

The Geneva Association: The invisible hand of insurance



The recent disaster in Japan was exceptional. The extremely high magnitude Tohoku earthquake triggered a devastating tsunami which not only wiped out the existence of thousands, but also caused the worst nuclear accident, since Chernobyl, at the Fukushima Daiichi nuclear power plants. In this article extracted from The Geneva Association's Risk Management papers, **Dr Hans Peter Wurmli** from **The Geneva Association**, debates whether this was a case of risk management gone wrong or one of these rare but possible low probability events still remaining.

Let me ask a question: what have off-shore oil drilling in the Gulf of Mexico, the operation of nuclear power plants in Japan and occupational pension plans in Switzerland in common? First I shall give the short answer. Those without the fortitude can then forego the more detailed explanations that follow!

All three are representative of huge societal problems and all three either lack appropriate insurance or violate important insurance principles in their chosen solution. In all three cases, the insurance community has failed, in my opinion, to convince the public of the benefits of insurance to society and, equally, legislators have failed to regulate appropriately.

The insurers' skills, knowledge and expertise to design, place and maintain appropriate insurance covers are not recognised adequately by society. Not only are their risk management skills not appreciated, but worse, insurers and pension schemes are burdened with a large part of the huge cost of regularly occurring monetary easing, jeopardising part of their business model and risking their long-term survival.

Strengths of insurance industry

Let me highlight just three decisive strengths of the insurance community: the ability and independence to assess

risk, including judgements as to the limits of insurability; the capacity to create insurance products to internalise external cost, e.g. of dreaded events; and, most important of all, having the right incentive to impose provisions and measures to manage risk exposures that can render dreaded events more unlikely.

Where society uses the insurers' services, the public's trust does not need to rest on some blurry hope for better and more competent experts, but it can rely on their profit incentive and loss disincentive that risk is assessed and dealt with objectively. The invisible hand of insurance operates to a great part with the transparency that is created by its activity. That's the short answer.

Insurers' business models affected by interventions since the 2007 crisis

If insurers and banks were to compete for popularity, insurers would lose with the public, even in the light of the recent financial crisis. We are faced with a peculiar situation: the insurers' business model has proven sustainable, largely because insurers know how to quantify risk and how to set up appropriate technical provisions. On the other hand the banks' business model of transforming terms and the reserve system of fiat money regularly crash, prompting governments and central banks to loot taxpayers and the



insurers' and pension schemes' funds to "save" the banking system and the "economy".

There are of course politically correct terms to describe this: "rescue of the payment system", "active fiscal policy", "quantitative easing" among many others. This type of monetary policy takes place by large scale manipulation of bond and other investment instruments' prices by central banks, made possible by the availability of sheer unlimited resources of money.

The interventions since the 2007 credit crisis deprive insurers of instruments with the appropriate risk-return levels. By ignorance or ill intentions, the insurers' business model, if not their existence in the long run, is destroyed. To make matters worse, this does not appear to trigger discussions or outcries from the insurance industry. This might be because it perceives itself as frail in the arena of public opinion. A notable exception to this was the ZFS Chief Economist's and CRO's opinion published in the Wall Street Journal.

Insurers are experts in principal-agent issues

What makes insurance so valuable in a modern division of labour based economy? Insurance can address the agency dilemma or, as it is also called, the principal-agent problem better and more effectively than any other institutional set-up.

Risk managers know the principal-agent issue and its risk management mostly in the form of the risk owner-risk taker-risk controller relationship. The visible role of the risk controller lies in providing second opinions and independent views. The less visible role of the controlling activity is the beneficial disciplining effect it has on risk-taking resulting mostly from the gain in transparency.

In our democracies, we split political power into the executive, legislative, and judiciary power to address principal-agent problems. Where governments see their role as principal, the institutional setup of choice is often a government agency, be it an "energy agency" or an "insurance supervisory authority".

Example of an energy firm as an agent

But in many situations, other ways exist to monitor principal-agent relationships. Let us look at a concrete example. Our post-industrial service economies are still run on a lot of primary non-renewable energy. Society, or governments at its place, acts as a principal when it tasks energy firms, the agents, to produce the energy we need. This of course runs costs and the lower the costs, the lower the price of energy for society, at least when there is sufficient competition.

But as is foreseeable, in this simple set-up, only costs internal to the system are priced. How could we take account of all the cost that can arise to society or the environment, say, of possible oil spills, nuclear accidents, breaking dams or air and water pollution? We require that all possible threats should be considered, their full cost

taken into account, liabilities clarified and the contingent finance assured.

My claim is that private insurance would do all this better than any other institutional set-up. The profit incentive will drive insurers, but the loss disincentive will be an even stronger guiding hand.

Insurers and appropriate regulations can limit risks

Modern insurance takes a rational approach to managing risk. It is based on the insight that we humans cannot influence, say, earthquakes and tsunamis, but that we can manage our exposure to them, for example, by building differently or in different places. Certainty of law is required so that corporations are prepared to risk their owners' capital and act as risk carriers. In a modern ordoliberal understanding, Adam Smith's invisible hand leads self-interested agents best if also guided by adequate regulation.

Insurance activity, by no means only amounts to collecting premiums and paying claims, but an essential part of the activity is the assessment of risk, designing the proper products, defining the constraining clauses and requiring the necessary precautionary measures.

Private insurance is entrusted with the insurance of many of our personal and business risks. "Private" indicates that the prices and products result from either free negotiation or from free choice among competing suppliers. Insurance activity has created legions of underwriters, actuaries, marketers and sales persons, investment and claims specialists, as well as the insurance firms' managers that all have learnt to manage risk in its diverse facets.

When insurers quantify risk, they use models, but at best, these models can be appropriate for their chosen purpose. Good theories can only be falsified, never proven true and so models can never be "validated", but only deemed appropriate. However, our judgement does not need to be based on blind trust in insurers' expertise. If regulation sets up the institutional framework properly, insurers have to "put their money where their mouth is", ie the incentive for more profit is restrained by the disincentive to suffer unexpectedly high losses if their models are inadequate for the risk.

Success of insurance not appreciated

Even though insurance is a success story and the industry has a proven track record to adequately assess and manage risk, why then does it not get entrusted with solving our societies' mega problems? Why instead of being praised is the insurance industry confronted with mistrust and are its solutions doubted? One can only speculate on the reasons for this.

Maybe the insurers' rational realism destroys dreams by tagging risks with the right prices. One shoots the messenger who debunks the dreams of cheap nuclear power or oil from the deep sea, who exposes the true cost of long life or unmasks the consequences of unlimited access to medical



services. Where insurance proves successful and sustainable, its successes however are taken for granted. Successful insurance activity benefits society and insurers alike. But increased insurers' profits bring envy instead of gratitude.

Transparency and reality speak louder than words

No doubt, with targeted public campaigns, marketing and also lobbying work, the reputation of insurance can be improved and its mechanisms explained. The industry will have to be open and transparent about its inner workings to gain the public's reluctant trust.

This appeal for transparency grows out of risk managers' experience in corporate environments. The most successful solution for many risk management issues is transparency, because the exposed reality often speaks louder than words. Because creating transparency and openness within the firm has a highly beneficial effect, it is promoted in all the emerging solvency regulation, with the aim of engaging market discipline in managing risk. One of the most important transparency measures within companies as well as at the regulatory level was the requirement for market-consistent valuations of assets and liabilities; only values reflecting economic reality allow good judgements and appropriate decisions by employees, clients and competitors alike.

Insurance expertise can reduce risks through incentives and disincentives

The same applies for insurance. The invisible hand of insurance is not mysterious, but can be explained by our insights into human behaviour and how to bring the best out of it with appropriate incentives and disincentives.

Insurance requires and brings transparency into principal-agent relationships, thereby exposing the true cost of risky projects. If insurance had made the potential cost of failed or sloppy risk management more transparent, would failed projects such as the Deepwater Horizon platform or the Fukushima Daiichi nuclear power plants have taken a different course? Would insurance have required more effective and cautious approaches as precondition for insurance?

Failures can never be excluded, but where experience exists, as is the case with the well-defined and reasonably tight liability for oil rigs and pipelines in the North Sea, insurers can be confident that they have a beneficial impact on the incidents and the course of catastrophes. Thus, we can see that the invisible hand of insurance can work to the great benefit of society.

Let me close with an awfully topical quote from James Madison: "A popular government, without popular information, or the means of acquiring it, is but a prologue to a farce or a tragedy; or, perhaps, both."¹

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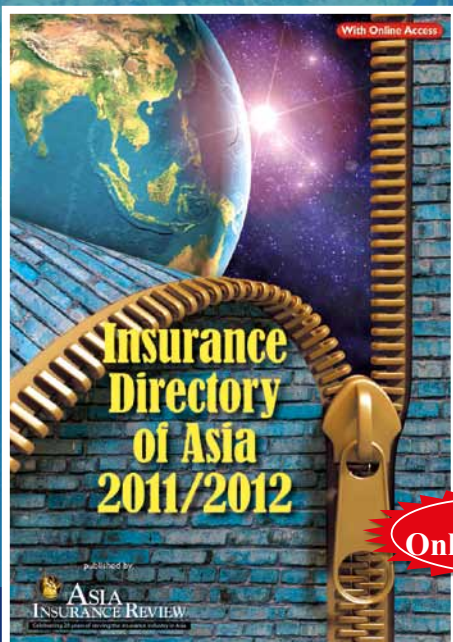


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