Deep Science Publishing
https://doi.org/10.70593/978-81-988918-0-8_1

DeepScience
Open Access Books

Chapter 1: Understanding the foundations and complex ecosystem of modern insurance

1.1. Introduction to Modern Insurance

Over the course of its development and the given socio-economic and market conditions, insurance has taken on different forms, changed fundamentally in its essence and purpose, became increasingly specialized and sophisticated, developed as a historical practice, and turned into an indispensable element of the current finance system worldwide. And although insurance has launched as a protective tool implemented only at a very personal scale – a typically communal aid from those who prospered in their earthly journey and on whom others counted in order to overcome difficult times – it has burgeoned in power and capacity increasing throughout the years, ultimately leading to the sophisticated globalized system that we observe today. Yet, the primary role of insurance has remained unchanged within a broad societal scope: to protect and insulate the economic agent from unforeseen circumstances which may create a negative and irreversible impact on his/her well-being or even outcome. Thus, with large firms specializing in insurance activities managing around 25% of financial assets worldwide (AltexSoft, 2024; Luxoft, 2024; Mobilunity, 2024).

The combination of the characteristics of investment and risk-sharing – the particularity which defines modern insurance – has been the main engine of the global development of the sector and the corresponding need for progressive adaptation to market and environment changes. The presence of a savings component implies that the various agents in the economy will invest or indirectly utilize a part of the funds incorporated within the institution, representation which is not without cost. But by sharing the portfolios that the insurance agents allocate productive activities generate by themselves the potential indemnities when the agreed contingencies occur. Risk-sharing provisions must be supervised and regulated in order to make the insurance institution truly efficient – so-called actuarial elaboration of risk – a principle that also applies but to a lower extent to other financial intermediaries.

These characteristics, along with the multitude of objectives that both insurance and deposit contracts try to accomplish for their administrators and the insureds, combine to create peculiar market structures and activities. Special characteristics of the insurance premium—allocations of expected revenue to various time periods—lead to unique market functional forms. A wide range of depth, breadth, and complexity across products, revenues, services, markets, and profits implies a highly complex and interconnected insurance market. As the global economy becomes increasingly more interrelated and financial crises more frequent, the structure of the insurance industry and the impact of insurance mechanisms on the world economy merit increased interdisciplinary analysis (Ulavan, 2024; Stratoflow, 2025).

Fig 1.1: Foundations and Complex Ecosystem of Modern Insurance

1.1.1. Background and significance

The importance of the insurance industry in the modern global economy cannot be understated. Insurance markets today provide a safety net for individuals, businesses, and nations by protecting against the potentially catastrophic financial consequences of unexpected loss events. Insurers help mitigate losses by pooling resources, reducing risk exposure, and covering loss replacement costs. Insurance markets have a far-reaching

effect on other industries, influencing material demand and production decisions in the construction, finance, investments, and banking sectors. The banking and insurance industries are both part of the financial services sector and are closely interrelated with functions that can, in part, substitute for one another. However, insurance markets are also unique. Traditional banking services involve the transfer of funds while the primary function of an insurance contract is to indemnify against specific risks. Unlike with traditional banking services, insurance involves provisions to account for, and distribute, expected transactions that may not happen for either an individual or the financial institution.

These differences lead to unique operational structures for insurance markets. Insurance companies function by pooling insurable risks that are less than fully correlated, allowing spread of risk and covering claims with premiums and investment income.

1.2. Historical Development of Insurance

Since one of the first definitions of insurance as "the equitable transfer of the risk of a loss" insurance has been considered an activity of great importance for the economy of societies and the business development because it serves to minimize matters related to the transfer of risk. Yet, even before our time, such operations existed, for example the Babylonians, Chinese, Greeks and Romans had already developed some form of insurance. Thus, in order to present a brief historical review and understanding about the development of the institution of insurance, we will present the Review Historical Development of Insurance. Through this review it will be proposed the understanding that, throughout history, insurance has adapted to meet new demands, gradually expanding its scope and coverage, to the point of making itself indispensable in modern society. Empirical evidence about its historical development may thus provide support for studies about current and future developments of insurance which are the basis of our research objectives. The concept of insurance is not new. Insurance develops gradually from the simple institution of dating back millennia, which glorifies the fragility and vulnerability of the human condition and then evolves through scripts in which the dead were compensated, paid to the family of the deceased. Gradually, the economic development of society causes the institution to abandon its exclusive and sacred relationship with culture and protection and replacement of life by the more profane relationship of protection and replacement of monetary assets and commodities.

1.2.1. Research design

Designing research on the development of an activity as diverse and complex as modern insurance is not an easy task. On the one hand, it is difficult because the interests of

different legal systems, their level of development, their civilization models differ from one another. Furthermore, the same business proposal can be very different from country to country, and it's true nature can only be understood with profound knowledge of the particular situation. However, it is also easy because, due to its autonomous internal regulation, insurance interests all civilizations, all different legal systems, at different times and levels of development.

Liberal insurance as we know it in the western world has been present for about three hundred years. Since then, there have always been far more insurance markets in common law countries than civil law ones. Indeed, among the latter, during the last two centuries, some have taken longer than others to develop modern forms of insurance and to answer questions that soon became common – life, health, and credit insurance, in non-euro-zone civil law countries, were developed much more recently than in their Eurozone partners – while some Eurozone partners such as France and Germany have up to now developed life insurance markets that are much bigger than those of all other countries.

1.3. Key Principles of Insurance

In order to appreciate the complexities of the modern insurance sector, it is important to understand some of the foundational principles on which it is built. These principles include the concepts of risk assessment, underwriting, indemnity, contribution, subrogation, and utmost good faith. These principles, particularly the concepts of underwriting and indemnity, are so critical to the business of insurance that they effectively define what it means to be an insurer, and any organization that acts outside of them can be stripped of its insurance license. This section discusses these principles, first reviewing the simple concepts before considering some of the more complex ideas such as subrogation and contribution.

The insurance sector relies on the ability of insurers to be able to assess and quantify risk. The insured pays a premium, which goes into a pool with the premiums of other insureds, and at some point, a claim might be paid out for a particular loss event. However, the amount paid out is not related to the amount of the insured’s premiums, as the insurance policy is fundamentally a long-tailed option position. The payment of premium also represents an option for the insured, and it is generally very cheap relative to the potential payout. The insurer’s assessment of the probability of loss occurring, set out as a rate per policy period, and the size of the coverage are critical to correctly pricing this option. The probability of loss occurring in insurance is not actually an independent random distribution; it is the result of complex underlying stochastic processes which, while having some random element, are highly predictable in aggregate. The aggregating

principle allows actuaries to price both the option exposed to an individual insured, as well as to aggregate it across the entire portfolio of insureds.

Life Insurance is a contract that assures payment either on the death of the insured person or after a specific period. Life insurance is essentially a combination of investment and risk cover. Life insurance products are typically of three-fold stages, an initial growth stage, a saving stage, and a protection stage. During the early years of the contract, the risk premium is low since the possibility of an early death is minimal. There is no risk cover during the initial years and all premiums are invested. As the mortality increases, a larger portion of the premium is allocated to providing for the risk cover. The premium is relatively high in the last few years of the contract. In this stage, the only return on investment may be in terms of the interest earned.

Fig 1.2: Key Principles of Insurance

However, insurance markets cannot function smoothly with only these two participants: the insurers and the insured. Insurance markets comprise additional support systems. These additional system participants are middlemen, or agents and brokers, drawing up

the contracts. The ratings agencies assess the financial strength of insurers, aggregators provide an interface for customers to compare products, risk consultants help with claim management, capital market participants invest in insurance-linked products, and also clarity of risk definition by way of contracts by the insurers become essential features for proper working of insurance markets. Furthermore, due to increasing globalization and value chain partnerships, loss events are no longer restricted to the insured's balance sheet. Third-party insurance is needed on a web of complex interdependencies. But enough about the market and its ecology. What of the insurance participants?

1.3.1. Risk Assessment

Insurers cover risks stemming from specific exposures and defined outcomes. From the microfinance perspective, the perception of insurance risk is a significant difference compared to other kinds of financial services. Credit and savings stakeholders deal with a future exposure, while insurers focus on the future outcome. Insurance reduces or removes uncertainty stemming from adverse deviations of future outcomes compared to estimations based on the time value of money. The reduced risk is the value of an insurance policy and defines its price. The first difference between insurance and other forms of financial services is that the risk premium, which defines the price of the service, is based on deviation frequency and average size of losses, while credit and deposit pricing is based on the term structure of money market rates. The risk premium dividends are not based on an individual client’s behavior. Just as interest is paid by banks to all clients and received from clients with outstanding loans, the insurance premium is a defined financial transfer from one party to another that results in a possible future payment triggered by the occurrence of a defined event within a specific period.

The second difference relates to a simple remark: Insurers use anticipated value as their only updated estimate of future insurance outcomes, while credit institutions and investors apply anticipated and other forecasting methods. This means that microinsurers usually do not adjust the insurance premium during the coverage period, while adjusting risk pricing is a common principle of credit institutions. In this section, we focus on the risk assessment processes applied by insurers as part of defining the basis risk premium to be charged.

1.3.2. Underwriting

Underwriting is a critical cog of the insurance industry, without which none of its services would be possible. Underwriting leverages actuarial techniques to derive the price of the risk. In other words, the job of the underwriter is to evaluate risk and determine the price of insuring it. That means that the underwriter has to acquire all the

information on the risk and possibly gauge the veracity of the information acquired. Also, underwriting uses brute actuarial methods, not complex intricate models, to derive this price. The actuarial methods are based on historical empirical information. For health insurance, it would usually be mortality or morbidity and for non–life insurance, it would usually be claims data.

Insurance principles rest on the premise that each policyholder pays a premium in direct correlation with the risk presented, thus the exposure that each insured party imposes on the carrier's pool. To do this requires the risk presented to be perfectly understood—the policyholder's insurance coverage intent, the risk presented to the carrier, and additional external factors describing the risk, its frequency and severity, and finally the competency of the underwriter to build the description into pricing that moves the policyholder and sustains the underwriting profit margins for the insurance carrier. The uncompromising foundation of underwriting is the underwriting cycle—periodic fluctuations over time in the relative abundance and avarice for risk as enlisted agents take temporary leave from the largely effortless production of insurance premiums to chase investment returns or increase their capacities to deal with the terror of underwriting losses. The combined impact of the underwriting cycle, climate change, modeling technologies, the growth of alternative capital, and political and regulatory decisions causes wide sways in cycles and the loss reserves of automated computer software models.

1.4. Types of Insurance

A person who enters into a contract of insurance is referred to as the insured or policyholder. The person receiving the benefits is known as the beneficiary. The insurer will have an interest in the performance of the contract and would be likely to suffer a loss resulting from the party's death. In insurance terms, the insured is known as the life assured. Insurance of all kinds has three parties: the insurer, the insured, and the beneficiary. The danger of loss or damage to the insured person or property, and the payment of a sum of money in the event of such loss or damage to the insured person or property.

Essentially every commercial institution has some risk factors. The people or institutions which are at risk can transfer this risk to the insurance companies. The insurance companies charge an insurance premium for the transfer of risk and undertake to pay the insured capital if the risk occurs. All the insured persons may not suffer loss at a given time; the insured loss is covered from the premium amount paid by the group of insured persons. There are several types of insurance available. It would be useful for the readers to briefly get an overview of these insurance types. Insurance is broadly classified into life and non-life insurance.

1.4.1. Life Insurance

Life insurance is a unique form of insurance because it covers a living person for an event for which the insurance company has significant concerns for the future. It is indisputable that life insurance plays a key role in most discerning households in the modern world because many of their actions are likely to be economically detrimental to their heirs at law, and because of the inherent difficulty of estimating the magnitude of such detriments at law. These determinants include funeral expenses, the loss of earnings of a family elder, the consequent loss of expenditures for the education of children and for other family purposes, and, for the wealthy, the loss of care of an estate for the benefit of other heirs. What is somewhat ambiguous is the welfare function of the household decision-maker, who might be different from the insured person. In other words, is he or she concerned about the magnitude of the harm expected by the other family members, or is he or she concerned about the magnitude of the insurance premium and its opportunity cost? In either case, the product seems to be needed by all except possibly very poor or very risk-averse people.

Yet, the product has historically been shy of mass-market acceptance without successful encouragement by financial planners and advisers. Perhaps this is because the decision variables are inherently privately held and depend on a prediction of the future solvency of the family decision-maker to ward off such effects; decisions could go very wrong for a family of small resources if too heavy a stake rests on the decision-maker mentioned earlier to avoid future family-level insolvency.

1.4.2. Health Insurance

Health insurance offers financial protection against substantial health care costs. Health care typically involves a series of minor expenses such as preventive care and outpatient treatment for conditions that do not require hospitalization. In addition, health care also involves substantial and unpredictable expenses due to catastrophic illness that may involve surgery, hospitalization, and prescription drug therapies. Individuals must pay for the minor expenses but face the risk of loss from the much larger costs associated with catastrophic illness. The popularity of health insurance is a response to the unpredictable risk associated with the high costs of major illness.

In many countries, the government or a group that is subsidized by the government offers health insurance to all or a large sector of its residents: a single-payer system funded primarily from taxation, where the government is the primary provider of services but which also allows private insurance on a limited basis. Other countries provide a large element of private-sector health care as their primary source of coverage, supplemented

by government-funded programs for the elderly or for the indigent. In many European countries, health care is provided by both public and private insurance programs.

1.5. Insurance Markets and Participants

Insurance is related to mitigation of risk, whereby part of risk is shifted to the shoulders of insurers. The basic concept of insurance is that it is intended to cover the financial loss arising from an unforeseen event by a pre-agreed fixed amount. The payment of this amount to the assured comes at a small cost. When a number of people face the risk, they pool their risk, and the insurance market is created. Markets are usually characterized by buyers and sellers. The insurance market is no exception and comprises both insurers and the insured — groups of people buying policies from insurers. The insurer is the seller of the policy, while the insured are the buyers. Following a pre-agreed arrangement, the insured pays a premium to the insurer, which in turn promises to pay a certain amount of money when a specified event occurs. The insured become members of the "pool" of funds and share the possible loss.

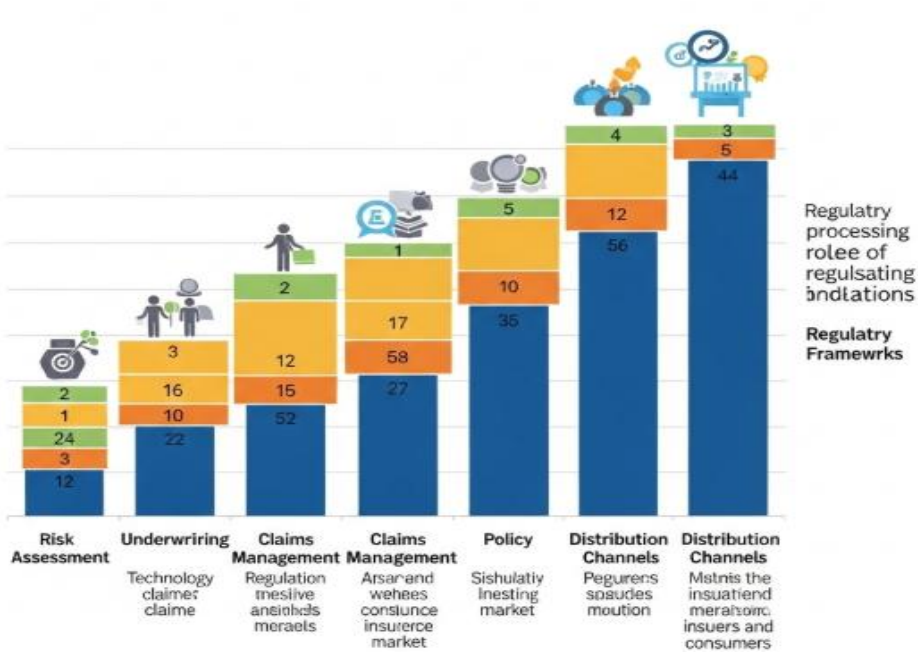

Fig : Foundations and Complex Ecosystem of Modern Insurance

We hope to motivate researchers and industry leaders alike to put some more thought into re-thinking the whole industry. With the growing investment clout of both insurtech and insuretech investors alike, we believe that the time is ripe: why not combine the tech with the insurance expertise? Thus, while we recognize that each discrete piece of the

insurance infrastructure operates largely in isolation today from one another, we feel it is time to ignite conversations about how all of these pieces could tie together to result in a more effective and optimized overall insurance ecosystem delivering services to customers. Such a connected vehicle for the insurance business would likely involve thought leadership from some larger incumbents in re-shaping, as well as cooperation across multi-industry boundaries for a common vision.

1.5.1. Insurers

Insurance is a commodity: it is a product for sale, as a company exchanges monies for a promise of future payment. This means that the raw product, the promise itself, must be defined and standardized for it to constitute a feasible business model. Insurers are suppliers of insurance, agents of risk transferral. They are most often considered the main actors in the insurance system; but this is not entirely true. Although they are the principle-crossing of insurance activity over the financial flow of society and its economic engine, they only offer products under contracts that are written upon a complex theory of risks and risk sharing. They are price makers, but they determine those via accounting models based on their portfolio results. So, their efficacy does not relate to the specific work of supplying what they sell, but with all the orbit of theories and techniques orbiting around risk analysis and management, as well as how much they charge and when.

Because the main role of insurers is enhancing other's risk management strategy, there is an essential aspect of their operation: that is why they specialize into classes of business and build portfolios of products that address very unique consumer needs. From there, the price they charge for the insurance promise defines the terms of economic exchange. Their functions therefore relate to information aggregation, data mining and risk measurement evaluation, public trustworthiness, and the engagement and commingling of claims. These functions are similar, although with margin differences, for both life and non-life insurers.

1.5.2. Reinsurers

Reinsurance is an arrangement that an insurer makes with another company to protect the insurance company from loss. The company that sells the insurance to the public is the ceding company; the company that takes the risk is the reinsurer. When a reinsurer accepts the risk and pays the reinsurance premiums, it becomes liable to the insurer for amounts in excess of those specified in the agreement. Furthermore, there are many ways that the reinsurer can design the agreement to limit liability and do it more efficiently. These various forms of reinsurance help insurance company managers reduce the

volatility of their results; increase their capacity, such that they can underwrite more profitable risks knowing that the risk is not too great; provide price benefits; gain additional knowledge about certain kinds of risks or catastrophes; gain the ability to reinsure small cap or big cap business risks; and overall, align the objectives of the reinsuring company with those of the reinsurer. The services that reinsurers offer can be thought of as insurance products that include various pricing, design, capacity, sustainability, and expertise in deal-making options.

One category of reinsurers does business only through brokers—called treaty reinsurers. They prefer to enter into broad treaties for many risks rather than go deal by deal with ceding companies. The reinsurers that do business only with ceding companies do intend to build a relationship by treating these transactions as one part of a longer-term outlook. These are also somewhat treated in their arrangements as treaty reinsurers as they tend to do business. Their customers are ceding and customers want to believe they value these relations highly in treating these products as being low priority compared to other products.

1.6. Conclusion

This essay outlined the core foundations and existing ecosystem of modern-day insurance systems and reviewed the existing ecosystem that dictates the overall practice and business of insurance. As previously mentioned, today's insurance landscape is a structured yet complicated ecosystem in which a wide range of players coexist and evolve. Each of these players offers its respective products, services, and contributions to society. Though the roles are clearly defined and well-acknowledged, the ecosystem is still very fragile. The rapid influx of innovation coupled with a market heavily dependent on the economic clout of older corporations means that much of the industry is at risk of developing glaring holes that could collapse key players in this business. While we recognize that there is ongoing conversation about innovation in certain discrete pieces of this solvable ecosystem, we argue that much of the effort has been niche and narrow.

1.6.1. Future Trends

The 2030–2040 time range is a flashpoint for profound changes in how assets are owned, how policies are written, and how technology works. Ownership will shift to transferability. The very nature of what is covered by traditional insurance policies will shift. Future focus will turn toward climate mitigation and protection, bodily security from infection diseases, and robustness against special repetitive pandemic events. Policies will directly address everything from both individual risk and collective

response. Insurance will work hand-in-hand with affected communities. Yet just as importantly, with the visible/visible and invisible/invisible stakes of improving society as a whole and protecting the most vulnerable, the ethical, timely, fair provision of access to funds disbursed by insurance will be technologically seamless, and timing will be imbued into the very policies' structures and mechanisms that dictate the use of the funds once received.

Currently, these fund disbursal mechanisms tend to invoke bureaucracies that are ill-suited to do what is actually in the best interest of all because they are focused on deterring fraud. Yes, what needs to happen is to use technology, not to prevent fraud as an outcome of a weakness in the system, but to provide service, in the best sense of that word, to a society that has, in fact, sheltered its insured members, when there is a tragedy, not an expense. The shift is subtle and yet profound. It is not fraud that should be the focus, but outages – that is, the temporary, no-fault absence of service provision in a region, community, or specific members. But it is rather to radically improve access at every smallest scale of sharing everything, such that the collective is robust enough to handle, by a simple mechanism, whatever incident may occur. At every small, as-relevant social structure, able to take care of people who at that moment need help you are thereby fulfilling the social contract to assist others in need, only to expect help in return for when you are in need in a different moment.

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