- Help insurers to respond to real concerns of the public and keep the cost of insurance as low as possible by keeping regulation efficient and by avoiding unnecessary costs.
- Provide insurers with the flexibility to innovate and provide products tailored to their individual national markets, to better meet the needs of policyholders. This will allow more people and businesses to access appropriate cover.
- Make access to insurance more straightforward; for example keep a wide diversity of distribution channels and allow consumers to purchase insurance with or without advice.
- Take prevention measures, for instance in the area of natural catastrophes, in order to adapt society to the increasing effects of climate change, and thereby make insurance available and affordable to more people.

### **Don'ts**

- Do not propose, issue or review legislation without considering the real benefits for the policyholders. Often when a new rule is proposed or created, or a current one reviewed, it costs insurers – and ultimately their policyholders.
- Do not be too prescriptive, thereby restricting insurers' product design, such as by requiring pan-European mandatory coverages where they are not appropriate. This can stifle innovation and lead to products that do not properly protect policyholders.
- Do not impose EU solutions on issues which do not have a strong single market dimension (for example, personal pension products (PPPs) or liability law).

# Renewing the family's protection



The time has come for Maxine and her family to renew their policies. While doing this they notice that the price of some policies differs for different members of the family, and that some prices have risen in comparison to the year before, while others have fallen.

## Why this happens: Understanding underwriting

In order to price a policy, insurers need to analyse the risk a policyholder wants to transfer to them. This enables insurers to price policies according to the risk they are taking on, which is called risk-based pricing. To analyse the risk, insurers need to use data.

## Why is data so important in pricing insurance policies accurately?

Each policyholder wishing to be insured presents insurers with a different level of risk; for example, a timber house is at greater risk of fire than one made of brick. To ensure that each policyholder pays a fair premium, insurers analyse data to determine the level of risk that they are taking on. In this example, this data could include: the materials the house is made from and its geographical location.

By analysing this data insurers can predict the premiums they need to build sufficient financial capacity for the payment of future claims. This ensures that premiums accurately reflect the risk policyholders wish to transfer to an insurer, while also encouraging behaviour that reduces the risks.

An example of this is Maxine's son who has recently moved abroad to study. He has found that his car insurance premiums differ in the new country that he is staying in. This is due to the fact that his risk profile is now based on the new country's risk specifics, including local accident statistics, vehicle damage values and medical costs.

### **Keeping policyholders informed**

While renewing her family's policies, Maxine notices that the amount of paper work that she is meant to read and sign in order to renew her policies keeps increasing. What she really wants to know are the terms and conditions of her policy and how much it costs. However, she feels that year on year she is being deluged with more and more information with little relevance at the time when she makes the decision.

There is a tendency for EU policymakers to concentrate on the quantity of information that insurers need to provide to policyholders. Paradoxically, policyholders may not get the most relevant and useful information out of this measure, because too many documents may simply discourage policyholders from reading them, and as a result may make them less informed about products.

It is, of course, crucial that policyholders are provided with the most relevant information to enable them to compare products and understand the cover that they are buying. However, bombarding policyholders with too much information can in fact distract them and obscure the most relevant information.

## How data protects policyholders against fraud

Data is also very important in enabling insurers to fight fraud. In order to do this, insurers must have access to the relevant information needed to detect repeating patterns of fraud. For example, there have been many examples where members of criminal gangs pose in differing roles in fraudulent claims.

However, proposed EU legislation on data protection that was originally developed to stop the profiling of online consumers, could allow insurance fraudsters to demand the removal of their data from insurers' databases. If this legislation comes into force unchanged, it could make it harder for insurers to fight fraud, which would lead to the price of premiums increasing for honest policyholders.

## Avoiding adverse selection

Analysing data allows insurers to make an objective analysis and align the price of the policy with the risk the policyholder poses. Consequently, insurers differentiate to ensure that the premium charged accurately reflects the risk.

Without such risk assessment, there is a risk of adverse selection. This is where policyholders with a higher risk profile are more incentivised to take out insurance than those posing a lower risk.

For example, if smokers and non-smokers are offered life insurance at the same price, the premium will be better value for smokers — who are more likely to generate a claim against the policy — than for non-smokers. As a result, it is likely that more smokers than non-smokers will take out the insurance. The insurer will then likely face a high volume of claims, which means it will have to increase the cost of premiums for policyholders in order to ensure that it maintains the ability to pay all claims.

By taking smoking into account in the underwriting process, however, the insurer ensures that a fair premium will be charged to a smoker, which in this case is Maxine's husband, who then pays more than Maxine, who does not smoke.

## **How can we keep increasing value for policyholders?**

Policymakers can play an important role in enabling insurers to continue delivering more value to policyholders, and in keeping them better informed.

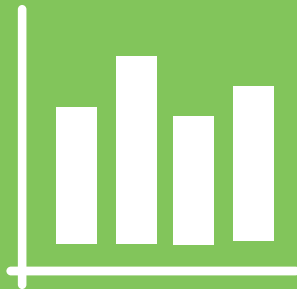
### **Do's**

- Make information understandable. Develop disclosure requirements which are actually read and understood by policyholders while avoiding excessive costs.
- Only require insurers to provide the most relevant information to policyholders when they are choosing insurance products.
- Ensure that insurers have adequate access to data in order to allow them to price according to the risk and to fight fraud.
- Allow insurers to continue to differentiate between risks, in order to ensure that policies are accurately priced.
- Allow insurers to use data to develop more innovative products, and in doing so create more competition, which benefits policyholders, society and the economy as a whole.
- Promote financial literacy to enable people to make better financial decisions.

### **Don'ts**

- Do not introduce rules that restrict insurers' access to data necessary for a contract or inhibit their ability to use it to analyse the risks they face.
- Do not require insurers to provide an ever increasing amount of technical information that can distract policyholders from the important information that they require to make a decision.
- Do not introduce overlapping, duplicative and contradicting information requirements, which could confuse policyholders.

# How do policymakers influence the price of protection?



The choices that policymakers make directly affect the price of insurance policies for people like Maxine and her family. Legislation is, of course, crucial in both protecting the public and businesses, and in providing confidence in the financial system. However, policymakers must bear in mind that every time they issue a new proposal or enact new legislation or additional supervisory rules, it may cost insurers a huge amount of money to research, understand and implement it in their systems. While good regulation can improve protection for consumers, the costs of excessive regulation can often exceed its benefits.

While insurers' shareholders absorb some of the costs, there is only a certain amount that they can accept before withdrawing to invest somewhere else. Shareholders — which often include members of the public and organisations that invest the savings and pensions of people like Maxine and her family — need to search for adequate return on their investments. If those returns reduce by a greater degree in one particular business sector, they will naturally look elsewhere.

Consequently, insurers need to pass the majority of any additional costs on to their policyholders through higher premiums. Unfortunately this can:

- Lead to policyholders paying more than is necessary.
- Discourage people and businesses from taking out insurance policies, leaving them without financial protection.
- Even result in insurers withdrawing certain products altogether, if they become unprofitable.

These outcomes are in no one's interest, as they can leave large swathes of the population and businesses without adequate financial protection, resulting in governments, and therefore taxpayers, taking on risks that could have been covered by insurance policies when a loss event occurs.



### **How can policymakers ensure more people are protected?**

Regulation can either encourage more policyholders to benefit from adequate insurance protection, or discourage them and leave them vulnerable.

#### **Do's**

- Raise people's awareness of the risks they face and of the value of taking out insurance to protect them.
- Provide insurers with a regulatory framework that allows them to innovate and improve insurance solutions or reduce costs for policyholders.

#### **Don'ts**

- Do not ignore the unintended consequences of poorly designed regulation on availability of products, customer access to products, and cost of products.

# Ensuring people can better provide for old age



All the adults in Maxine's family have saved for their retirements using both occupational pensions and insurance savings products. They have also encouraged the children to begin saving as soon as possible for their future and retirements.

This is a very good idea, because as the proportion of Europe's population in retirement increases compared to the population of working age, it is likely that society will become much more dependent on personal savings products to fund people's retirements.

## Why are long-term investments important to pension holders?

In order to provide pension holders with the best possible return and to match their liabilities, insurers need to make long-term investments. By pooling the funds of many investors and investing in a diversified portfolio of assets, including illiquid and long-term investments, insurers can both better manage their investment risks and achieve greater returns for policyholders.

Pooling investments also enables insurers to provide people like Maxine's family with access to investment opportunities that they would otherwise not be able to reach, such as infrastructure investments.

## How can people be convinced to save more?

It is important for people to save adequately for their retirement, and for them to access the best return on those investments. The level of return on retirement savings can make the difference between being comfortable in retirement and struggling to pay the bills. For example, an additional 1% extra return on investment can increase income during retirement by 25%<sup>1</sup>.

Given the increasing challenge that governments face in providing for their retired citizens, it is very important for people to begin saving more for their old age. Often, however, people do not realise the importance of saving for their retirement or how much they need to save.

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<sup>1</sup> This example is based on a person investing over 40 years, and increasing their investments from 1% to 2% of their earnings.

One example of how this can be addressed is to directly inform people of how much, given their current saving habits, they are likely to receive during their retirement. For many people the news would be an unpleasant surprise. The Swedish government developed a scheme, dubbed the Orange Envelope programme, which did just this. This simple and effective way of communicating the information led to people saving more prudently for their retirements.

### **How can we further strengthen people's financial security in retirement?**

It is in everyone's interests for people to have more financial resources in their old age.

#### **Do's**

- Encourage people to save for their retirement through a combination of education and incentives, as well as taking into account how real people behave in practice.
- Ensure consistently high levels of protection for all occupational pension holders irrespective of where they get their pension from, ie an insurance company or a pension fund.
- Ensure that policyholders and beneficiaries of occupational pensions are clearly informed of whether their pension promise is guaranteed or can be adapted.

#### **Don'ts**

- Do not leave the situation as it is. Action must be taken to increase peoples' retirement provision to avoid bigger problems down the line.
- Do not allow people to be confused about the level of protection they have. If there is a risk that their pension fund may have to reduce benefits to their members, those members should be made aware.
- Do not ignore the specificities and differences of national pension models.

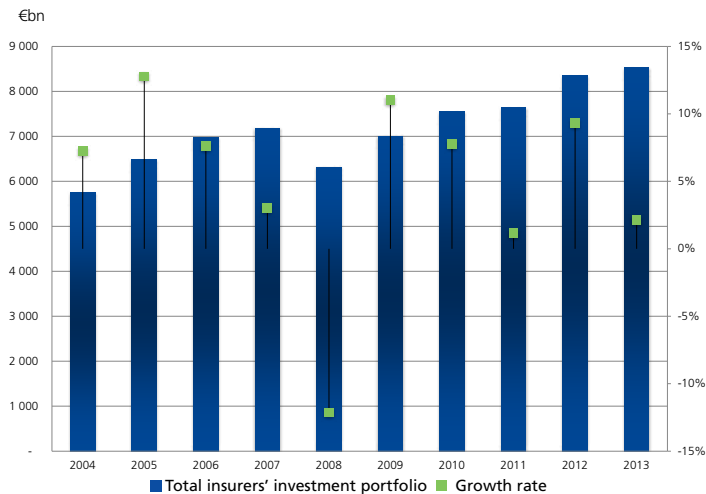
# Providing investment for growth in Europe



Like most people, Maxine’s family want to know that the companies they do business with invest responsibly in our society. Insurers will usually use premiums to make an investment that matches the expected time when claims and benefits would be paid.

Insurers are Europe’s largest institutional investors, and in 2013 had over €8 500bn of assets under management. This is roughly equivalent to 60% of the entire Gross Domestic Product (GDP) of the EU.

**Chart 1: European insurers’ investment portfolio — 2004–2013 (€bn)**



**Quick fact**

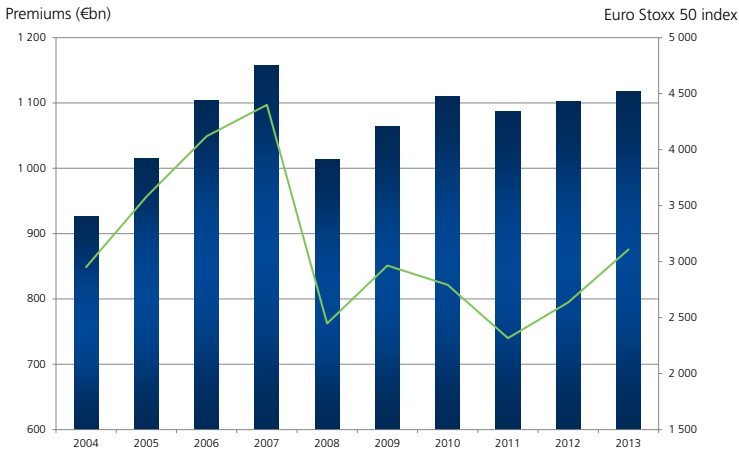
Insurers hold approximately 25% of all European government bonds and approximately 21% of European corporate bonds, as well as a significant percentage of all listed equities and billions of euros in assets such as infrastructure and private equity.

By making these investments insurers encourage stability and growth through enabling governments and companies to make investments themselves. Therefore, insurers’ investments are important for the whole economy, especially when refinancing banks and the real economy. Insurers also contribute directly to important infrastructure projects, such as bridges, hospitals and new housing, and while these do not make up a large percentage of insurers’ investments, they are certainly an asset class that could be suitable for more investments in the future.

## Defending against downturns

People and businesses tend to keep paying their insurance premiums during times of economic downturn. This constant flow of premiums enables insurers to continue to fund the economy during difficult times. It also enables them to buy suitable assets that others need to sell, which in turn helps to kick-start recovery. In this way, insurers help to reduce volatility in the financial markets.

**Chart 2: Premiums provide a stable source of funding even during downturns**



## Regulation could reduce investments

While there is wide-spread insurance industry support for the new risk-based regulatory regime for European insurers, called Solvency II, there are some important details that need improving. In particular, there are significant concerns because this new regulation treats insurers as if they invest like traders and are faced with the same risk as traders.

Insurers invest to match the promises they make to their policyholders and for most of their business this makes them very long-term investors — the opposite of traders. Treating insurers like traders exaggerates the actual risks involved in long-term investing.

As a result, the capital requirements related to long-term investments are set too high. This will create unnecessary costs and problems for insurance companies wanting to offer long-term products to policyholders where they have to invest long-term to match their promises to policyholders.

This will make long-term insurance products (such as pension products with guaranteed returns) more expensive than needed and could also reduce the availability of these products. It will also limit the insurance companies' ability to maintain their traditional role as patient long-term investors, providing stability in times of financial crisis and in turn reduce their ability to invest in long-term assets, such as infrastructure. The regulatory requirements governing insurance business must, therefore, take into account the long-term perspective.

### **How can we ensure those investments create more jobs and growth?**

As long-term investors, insurers are particularly suited to make investments that create jobs and stimulate economic growth.

#### **Do's**

- Ensure regulation is adapted to accurately reflect the long-term investment risk that insurers face.
- Remove regulatory hurdles for insurers investing in infrastructure projects and small to medium-sized businesses, which have a more direct positive impact on economic growth and employment than other types of investment.
- Take steps to improve the supply of and access to long-term investments, such as infrastructure, so there are more suitable assets for insurers to invest in on behalf of their policyholders.

#### **Don'ts**

- Do not treat insurers as if they act like traders and instead recognise that their long-term liabilities can reduce their exposure to market volatility.
- Do not ignore the potential unintended consequences of regulation on insurers' investments and therefore the economy.



**What happens when  
an event occurs?**



A couple of months later Maxine and her husband buy the new house. Unfortunately, just as they finish moving in a local river breaks its banks, causing a flood that severely damages the ground floor of their new home.

Because of the flood many of their possessions need to be replaced and extensive repair work is required. Following all of the expense of their recent move, it could not have come at a worse time. Luckily, they had already got a new insurance policy for both the house and its contents.

This meant that their insurers arranged the repairs to the house, using their local network of suppliers to get the work done, as well as paying for the family to stay in a hotel while the work was carried out and replacing their possessions as quickly as possible. The insurer's assistance, therefore, helped to alleviate a stressful event for the family.



# How can we increase policyholder protection?



Following the flood the family wants to become better prepared against events and occurrences that could cause them financial loss or even physical harm.

## Protection through prevention

They do some research and find out that their national insurance association provides advice on a wide range of risk prevention subjects to both the government and the public, and that their local insurer also holds awareness events.

### **Reducing costs for policyholders**

The way that insurers price insurance premiums can also have a wider impact on society by encouraging better risk prevention and management practices. The prospect of lower premiums and deductibles can encourage individuals and businesses to reduce their risks by altering their behaviour or by taking preventative measures.

Examples of this include individuals giving up smoking to reduce their life insurance premiums, fitting intruder alarms to reduce their household insurance costs and businesses implementing more effective risk management systems to reduce their liability premiums.

## **How can we further reduce losses and costs to policyholders and governments?**

In order to help everyone to live safer and more prosperous lives, there are several things that policymakers can do.

### **Do's**

- Warn people about the risks of living in areas that are highly susceptible to natural catastrophes, such as flood plains, and if possible, stop building houses in those areas completely.
- Invest in prevention measures, such as flood defences.
- Enforce building codes, improve the resilience of urban infrastructure and conduct responsible land-use planning.
- Engage in more open dialogue with the insurance industry, particularly at national level, to understand what more can be done to reduce exposure to risks and enhance the insurability of risks.

### **Don'ts**

- Do not ignore the significant issues society faces regarding natural catastrophe risks.
- Do not ignore insurers' concerns over disaster prevention and the insurability of risks. Buildings resilient to the effects of climate change and natural catastrophes, and more people and businesses being covered by insurance, are a better result for everybody.



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