IRS 4 AND INSURANCE MARKETS

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Abstract: Insurance system are actively involved in a vast array of "social" insurance services, prominently through provision of public pensions, health insurance schemes and medical services, regulation of health insurance markets, unemployment and work injuries insurance. Recent economic literature emphasizes a tension between Insurance system, and competitiveness and growth. In particular, a trade-off is envisaged between redistribution and growth, as the high fiscal burden needed to finance the Insurance system has perverse incentive effects on wages, lab our supply, capital accumulation, and the adoption of new technologies. In this paper we focus on the Insurance system as a "public insurer", rather than as a mechanism for redistribution of income. The authorized insurance companies have the obligation to have at all times an available solvency rate, in concordance with the activity developed, at least equal to the minimum solvency rate calculated in conformity with the valid regulations.

Key words: Insurance system, IFRS 4, insurance contract, insurance market.

In most deve1loped countries Insurance system systems are undergoing substantial re-organization. Growing costs of welfare systems, stringent public budget constraints, and the intense development of financial markets allowing for significant innovation in the design of insurance contracts, are amongst the main reasons behind this fact. In many European countries, re-organization of Insurance system systems is also strongly stimulated under the Lisbon agenda.

Within this perspective, the fundamental question underlying the present paper can be framed as follows: In what circumstances, to what extent, and under what conditions can the provision of "social" insurance services, nowadays typically offered in Europe by Insurance system institutions, be delegated to the market? The answer to this question will be sought by linking together, and providing advances on, several strands of analysis. First, a detailed analysis of the several instances of market failures in insurance markets will be performed, with specific emphasis on market failures connected with insurance typically provided by Insurance system institutions. Second, competitive equilibrium, and the conditions for Pareto optimality and "fairness", under both adverse selection and moral hazard, will be characterized.

Third, the literature on mechanism design will be applied to a number of social security programs, in order to obtain deeper comprehension on issues such as: public provision or financing of "private goods"; the bundling of different social insurance programs; the optimal design of pension schemes under both private and public provision; the optimal management of retirement wealth in the face of life risks; the optimal provision of old age health risks insurance; the design of prevention policies aimed at reducing health risks associated to transmissible diseases.

The "Lisbon strategy for growth and employment" (the "Lisbon agenda") commits the European Union to become by 2010 "the most dynamic and competitive knowledge-based economy in the world capable of sustainable economic growth with more and better jobs and greater social cohesion, and respect for the environment" (italics added).Under the objective of "greater social cohesion" the agenda includes the ambitious paper to a tighter compatibility between sustained competitiveness (as the development in world trade demands) and social protection that nowadays, in many countries belonging to the European Union, rests on a diffuse public Insurance system. Insurance system systems usually serve two, often intertwined, tasks: they implement income redistribution and they provide public insurance against a class of "social" risks largely connected with health, work injuries, unemployment, and retirement.

Recent economic literature emphasizes a tension between Insurance system, and competitiveness and growth. In particular, a trade-off is envisaged between redistribution and growth, as the high fiscal burden needed to finance the Insurance system has perverse incentive effects on wages, labor supply, capital accumulation, and the adoption of new technologies.

In this paper we look at the Insurance system as a "public" insurer, rather than as a mechanism for redistribution of income. We intend to focus on the reasons behind public provision of "social" insurance, and to examine the efficiency conditions under which the State as a "social insurer" can act. In many European countries Insurance system are undergoing substantial re-organization, induced by the fast growth of their costs.

In addition to the cost effects of the ageing process of the population and of scientific innovation in the provision of retirement and health insurance services, the "cost" of the Insurance system is also linked to the pervasiveness of perverse incentives it can exert on the economy's supply conditions, thus on growth and competitiveness. In fact, the institutions of Insurance system have often shown themselves to be permeable both to individuals' strategic exploitation of private information and to the inefficiencies of collective, i.e. political, decisions. These facts can have perverse effects on social cohesion, thus weakening the political consensus towards the institutions of Insurance system.

As a matter of fact in recent times we have been observing a growing demand for "decentralization", i.e., for "market" and "competition", in many "social" insurance services traditionally provided by the State. The "modernization" of the insurance system, i.e. the reshaping of social protection mainly provided nowadays in Europe by "the State as an insurer", is accordingly a major challenge for the EU countries within the framework of the Lisbon Agenda. A central issue - and the one we intend to tackle in this paper - is whether there can be efficient scope for market delegation of "social" insurance services, and the conditions for it.

The definition of an insurance contract refers to an insurance risk that IFRS 4 defines, other than the financial risk, transferred from the owner of the contract to the eminent. A contract that exposes the eminent to a financial risk, without a significant insurance risk, is not an insurance risk.(Barry j. Epstain & Abbas Ali Mirza, 2005).The definition of the financial risk includes a list of financial and non financial risks, the list includes non-financial variables that are not specific to to a contractual party like an index of the damage provoked by earthquakes in a certain region or an index of the temperatures in a certain town, the list excludes the non-financial variables that are specific to a certain contractual party like the fact that a fire takes or does not take place which affects or destroys an active of that part. Besides that, the risk of changing the right value of an non-financial active is not a financial risk if the right value does not reflect only the modifications of the prices on the market for such actives (a financial variable) but only the stage of a non-financial specific active owed by a contractual party (a non financial variable)For example a guarantee for the residual value of an automobile exposes the warrant at the risk of change of the physical state of the auto, that risk of insurance and not a financial risk. (Constantinescu Dan Anghel, 2004)

The definition of the insurance risk refers to the risk that the insurance company accepts from the insured person, in other words, the insurance risk is a preexisting risk, transferred from the insured person to the insurance company. Consequently, a new created risk by the contract is not an insurance risk.(Dobrin Marin & Ionescu Luminita, 2003).A contract that exposes the eminent to a negligence risk, to a persistence risk or to an expense risk, is not an insurance contract, except when it exposes the eminent also to the insurance risk. However, if the eminent of that contract lowers that risk by using a second contract to transfer a part of that risk to a third party, the second contract exposes the contract to an insurance risk.

Insurance system are actively involved in a vast array of "social" insurance services, prominently through provision of public pensions, health insurance schemes and medical services, regulation of health insurance markets, unemployment and work injuries insurance. In most developed countries Insurance system systems are undergoing substantial re-organization. Several reasons lie behind this fact. First, the costs of welfare systems are growing fast, also due to the ageing process of the populations and the effects of scientific innovation on the costs of health services. Second, stringent public budget constraints increase the awareness of the incentives problems generated by public interventions. Third, the intense development of financial markets allows for significant innovation in the design of insurance contracts.

Within this framework, a major issue in many European countries is whether there can be scope for market delegation of social insurance services - and the conditions for it. Policy proposals to reform the Insurance system systems, also through recourse to "market delegation", have to be subject to an articulated set of

evaluation criteria. Firstly, stringent accountability and cost-benefit analysis are to be adopted to evaluate the scope for market provision of social insurance services vis a vis public intervention.

Secondly, the optimal design of public policies becomes a crucial issue where public intervention continues to play a significant role. Third, in many an instance in which welfare systems continue to provide insurance, there can often be scope for public and private insurance systems to coexist. Fourth, under both regimes, when market results may involve incomplete risk-covering, regulation can be needed to ensure acceptable levels of both efficiency and fairness. A common answer to incomplete risk-covering is recourse to straightforward coercive powers, namely compulsory insurance.

To summarize, the basic paper question can be framed as follows: In what circumstances, to what extent, and under what conditions can the provision of "social" insurance services, nowadays typically offered in Europe by Insurance system institutions, be delegated to the "market"? To tackle the question, the background literature relating to several strands of analysis has to be taken into account.

A first strand of literature focuses on the several instances of market failures in insurance markets (emphasis will be specifically put on market failures connected with insurance typically provided by Insurance system institutions): Competitive conduct of firms can lead to excessive price discrimination (Rea, 1992; Crocker e Snow, 2000), to the inability to credibly commit to long period contracts (Cooper and Hayes, 1987), to insufficient incentive to control costs (Cummins and Tennyson, 1992, Scalera e Zazzaro, 2003). Contractual design allows to reach second best solutions under moral hazard (Cooper and Hayes, 1987; Winter, 2000; Chiappori et al., 2004). However, neither the insured nor the insurer have incentives to propose adequate contractual devices when the effects are "external" to their relationship, and directly fall on society as a whole (Vickrey, 1968, Edlin, 2003, Buzzacchi e Valletti, 2005; Emons, 2001).

The possibility of incomplete coverage is known in the literature of competitive insurance markets at least since Rothschild e Stiglitz (1976) and is particularly severe in long-term contracts. Incomplete coverage can result from cream skimming strategies (Crocker and Snow, 1986); or because risk factors undergo relevant exogenous changes; or because a strong correlation among risks makes the assessment of the risks themselves extremely difficult (Gollier, 2005). Difficulty in risk assessment calls for the need, and the tough task, of aggregating the opinion of experts (Morris, 1977; Bayarri e DeGroot, 1991). Administrative costs can rise very high. In health insurance a common explanation for this result is the competitive search for separating equilibria (Diamond, 1992). In the literature relating to pension funds, the same result is expected to arise from contract incompleteness and renegotiation (Acemoglu et al. 2003; Besley and Prat 2003) that limit the capacity of future pensioners to (ex ante) identify and legally verify good indicators of fund managers' performance.

Conclusions

To ensure fairness, compulsory insurance goes frequently together with forced pooling equilibrium, when separating equilibrium, particularly burdensome to the riskiest subjects, are expected to arise. Another regulatory arrangement intended to combine efficiency and fairness policy objectives is the bundling of social programs under a comprehensive scheme whereby insurance against a number of different social risks is provided together with redistribution. Still, in a policy perspective, the search may also be open for alternative routes. For example, more indirect regulation may serve the purpose of favoring product innovation, that is, the design of more sophisticated insurance contracts, also as a result of competition.

A final theme deserves attention. Provided social insurance is delegated to the market, insurance firms are subject to antitrust law. Particular aspects of antitrust law that come into play would typically involve: prohibition of agreements among firms, strict regulation of information exchanges; severe restrictions, under several circumstances, of the possibility for firms to refuse to deal with customers. Antitrust constraints, especially when coupled with other regulatory constraints, can significantly affect the way in which insurance firms compete in the market.

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