Between Public and Private – Insurance Solutions for a Changing Society

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Two major developments are under way in Europe which are already having an impact on the insurance sector and look set to influence it even more profoundly over the next few years. In many Member States, the debate about the need to rethink the scope of the "Welfare State" is intensifying. An ageing population combined with low birth rates, rising healthcare costs and lack of employment, are making it difficult for public schemes to continue financing social security benefits as known so far. The key question is to know what should still be covered by the State and what could – or should – be left up to the market.

The second development concerns the concept of new emerging risks. Floods, hurricanes, terrorism, pollution, food crises etc. While all these risks vary enormously, they have something in common: They raise the issue of who should pay for the damage?

Europe´s society and its risk environment are therefore undergoing fundamental changes, and there is a growing interest for society to encourage private insurers to intervene in areas traditionally operated by the public sector.

To make sure there is no gap between expectations and market realities, public authorities, insurers and all interested parties need to enter dialogue and understand the very nature of each sector.

1. A Changing Society

1.1 Rethinking the welfare state – How can insurance contribute?

Europe is getting older. One in six (16.3%) of the EU population was aged over 65 in 2003, while the proportion aged below 15 has fallen from 24% to 16.6% between 1975 and 2003.[1] Fertility levels for the EU declined steadily from 2.72 children per woman in 1965 to 1.42 in 1995 and have changed little since.[2] With life expectancy simultaneously increasing in all EU countries and the current unemployment level remaining little changed in most Member States, the longterm sustainability of public pension systems is at stake.

At the same time as ageing of the population, the development of more and more expensive medical techniques and the evergrowing demand for healthcare make the costs of health expenditure increase more rapidly than

The article is based upon a publication from Comité Européen des Assurances (CEA) and edited by *Erik B. Johansen,* Danish editor, Scandinavian Insurance Quarterly.

The full length can be found on the home page of CEA – www.cea.assur.org.

national wealth everywhere. The average health expenditure per inhabitant in Europe in 2002 was 2008 Euro compared with 1750 Euro in 2000 and 1382 Euro in 1992.[3] The rise in health expenditure is posing risks for social security schemes in many countries … and then for the future financing of health expenditure.

Under these circumstances, pay-as-you-go-based social security schemes are becoming less and less viable. Thus, reforming social security systems is a government priority throughout Europe.

Little by little, a rethink is occurring with regard to the welfare state concept and viable long-term solutions are being assessed in an attempt to cut public expenditure whilst safeguarding, or even improving, the situation and the well-being of European citizens.

The insurance industry clearly has an important contribution to make without the fear of a loss of service quality to the insured. On the contrary, the competitive framework in which insurance undertaking operate leads them to continuously improve their product quality. Therefore they have to seek out the most suitable forms of cover for their customers' needs.

Private insurance has the advantage of being financed via the funding method which considerably mitigates the demographic problem. Since an individual's contributions are capitalised until benefits are paid out from his/her account, it avoids a transfer of the financial burden to the detriment of future generations. At the same time, it allows for increased financial investment which could contribute significantly to the economic development of Europe, a main objective of the Lisbon Strategy.

However, private insurance can only achieve its full potential as a complement or an alternative to public schemes if its specificities and principles are taken into account.

1.2 A world of risks – Can insurance alone make it more secure?

Our society lives in a world of risks – risks we increasingly wish to be protected from, at least financially.

New or emerging risks can be related to previously unknown health risks (new cancers, passive smoking, asbestos), derived from science or technology (exposures through, for example, chemicals or other substances), or driven by social, economic or legal changes (medical liability). There can also be known risks that develop different trends or unprecedented dimensions (terrorism, natural catastrophes).

For example, in 2003 for Europe alone, floods caused approximately 1bn Euro in loss or damage and the drought had an impact assessed at more 10bn Euro. The 11 September attacks went completely off the scale as far as human losses were concerned and also with regard to insurance company involvement which was estimated at something like US Dollars 50bn.

For a number of new or developing risks, be it in the areas of environmental protection, the food/feed safety fields or professional liability, national and European legislators are examining how insurance can help take the burden off the public purse.

Insurers are fully aware of the need to provide people with protection and security. They are willing to face the challenge of developing new products. While insurance can help bear the cost of unforeseen losses, it cannot be the panacea for all emerging risks.

2. Public/Private Cooperation: Experience we can draw on

Over the last decade, cooperation between the public authorities and the private market has been intensified in many ways. European insurers have developed solutions for the opening of traditional state provision or for newly emerging risks independently or by agreement with the states (workmen's compensation, atomic pool, terrorism). Proof of this is abundant throughout Europe both at national and EU levels. The following examples show that insurance can really provide added value in the economic challenges to be met in the future. The quality of the services and products they propose proves their creativity and efficiency. Of course, the success of the solutions differs greatly in practice. Each specific situation should be carefully analysed to decide how the private protection system can be efficiently developed.

Insurance has a natural role to play in our evolving society and experiences demonstrate the absence of tension between public systems and marked-based insurance.

2.1 Rethinking the welfare state – How insurance contributes

In many countries where insurers operate in a complementary role or as substitutes for social security, people benefit from insurers' extended experience and savoir-faire in the areas of healthcare, pensions, accidents and disability. They have seen an improvement in the level of benefits and services, access to information, transparency, simplicity, rapidity and effectiveness of administration as well as in prevention.

Workmen's compensation

The workmen's compensation schemes for accidents at work have been successfully entrusted to the insurance market in Finland, Denmark, Belgium and Portugal since the early 20^{th} century. The positive results show that private insurance has for many years been able to provide high-quality social protection. Private insurers even developed their services beyond the public authorities' expectations by improving risk prevention and enhancing rehabilitation measures.

In the Netherlands, there has been a successful gradual privatisation of the social security system over the last 10 years. Partially private insurers have replaced social insurance schemes. This has strengthened the financial incentives for employers, employees and insurers to work on prevention of illness and (long-term) disability, and on re-integration of disabled employees.

Healthcare

In many countries, such as Denmark, Belgium and Sweden, the role of private health insurance has significantly gained ground providing extra resources for the provision of care. The quality, variety and affordability of products and services proposed by insurers help in filling a gap left by public systems. Indeed open competition leads to a certain flexibility and competitiveness of premiums.

In Spain, the so-called MUFACE model has unique characteristics in the EU as it is a "substitutive care" model: State civil servants freely choose if they want to be subject to private cover.

In the Netherlands and Germany, private insurers play an important role in health care. They provide insurance coverage which substitutes social health insurance schemes and in addition offer insurance products that complement social health insurance schemes. In 2006, the Netherlands will face a radical change in the health insurance system. The distinction between private and social health insurers will disappear. They will all become private insurers operating in a private setting under public restrictions. Every insurer will be obliged to accept every Dutch citizen for a so-called basic package insurance irrespective of their health conditions.

In France, the union of supplementary health insurance bodies (Unocam) should provide a major advantage in implementing a better health and social policy. Constituted on an initiative by the various actors in the sector, it is meant to be a forum for exchange and proposals on all measures and reforms which may make it possible to resolve issues relating to health insurance. It should allow consensual agreements between the different actors which could constitute the basis for a constructive exchange with the authorities.

Also in France, private insurers can participate in the supplementary universal health cover scheme (CMUC) which allows persons with no means to benefit from free supplementary health cover. This system is financed partly by the state and partly by all health insurers. It indemnifies insurers who issue CMUC contracts. However, five years after its establishment, the system still has many coordination problems between compulsory health insurance and supplementary bodies and many companies have pulled out because of the inadequacy of sums allocated by the Fund.

Pensions

At EU level, the directive on the activities of institutions for occupational retirement provision (May 2003) sets the prudential framework (freedom of investment and management, protection of the rights of pensioners, prudent person principle, etc.) to enable insurers who offer occupational pension products to carry out their business across borders. Occupational pensions represent an attractive means of preparation for retirement in additions to – and not as a replacement for – state pension benefits. The position that the insurance industry advocated throughout the procedure has very largely been taken into account. As a result, the directive will increase competition and the variety of products offered, which will be beneficial for operators and consumers alike.

On the other hand, the "stakeholder pension" designed by the British government and introduced in 2001 has not met expectations. Its main objective was to increase savings in simple, low-cost private pensions by people on modest incomes. Over 2 million stakeholder policies have been sold, but evidence suggests the majority of sales are to better-off consumers. Tight regulation – both of the product and the sales process – and massive extension of the scope of means-tested benefits have constrained the market. As a result, over 80% of employee-designated stakeholder pensions are "empty shells", with no employer or employee contributions.

Risk assessment

Most recently, the EU Commission tried to ban the common practice of using gender as one of the risk-pricing factors in a number of insurance contracts. European insurers explained that risk differentiation is inherent in insurance and does not equal discrimination. On the contrary, such a criterion allows a fair and objective assessment of the risks to be covered. Member States have finally been left with the option to continue to allow the use of gender in this way.

2.2 A world of risk – can insurance alone make it more secure

For risks that are not fully privately insurable, e.g. major catastrophes, insurance and reinsurance can help bear the costs which would lead individuals or companies into bankruptcy and share the costs that the State alone could not afford.

Terrorism, nuclear risks and natural catastrophes

In the Netherlands, as in many other countries, the industry has initiated talks with the government with a view to finding a solution in the aftermath of 11 September 2001. The goal was to avoid the total exclusion of terrorism risks, with the interests of the clients in mind, as well as the image of the industry. The government's help has been requested, which resulted in a public-private arrangement, with shared responsibility. A reinsurance system has been set up, entering into force on 1 July

2003. Coverage in the policies has been limited via self-regulation to 1 billion Euro (400 million Euro for direct insurers, 400 million Euro for reinsurers and 200 million Euro for the State). This positive solution that satisfies both the insurers and the State is widely seen as the best alternative possible.

In some areas, insurers cannot bear the costs alone as the risk may be too large for the private market. In Germany, France and other countries, the nuclear risk is therefore shared between the state and the private insurance sector by means of a layered system. The private sector covers a part of the insured liability while state guarantees cover the rest (up to a maximum). Similar solutions for terrorism insurance and insurance for natural hazards such as flooding, with the participation of the State to share the risk and intervene in the last resort, are well developed and successful in France and Spain. They show that sharing the risk may provide a viable insurance solution for an otherwise uninsurable risk.

In France, a law from March 2002 established an obligation to take out insurance in the field of medical liability, obliging insurers to guarantee uninsurable risks. This led to the withdrawal of several insurers from this market. A recent law improved the insurability of the medical risk, thus creating the conditions for a restoration of this marked. Since its effects cannot be immediate, insurers had to establish exceptional systems so that all actors subject to the obligation to take out insurance are effectively covered. This is the case of the Central Rating Bureau (BCT) which addresses requests from health professionals who have received two refusals for insurance and of GETREM which mutualises the cost of serious risks. In January 2005, following several years of difficulty, health professionals are not now encountering any problems in covering their liability.

Public authorities frequently seek to impose compulsory liability insurance for new risks. At EU level, the European Commission proposed to do this in its first drafts of the environmental liability directive and the feed hygiene regulation. European insurers successfully explained that, as they face new, unknown, risks for which little statistical data is available, they are less able to estimate losses and compensation. They must be given time and flexibility if they are to provide adequate, good-value cover by a step-by-step approach. In general, compulsory insurance must be restricted to the few exceptional areas where the development of extensive insurance cover cannot wait, because conceivable losses may jeopardize the livelihood of a multitude of individuals, as the extent of potential losses from an overall societal perspective exceeds by far the general risks of life in a modern innovative society and economy.

(For further details, please refer to the CEA note: Considerations for compulsory insurance in general liability. 2005)

Agricultural risks

In Italy, public and private cooperate in order to protect farms against the effects of adverse weather phenomena (above all hail) which may put crops at stake. Owing to ad hoc legislation obviously abiding by EU law, the State encourages the use of insurance cover for such risks, modifying its intervention every year, also following suggestions coming from a committee made up of the competent authorities as well as the different stakeholders on the market (insurance companies and farmers).

Cartography of risks

Another successful area of public-private cooperation concerns the development of a public-private partnership for the cartography of risks, particularly concerning floods, in order to help to limit the risks and to facilitate delivery of cover by private insurers. Austria, with an agreement with the authorities the Government Environment Agency and insurers in terms of zoning, land planning and prevention measures, are significant examples.

2.3 Successful examples of public and private cooperation in other areas

In Belgium, close cooperation at an early stage between the government and the motor insurance sector gave birth to the 29/29 agreement. The motor insurance sector agreed to offer motor insurance for youngsters at a premium that does not exceed 129% of the premium paid by a driver aged 29. This advantageous premium level is linked to conditions for safe driving. A flexible solution was found through negotiation, instead of imposing unnecessarily restrictive and complex legislation.

Health insurers in Spain are financing the construction of hospitals. After its construction they manage and coordinate the medical assistance that the hospital provides, including primary care, in certain geographical areas. This kind of cooperation was found to be beneficial to both the authorities and the insurance companies involved.

Austria provides an example of public services, other than financing, which are performed by private insurers. Since 2000, the government's administrative burden has been reduced by entrusting motor vehicle registration to the insurance sector. This transfer has made the procedure faster.

3. Public/Private Cooperation: How to ensure success?

In Europe, the scope of the welfare state is under pressure and our society is increasingly being faced with emerging risks that are, by their very nature, difficult to insure. These two developments are changing the role of the insurance sector in our society. All the parties involved should now be aware of these developments and anticipate the consequences they may have for the policies to be implemented. Insurance is not a miracle solution to all society's problems, but it is certainly a key instrument for the provision of financial cover in a changing society. On their side, private insurers are ready to take up these new challenges and to contribute towards the prosperity of our society. Where need be, the public authorities and the insurance sector should work together to find a solution that constitutes "the best of both worlds", with each party contributing elements that are rooted in their strengths.

First of all: dialogue!

Insurers are willing and able to cooperate with the public sector. Cooperation implies a constructive dialogue, understanding of mutual principles and limitations, consultation prior to any initiative.

Understanding and respecting insurance principles, a basic requirement

Private insurance can only be an alternative or complement to public schemes if its specificities and principles are fully taken into account. For instance, the compliance with the principles of fair and objective risk pricing that underlies private insurance guarantees the quality of the services to consumers. Society in general knows little about what risks insurers can and cannot cover. When drawing up measures that will require a response on the part of the insurance sector, the government should consult the sector early on in the process to ascertain possible ways of responding. The sector can then advance its own specific know-how and develop appropriate solutions together in dialogue with the public authorities.

A competitive framework is to the benefit of customers

Competition also provides a better service to the insured. The private insurer placed in a competitive environment is obliged in practice, because of commercial requirements, to implement a policy of establishing customer loyalty. This requires him continually to strive to optimise all the services which he offers insureds (diversity of products, premium levels, covers, benefits, and providers for the insured/client) and to search for the best ratio between price and quality. Private insurers, because they operate in a competitive environment, must adapt rapidly to market needs.

But where there is a competitive market, all operators in this market, whether operating on a profit-making basis or not, should be subject to the same rules. Otherwise the level playing-field would be threatened. Public authorities must also avoid providing compensation for insurable risks, which can cause a private initiative to fail and be counterproductive to the implementation of good solutions.

Regulation should not hinder insurers' smooth functioning

Market freedom, entrepreneurship and competitiveness are sine qua non conditions of an effective insurance business and the key to its successful management by private operators. Too narrow a room for manoeuvre and an excessive administrative burden would prevent insurers from meeting the customers' expectations. In all cases, over-regulation and excessive interference in insurers' principles should be avoided. An over-regulated market finds itself hindered from doing its job properly. If insurers are given too little breathing space, they cannot fulfil their role nor offer innovative products.

Insurance is not a substitute for social security

The private insurance market can never copy perfectly a public insurance solution. The private sector functions in a different environment governed by other laws and mechanisms, notably based on market operations. Thus, public authorities should not expect insurers to function as social security and insurance basics such as risk-based premiums should be respected. The authorities should not deal with acceptance policies or setting premiums, two freedoms guaranteed by the insurance directives that are vital to a smoothly functioning insurance sector. Although, in certain cases, a legislative structure is indeed necessary, private insurance can only function according to the logic of insurance.

Slowly but surely

For the insurance sector to be able to develop adequate solutions, it is important that it is given time especially when new risks or extended liability should be covered. It is therefore useful to enable an insurers' step-by-step approach. Sometimes the consequences of a policy aimed at prompting insurers to make an additional effort will not always be clear in advance. This may justify opting for a transitional period which could involve measures to see whether they are effective before proceeding to the next stage.

Prevention

Insurers are willing to help the public authorities, companies and society to bear the cost of unforeseen events. However, where possible, the focus should shift on how to prevent these events from happening rather than only discussing what solutions insurance can offer once it is too late. All the actors need to assume their responsibility to prevent such events occurring. In this context, insurers' experience can be helpful. They can contribute to reinforcing loss prevention measures by companies and private individuals through individual loss-based rating and through bonus-malus systems. Public authorities and business should therefore cooperate with insurers and adopt a high standard of care to prevent environmental disasters, food contamination and other adverse events from occurring as effectively as possible.

A 3-way win scenario

Experiences demonstrate that win-win-win (public authorities, people and insurers) situations are common when private insurers have the opportunity to carry on using their savoir-faire in an environment of mutual understanding.

Public authorities and the insurance sector have become partners who jointly bear their responsibilities and have to come up with solutions to take up the new challenges faced by Europe. Instead of standing on opposite sides, they should be working with each other and not formulate their policy in isolation, but share their know-how. The right attitude to adopt, then, is one that is based on an open and transparent agenda, on cooperation and dialogue taking into account the very nature of each sector.

Notes

1 Source Eurostat: Portrait of the European Union issued on 5 January 2005 (EU-15)

2 Source Eurostat: Population Statistics June 2004 (EU-25)

3 Refer to CEA ECO No. 20 : Health Insurance in Europe – 2002 Data, 20 April 2004