Distr.
GENERAL

TD/B/C.3/176
8 October 1982

Original: ENGLISH

United Nations Conference on Trade and Development

TRADE AND DEVELOPMENT BOARD
Committee on Invisibles and Financing related to Trade
Tenth session (first part)
Geneva, 13 December 1982
Item 9 of the provisional agenda

INVISIBLES : INSURANCE

Problems of Motor Insurance in Developing Countries

Study by the UNCTAD secretariat

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GE.82-53012

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Introduction

(i) In its resolution 19 (IX) of 3 October 1980 the Committee on Invisibles and Financing related to Trade requested the UNCTAD secretariat to prepare a study on third-party automobile insurance. 1/ This study has been prepared pursuant to this request, which was predicated on the reported negative results being experienced by many developing countries in connection with this class of business. The study analyses the operational methods and practices of insurers in writing motor insurance in general and motor liability insurance in particular, and suggests ways that they, in conjunction with insurance supervisory authorities, can improve performance and results.

(ii) The issues associated with motor insurance, however, are complex and involve more than insurers. The interests of motor vehicle operators and owners, of the victims of motor accidents, and of the public at large should be carefully considered. Given the nature of the Committee's request, this vast array of issues has been but touched upon lightly in this study. None the less, recognizing their importance, the secretariat commissioned a separate study by Dr. A.R.B. Amerasinghe that hints more broadly at some of the issues. 2/

(iii) Thus, this study should be considered as providing for insurers some solutions to the problems faced by them in writing motor insurance. This emphasis is appropriate as, consistent with previous CIFT resolutions, the creation (and maintenance) of a strong domestic insurance industry is a pre-requisite for economic development. It appears that, for many developing countries, the negative results of the motor branch may pose a threat to the maintenance of that strong domestic insurance industry.

1/ *Official Record of the Trade and Development Board, Twenty-second Session, Supplement No. 2*, (TD/B/833-TD/B/C.3/174), annex I.

2/ Report by the UNCTAD secretariat, "Problems of developing countries in the field of motor insurance" (TD/B/C.3/176/Supp.1).

Chapter I

THE MOTOR VEHICLE ENVIRONMENT IN DEVELOPING COUNTRIES

1. The number of motor vehicles in developing countries has been increasing yearly. In 1970 the total motor fleet of developing countries represented 7.9 per cent of the total world fleet (excluding Eastern European countries). By 1980, with some 46 million vehicles on the roads, it reached 11.9 per cent. Unlike the situation in developed countries, the increase in the purchases of motor vehicles in developing countries represents more a real growth in the rate of motorization, rather than vehicle replacement.

2. In spite of the rapid growth in the number of vehicles in developing countries, the number of vehicles *per capita* is far below that of developed countries. In 1980 the number of vehicles per 1,000 inhabitants in Africa (excluding South Africa), Asia (excluding Japan) and Latin America was 11, 8 and 81 respectively. This compares with 687 in North America, 505 in Oceania, 524 in Japan, and 294 in Europe. 3/ The reason for this difference is the difficult economic situation in most developing countries. Also many governments in developing countries deliberately restrain car imports in an attempt to use foreign exchange in other areas.

3. The increase in motorization in developing countries has accelerated development by facilitating the transport of people and merchandise. However, it has also produced a heavy toll in accidents. Such accidents have a negative impact on the economic and social life of the community. They result in wasted human, financial and material resources. Even if these losses are compensated by insurance or other forms of indemnity, the society at large ultimately bears the full brunt of the losses.

4. A comparison of motor accident rates in developed and developing countries shows the unenviable situation of the latter. 4/ These high accident rates exist in spite of the fact that the number of vehicles *per capita* in these countries is very low. High motor accident rates in developing countries can be attributed to poor road conditions, inadequate traffic control, poor vehicle condition (due to inappropriate use, poor maintenance and old age), and inexperienced and sometimes careless drivers.

5. Besides the high frequency of motor accidents, there is a marked trend towards increased severity of losses. This is due to the high density of the population in urban areas, the introduction of heavier and more powerful vehicles, the insufficiency of first aid and ambulance facilities, increased costs of auto repair and the general inflationary spiral that has increased costs in all areas.

6. However, even under the best of conditions, motor accidents will continue to occur. It has, therefore, been deemed important to have a compensation system for innocent victims of motor accidents. As discussed below, most countries rely on a combination of tort law and liability insurance to provide this compensation.

3/ *Sigma* (Swiss Reinsurance Company, April 1982), p. 5.

4/ See *Statistiques routières mondiales*, Geneva, Fédération Routière Internationale, 1981.

Chapter II

THE IMPORTANCE OF MOTOR INSURANCE TO INSURERS IN DEVELOPING COUNTRIES

7. The motor insurance line is exceedingly important in developing countries. 5/ It represents for them the major source of premium income. The total non-life insurance premium income of insurers in developing countries was $US 12.4 billion in 1980. Of this amount, one-third or $US 4 billion was generated by motor insurance branches. Moreover, this one-third figure likely understates the potential importance of motor business as premium levels in many countries are artificially depressed and as sizeable portions of motor fleets in developing countries are uninsured.

8. The importance of motor insurance stems not only from the fact that it occupies a dominant position in terms of total premium income; it is also the major source of insurers' cash flow. Motor insurance premium income is steady, with no specific periods or seasons. Thus, a continuous cash flow is provided, allowing insurers to meet their normal obligations and obviating the necessity of keeping all of their assets highly liquid. The cash flows from motor insurance also allow insurers to finance expansion in new fields of activity.

9. Another feature of motor insurance, making it of particular importance to insurers in developing countries, is the fact that, unlike most other classes of insurance, it does not require proportional reinsurance. This is because it enjoys a favourable "spread of risk". Only very high liability limits require excess of loss cover and the cost of such cover is small. Thus the major part of premiums generated by this class of business remains with the direct insurer, becoming its main source of investment earnings. This is not normally the case in other lines, which can require extensive reinsurance.

10. The motor insurance business often provides the essential underpinning for insurers' entire sales efforts in other lines of insurance. Sales persons rely on the steady commission generated by a constant flow of motor business to enable them to remain in business and to sell other types of insurance. Without this basic income source, they probably would not be able to persist in insurance sales, resulting in a curtailment in the availability of other types of insurance.

11. The growth rates of motor insurance in developing countries have been greater than that experienced in other classes of business. In some developing countries, motor premium growth has exceeded 25 per cent per annum, whereas other classes have experienced growths of 10 per cent. Such growth rates normally reflect increased motorization rather than tariff adjustments.

12. Motor insurance premiums are derived from both compulsory (i.e., required by law) and voluntary motor covers. The relative importance of the two covers varies depending on whether (a) both bodily injury and property damage liability insurance are compulsory (as is common in developing countries influenced by French legislation) or (b) only bodily injury coverage is compulsory (as is common in those countries influenced by United Kingdom legislation).

5/ This study focuses on the importance of motor insurance to insurers. However, one must recognize that motor insurance fundamentally is of greatest importance to individual insureds who are afforded protection by such coverage and claimants whose losses can be compensated.

13. The price of compulsory insurance has a decisive effect on the ability of insureds to purchase other covers. The higher the compulsory insurance premiums, the less the client is inclined to purchase other covers. However, the premium volume for non-compulsory covers generally increases more rapidly than that for compulsory insurance. This is due to (a) the increasing values of vehicles, which mean higher sums insured and larger claims on first party physical damage covers and (b) more rating flexibility with voluntary than with compulsory covers.

Chapter III

MOTOR INSURANCE PERFORMANCE IN DEVELOPING COUNTRIES

14. Motor insurance performance in most developing countries apparently has not been favourable. This is in spite of the fact that motor insurance unlike many other lines of insurance in developing countries, has a sufficiently large number of insureds to permit the law of large numbers to operate successfully and to facilitate compilation of meaningful statistics and reliable loss predictions. The implication of this is that motor risks can produce a balanced account provided the rating faithfully reflects loss experience.

15. A second positive feature of motor insurance is that its underwriting expenses should be low. Most of the indicators of physical and moral hazards can be obtained from the proposal forms and there is seldom need to inspect motor risks for rating.

16. Also, unlike many other lines, motor insurance does not require a highly specialized underwriting knowledge. It is sufficient for staff to receive firm underwriting guidelines coupled with a reasonable rating system. Further, acquisition costs in many countries should not be as high as for other forms of personal insurance since the purchase of liability cover is compulsory.

17. The large volume of premiums, the spread of risks, the ease of underwriting, the reduced reliance on reinsurance, and the availability of investible funds from which additional income can be derived would lead one to expect motor insurance to be profitable. Yet, the facts are quite different. The motor insurance branch records large deficits in many, if not most, developing countries. 6/ In some developing countries, loss ratios of up to 180 per cent and higher are found.

18. Because of their dependence on motor insurance, the insurance companies of developing countries have been particularly hard hit by the poor results from this class of business. Some companies in these countries have experienced such large losses that they became insolvent. Others have abandoned or restricted their writing of motor business. If the trend continues, motor insurance experience could jeopardize the emerging insurance industry in many developing countries or, at best, hamper its growth.

19. The unhappy situation described above in developing countries persists for several reasons. Claims control is sometimes lacking. Expenses are high. Investment yields are often artificially depressed. Finally, and most importantly, premium rates, especially as related to compulsory motor insurance, have often been held to insufficient levels by regulatory authorities. Each of these difficulties is discussed briefly below.

6/ To state that the motor insurance branch is unprofitable requires a definition for profit. As used in this study, total profit is defined as underwriting profit plus net investment income. Underwriting profit is found by subtracting incurred claims and underwriting expenses from premiums earned in a year. Net investment income is found by subtracting investment expenses from gross investment income.

A. Claim payments

20. In most developing countries, losses arising from motor accidents are settled according to the liability system. To receive compensation, the victim must file a claim against the party causing injury (the tort feasor) and the tort feasor must be found to be at fault in causing the damage. Also, generally, the victim must not have contributed significantly to his or her own loss. Until recently, many persons living in developing countries either were not aware of their legal rights regarding compensation for death or bodily injury caused by another or did not believe it proper to file a claim for "blood money". Societal values are changing. People are becoming more claim conscious. It is becoming unusual not to make a claim for bodily injuries or property damage caused by motorists.

21. The trend in developing countries is to make the purchase of motor liability insurance compulsory. The required minimums vary from country to country, with many countries requiring unlimited protection for the bodily injury liability cover and some requiring it for the property damage cover. Making the purchase of motor liability insurance mandatory is deemed to be a sensible way of ensuring compensation to those who are harmed by a negligent motor vehicle operator. 7/

22. The method of establishing fault varies. In developing countries (in Africa and Asia) following British Common Law, the victim must prove the fault of the opposing party. In countries influenced by the French Civil Code (in Africa and the Pacific, as well as in some Latin American countries), a motor vehicle is presumed to be a dangerous object. Its operation on the road presents a danger to the public. Thus, if a motor vehicle causes injury, a presumption of liability attaches to the operator and proof of negligence is not required. The operator may, however, overcome the legal presumption by proving that he or she was not at fault.

23. Not unexpectedly, therefore, legal systems that are based on the French Civil Code tend to produce a greater number of successful claimants than does British law. The result is, other things being equal, insurance premiums must be higher for countries following the French approach.

24. Losses are classified as economic and non-economic. Economic losses include damage to automobiles and other property, medical expenses, loss of income and miscellaneous out-of-pocket expenses. Non-economic losses include "pain and suffering", personality deterioration and related general damages.

25. Economic losses are easier to quantify than non-economic losses. No uniform basis for establishing non-economic losses exists. Such losses are often exaggerated to obtain the maximum compensation. The discretionary rights exercised by judges in setting awards for such damages often lead to non-uniform awards for similar losses and, some say, to abuse. This affects motor insurance results negatively.

7/ Other compensation schemes are not based on tort law. See, for example, "Problems of developing countries in the field of motor insurance", (TD/B/C.3/176/Supp.1).

26. For settling third party property damage claims, the insurer normally relies on repair bills and expert appraisal. In most cases there is no litigation. The importance of property damage claims stems not so much from their severity as from their frequency. Such claims must be borne exclusively by the insurer as little, if any, reinsurance is typically involved.

27. Another problem associated with property damage claims is the escalation in repair costs. This escalation reflects the general world inflationary trend but is further aggravated by high custom duties on, and scarcity of, spare parts. Moreover, repair cost overpricing is widespread due to collusion of appraising experts and repair shops.

28. The percentage of claims in several developing countries which come before courts is high compared to that of developed countries. To an extent, this is attributable to the tort system. Insurers in these countries, however, are responsible to some degree for this tendency. They operate in an environment characterized by complicated claim settlement procedures and staff inexperience. The frequent resort to legal proceedings not only results in spending an inordinate portion of the premiums for legal costs, but also delays claim payment and this delay very often reduces the amount of the claim in real terms.

B. Expenses

29. A sizable portion of total motor insurance premium income is spent on acquisition and management expenses. Most insurers in developing countries rely on insurance intermediaries to sell their policies. The main reason for this is that insurance companies often lack a sufficient in-house marketing network. To develop such a network may not be cost effective. Thus they appoint agents and brokers to sell for them and also to service the business. The commission for selling and servicing is normally higher than the commission for procuring the business only. This explains why motor commissions in developing countries often appear to be high. In many markets, the commission rates for compulsory and voluntary covers are the same, while in others the rate is lower for compulsory business.

30. Determining the responsibility for and the extent of injuries requires time and often legal proceedings. Many insurers in developing countries deliberately delay the settlement of claims because they believe that they will pay less if they pay later. Delays of all types, regardless of the reason, involve additional expenses.

C. Investment returns

31. Investment returns in developing countries are often not large enough to affect greatly the technical results of the insurance business. This is because many developing countries have no organized money markets which could facilitate the buying and selling of securities and offer attractive returns. Moreover, government regulations often require insurers to invest certain proportions of their assets in low-yielding government bonds or other securities whose yields are often below the inflation rate.

32. Other factors explain insurers' poor investment performance. Because of the high claims frequency, some insurers keep sizable amounts of cash to meet everyday claims. Second, many agents or intermediaries withhold the remittance of motor premiums for long periods, thereby reducing the periods during which insurers could be earning income on such funds.

D. Premium levels

33. Increases in accident frequency and claim severity warrant review of motor insurance rates so as to achieve a reasonable balance between motor premium receipts and disbursements. Most countries mandate rates or maximum rates for compulsory liability insurance. These rates are fixed by the government or by the insurance supervisory authorities and are subject to change only by them. Companies or associations of companies may be required to provide basic information and loss statistics to help the authority establish rate levels, but the responsibility for fixing the rates remains with the authorities.

34. For the sake of expediency, resort is often made to a uniform and simple risk classification system. This hinders the development a more refined rating system which may reflect the risk more accurately. Further, it ignores different insurer operating costs.

35. Unfortunately, the prevailing ratemaking systems lead in most cases to long delays in adjusting rates to fit loss experience. The political and social pressures felt by the government may also lead to the inappropriate freezing of rates or making an inadequate adjustment.

36. In several developing countries motor insurance availability has been adversely affected by the poor results. This is often in spite of the fact that liability cover may be compulsory and the insurer cannot refuse to accept anyone. Many insurers illegally cancel or fail to renew policies. Others may illegally refuse to write motor policies altogether. These measures mean that many drivers have no insurance. In some countries a black market for motor insurance has emerged where agents and brokers impose illegal surcharges to issue policies.

37. Unlike compulsory motor insurance, the writing of voluntary motor covers seems to be profitable. This situation is due to the non-mandatory nature of these covers, which permits more insurer flexibility in selection, pricing and establishing policy conditions. The fact that voluntary covers yield adequate profit induces insurers to write them on a large scale in an endeavour to make good their losses under compulsory insurance. Some governments oppose rate increases on compulsory business on the grounds that voluntary covers are profitable and may compensate for losses from the compulsory business.

38. In summary then, the existence of a generally unprofitable major line of insurance, such as motor insurance, means that the insureds of the branch are receiving a subsidy, either from other branches or from other sources (e.g., insurers surplus). If insurer surplus is the source of the subsidy and if the situation persists, the insurer is doomed to insolvency. The deficits recorded by motor insurance may be particularly harmful to national insurers in developing countries because they cannot rely on other markets for profits. On the other hand, if foreign insurers are allowed to write any type of business and abstain from writing unprofitable lines, this will place national insurers in an even worse position.

Chapter IV

MEASURES TO IMPROVE THE PERFORMANCE OF MOTOR INSURANCE IN DEVELOPING COUNTRIES

39. The generally negative results achieved by insurers in writing motor insurance can be attributed to both external and internal factors. External factors, such as accident frequency and severity, vehicle repair costs, the legal system of indemnification, etc., are typically beyond the direct control of insurers and insurance supervisory authorities. Insurers and their supervisory authorities can merely urge that measures be taken to improve the motor vehicle environment. Further, such changes often take a long time to implement. 8/ This study focuses attention on internal factors; i.e., those that are within the direct control of insurers and insurance supervisory authorities. These factors include measures related to pricing and underwriting, claim payments, expenses and investment returns.

A. Measures related to pricing and underwriting

1. The premium level

40. With some exceptions, the chief problem for insurers writing motor insurance unprofitably is the establishment by governmental authorities of inadequate premium levels. It is of the utmost importance that such authorities realize that motor insurance rates should reflect claim experience accurately (or other appropriate recognition be made). Too often this is not the case, with the result that the very objective of compulsory insurance is defeated and a country's insurance market is threatened.

41. Governmental authorities understandably do not wish to raise premium levels. Motor vehicles have become an essential part of life for many citizens. An unaffordable premium in a country that requires motor liability protection means that the person either must not operate the motor vehicle or must violate the law and operate it without purchasing the required insurance.

42. This places the government in an awkard position. If the government continues to hold motor insurance rates to unreasonably low levels, the country's insurance market is jeopardized. If the government permits rates to rise to acceptable levels, citizens who are already financially constrained are harmed.

43. Of course, each government must decide for itself how best to deal with this problem. The following observations may be of some assistance in this difficult decision-making process.

44. First, it should be determined whether, in fact, insurers are writing motor insurance unprofitably. Often documentation that purports to prove that some insurers are suffering losses in the motor branch is not conclusive. It is sometimes unclear, for example, whether proper reserving techniques have been followed. An overly liberal assessment of incurred but not reported (IBNR) and other loss reserves could mean that an insurer showed a "paper" loss whereas, in fact, profits could emerge. A conservative assumption could mean the opposite: that losses were being suffered unknowingly. Other areas are subject to similar types of error.

8/ The UNCTAD secretariat report, "Problems of developing countries in the field of motor insurance" (TD/B/C.3/176/Supp.1), provides one view of changes needed in certain external factors.

45. A careful analysis of filings for rate increases and rating categories is therefore essential. The mere fact that an insurer owns large amounts of assets (e.g., in the form of real estate, bonds, stocks, and other securities) in no way means that the insurer (a) is financially sound and (b) should play no part in decisions as to whether changes in premium levels are needed. Insurers, for their part, should undertake a detailed review of all the components of their rate increase petition to ensure that they are reasonable. Integrity and utmost fairness by both insurers and governmental authorities are a necessary ingredient. Insurers must attempt to understand more fully the position and responsibilities of governmental authorities. The authorities, in turn, must not permit short-sighted, popular decision-making to cloud seasoned judgment as to what is in the long-term best interests of the country.

46. After rendering a careful, unbiased review of results, the authorities may find that, in fact, insurers' financial results can be improved through altering internal factors other than the premium level or that only a minor increase is needed. Several minor increases over time are often more socially and politically acceptable than delaying needed increases, only to make them all at one. Alternatively, one may find all that is needed is to develop a more refined system of rating, making adjustments in some categories only.

47. On the other hand, the review may reveal that a major premium increase is justified If so, the government may conclude that the increase will, none the less, not be granted as the deficit can be recouped from other insurance lines. Such an approach may distort the market for insurance products and to shift the cost burden from one group of insureds to another via the insurance mechanism. While loss sharing is at the heart of insurance theory, class subsidy is not. This distinction should be borne in mind.

48. Experience in many countries has shown that, as a general rule, it is best for each line of insurance to be judged on its own merits. Subsidies by one line to another are best avoided. If the government determines that, for public policy reasons, a line of insurance is deserving of support, that line probably should either (a) be run by government as a social insurance scheme, drawing subsidies from general tax revenues, or (b) be provided explicit, identifiable government subsidies in the form of special tax deductions, credits, rebates or other considerations to insurers.

49. Worth noting is that motor insurance rates in some countries are not regulated at all or only indirectly controlled by regulatory authorities. For example, some states in the United States permit insurers flexibility in rate-making and classification by allowing them to charge whatever rates they wish, subject to review by the regulatory authority to ensure that rates are not inadequate, that they are equitable and that they are not excessive. The insurers may be required to document the need for a rate revision and no single, mandated tariff exists.

50. There is no inherent logic for requiring all insurers to charge the same premium if their experience and solvency would permit flexibility in this regard and if an adequate regulatory system exists to exercise oversight.

2. The rating system

51. Closely related to the review process discussed above is the problem of not having adequate statistics. An adequate rating system must be carefully formulated and necessarily relies on adequate statistics. Many insurers in developing countries have not maintained data with sufficient detail to permit anything other than gross analyses. For example, fleet discounts in many developing countries appear to be too high in relationship to claims and expenses. A closer analysis would reveal whether the discount is fair. Insurers should begin immediately to compile this and other types of information by the various parameters which are believed to be statistically relevant. From this compilation will flow not only the justification for any needed rate adjustments but also justification for a more refined rating system, which could permit supervisory authorities greater flexibility in granting any needed rate changes. For example, it may demonstrate that rate increases are justified in a few categories only (e.g., commercial vehicles).

52. Too often in developing countries drivers who, because of loss characteristics, should pay different rates, are charged the same rate. In the absence of overriding public policy considerations, a fair rating system would charge each insured a premium that is commensurate with the risk he or she presents to the group of insureds. Thus, a person who constantly drives recklessly and is involved in many accidents should pay more than another person who exercises great driving care. The compilation and analysis of data based on driving experience, at fault accident record, use and type of vehicle, location of vehicle and other factors can provide the basis upon which a more equitable system of rating is formulated.

53. Establishment of a more refined system need not involve quick, sweeping changes. Indeed, a gradual change would be preferred. Further, a balance must be struck among actuarial equity, public policy considerations and practicality.

54. In some multiple company markets, no individual company may have sufficient exposure to permit a meaningful data analysis of the type discussed in paragraphs 45-53. Thus, the combining of experience from several insurers may be desirable. Having obtained these analyses, rates for each category should be reviewed periodically to match the loss experience.

3. The sales and underwriting process

55. Clearly established guidelines and instructions to be followed in the sales and underwriting phases are essential prerequisites for any well-run company. These are essential not only for insurer employees but, importantly, for intermediaries as well.

56. In some instances insurers do not receive completed proposal (application) forms for each applicant. This failure can lead to abuses, misunderstandings and rating errors. Insurers are urged to require a fully completed form for each applicant prior to policy underwriting and issuance.

B. Measures related to loss payments

1. Claims control

57. Adequate claims control is essential. Unfortunately this is lacking in many developing countries. This is often caused by inadequately trained staff. This results in delays in claim settlement and disenchantment of victims and insureds. A good claim procedure should seek a minimum of documentary evidence consistent with

a reasonable level of care. Expert advice is often required for large claims only. If an insurer has inadequately trained in-house personnel to settle claims quickly, fairly and reasonably, the services of professional adjustment services may be sought. However, it is often to the insurer's advantage to develop fully its own claims adjustment staff.

58. Negotiation and settlement methods vary with the nature of the claim. If it is reasonably clear that one of its insureds was at fault in causing an accident, the insurer should attempt to negotiate a quick and fair settlement with the victim. Litigation should be avoided. Often the responsibility of its insured is not clear even after a reasonable investigation. In such cases, it is often less costly for the insurer to negotiate a compromise settlement than to litigate the case. Too often the investigation of claims seems to become a goal in itself, with sight being lost of the fundamental purpose of the investigation: to make a quick, fair settlement.

59. Property damage claims are settled by cash payment or by undertaking the repairs. An advantage of cash settlement is that the insurer is immediately discharged and can no longer be held responsible for hidden damages that may later be discovered. However, many insurers find it more convenient and less costly to have damaged cars repaired in accredited garages.

60. Many insurers in developing countries seem to opt for litigation even when it is unnecessary. Apparently, employees responsible for claim settlement often feel compelled to litigate so as to remove themselves from any responsibility for the claim settlement amount. In doing so, no one could hold them responsible for paying either "too much" or "too little". This results in much wasteful litigation, costing the insurance company, the victim and the courts valuable time and money.

61. However, one probably should not blame the individual employee handling the claim for this unhappy situation. Rather, the employee's attitude and actions probably are rational responses to management failings. The blame, in other words, starts at the top. Upper management sets the tone for subordinates. While a degree of conservatism in claim settlement is sound policy, it can result in massive inefficiencies when taken to an extreme. Great care should be exercised to avoid such excesses.

62. In some developing countries, an intermediary may accept a clients' premium payment, issue the government required certification (attestation) that liability insurance has been purchased but not write the policy immediately. Instead, the policy will be issued and premium forwarded to the insurer only if there is a loss. Otherwise the premium payment will be illegally kept by the intermediary.

63. Such practices can be discouraged by reasonable quality control of the certification forms. A requirement to use only insurer authorized and provided pre-printed and pre-numbered certification forms (or another equally effective control device) coupled with a register would greatly minimize the opportunities for fraud.

2. Accurate reserving

64. Another area that deserved greater attention by insurers relates to the establishment of reserves. The calculation of unearned premium reserves does not normally raise any difficulties. However, the loss reserve situation is different. It may be several years after a loss before a court decides who is liable and for how much. In these cases the insurer must estimate the amount which must be paid. This liability is represented on the insurer's balance sheet by loss reserves and must be carried forward until the claim is settled. The insurer should review such estimates from time to time, not only to reflect the development of the case, but also to recognize any changes in money values. Also, reserves can be established initially to reflect inflation and other external factors.

65. Reserves for outstanding claims discussed above represent estimated liabilities for losses that have been reported but not yet settled. Each year, however, a certain number of losses are not reported. Reserves must be established for these incurred but not reported (IBNR) losses also. In some countries the IBNR reserve is set at a fixed percentage of the outstanding loss reserve. However, the best method for estimating the yearly IBNR reserve is to undertake an analysis of previous years' IBNR losses not only to have a reasonable idea of the current year's amount but also to detect any trends. Such study should be a continuing one.

66. Every year some closed claims will, for various reasons, be reopened. When this happens, loss reserves fall short. Reserves, therefore, should be established to meet these reopened claims. Again, a trend analysis will aid in this process. Contingency reserves, catastrophic reserves and other non-technical reserves also often do not receive enough attention.

3. Coverage amounts

67. As mentioned earlier, some countries require the purchase of motor vehicle liability policies that provide for unlimited liability coverage. From a social viewpoint a requirement that policies have no maximum limit may seem desirable. However, a deeper analysis could reveal that doing so increases the propensity to sue for exaggerated amounts and forces many persons to purchase liability protection far out of proportion to their net worth or income potential. Providing "unlimited" coverage raises the cost of insurance to everyone.

68. Governments may wish to consider establishing a requirement that each motor vehicle operator must be covered by at least some stated minimum liability protection and permit the optional purchase of amounts in excess of the statutority-mandated minimum. This would lower liability premiums for the average person while permitting those who needed very high coverage limits to purchase it. This is the approach followed successfully in many developing and developed countries.

69. The required minimum should be established to bear a reasonable relationship to the country's economic and social development and should be subject to periodic revision.

70. Claim payments on both compulsory and voluntary covers can be minimized by the judicious use of deductibles. This can avoid small claim payments, which, according to good risk management, should be absorbed by the insured anyway and can also avoid expenses that are disproportionate to their importance.

71. In some countries the use of deductibles for liability coverages is not permitted or is not feasible owing to the practical difficulties of co-ordinating insurer and insured actions.

4. Uninsured motorists

72. An unfortunately large proportion of motor vehicle operators in developing countries are and will remain uninsured, even though the purchase of insurance may be mandatory. As a result many victims of traffic accidents who otherwise would be entitled to compensation from a negligent motor vehicle operator will collect little or nothing.

73. Consideration may be given to permitting (or requiring) insureds to purchase uninsured motorist coverage on an optional basis. This coverage permits the innocent victim to collect from his or her own insurer amounts which would otherwise have been collected from the (uninsured and if desired also underinsured) tort feasor's insurer or from a driver of a "hit and run" accident. Alternatively, an insurer sponsored or government sponsored fund could be established from which to pay such claims.

5. External loss factors

74. Insurers and regulatory authorities should also take an active role in loss prevention and minimization. Motor accidents are complex occurrences. They result from a combination of three factors: the environment, the vehicle and the human being. Any attempt to improve road safety must recognize these factors. This involves a vast field of measures ranging from road construction, to the establishment of standards for motor vehicle condition, to the enforcement of traffic rules and the licensing of drivers. Most of the burden for such improvements rests with the government. However, insurers have an important role here also. With government approval, insurers can rate drivers and automobiles according to the likelihood of loss. This can serve as an incentive for insureds to purchase automobiles that are the least susceptible to damage and for them to operate motor vehicles safely. Insurers can sponsor driver education and training programmes. They can bring to the attention of government officials the importance of seeking improvements in all aspects of the three factors discussed above.

C. Measures related to expenses

75. Insurers must constantly search for ways to minimize management and acquisition expenses. Of course, expense control must not be practised at the sacrifice of acceptable sales and services.

76. With respect to acquisition costs, insurers may want to examine carefully the commissions paid to intermediaries. One can argue that commission rates on compulsory business should be lower than that for voluntary lines, as the intermediary acts more as an "order taker" than a sales person in such cases. Also, commission rates should justifiably be less for group and fleet policies than for individual policies.

77. As insurers' classification systems become more refined, insurers may want to consider having a sliding commission scale. The fact that one insured is required to pay twice as much as another for basic liability coverage (because, for example, the insured has a poor driving record) does not mean that the intermediary should be entitled to twice the commission. The work the intermediary must perform in each case is much the same. Hence, the higher the premium for compulsory coverages, the lower can be the commission rate or, alternatively, consideration may be given to paying intermediaries a flat fee for writing such coverages.

78. To hold underwriting and management expenses to the minimum necessary for smooth operation, care should be taken to ensure that duplication of effort between the work of intermediaries and the home office is minimized. Internal underwriting, policy issuance, and policy renewal procedures should be subject to constant analysis. Employees should be encouraged and rewarded for making suggestions for improving operational efficiency.

79. To the extent feasible, internal specialization should be encouraged and the benefits of computerization and other modern technology should be recognized and used.

80. To minimize the number of bad debts and the expenses of premium collection, insurers should, where practical, require that the premium be collected before the policy is placed in force. Also, where feasible, insurers may want to consider the "direct bill" approach. Under this approach the insurer bills the insured directly for the premium due, and the premium is paid directly to the insurer by the insured. This not only involves a more efficient use of premium receipts for the insurer but also minimizes opportunities for mistakes and fraud by intermediaries and can involve less expense.

81. Where legal and practical, all coverage related to the motor vehicle (i.e., both compulsory and voluntary covers) should be provided within a single policy. Similarly, if an insured has more than one motor vehicle, only one policy covering the multiple exposure should be issued, again, if feasible. Further, if more than one named insured is to be covered, they should be included within a single policy only. All of these techniques save on issue expenses.

82. As regards claims expenses, many of them are directly related to the claim settlement procedure, such as the cost of assessing damages, legal fees, etc. Insurers can reduce the costs involved in the settlement of claims through a reduction of the administrative procedures involved and the prompt settlement of small claims. Also insurers could establish agreements wherein subrogation rights between them are waived for claims below an agreed upon amount. These "knock for knock" agreements can avoid costly inter-insurer disputes and litigation. Moreover, insurers can avoid litigation and speed the settlement of claims by agreeing to arbitration, particularly for minor losses. Insurers also could agree to make advance payments to victims when the question of responsibility is reasonably clear.

83. While reinsurance protection may not be as important in connection with motor vehicle insurance as with other forms of insurance, some is usually a necessity and, therefore, represents an expense to insurers. Where several small or medium size insurers operate in a market, it may be desirable to set up a pooling arrangement. Members of the pool would automatically cede business to the pool which could then purchase excess of loss cover for common account. Reinsurance costs for the pool would probably be lower than similar coverage bought separately by each company. Also, since the business is pooled, litigation between insurers would be lower.

D. Maximizing investment return

84. The financial position of insurers writing motor insurance can be enhanced if their investment returns can be increased. Of course, the necessity to invest in reasonably secure assets and to maintain a fair level of liquidity must be recognized in all investments. Even so, many insurers can improve their investment return. For example, some insurers hold too much of their assets in cash or in accounts earning little or no interest. An analysis of the insurer's cash flow needs would indicate whether more efficient use could be made of these assets by placing them in perhaps a less liquid form. Idle, excess cash is a sign of poor investment management.

85. Insurers can further increase their investible funds by establishing a procedure whereby intermediaries must post funds to the insurer on a more frequent basis, if possible daily, as premiums are received. The object should be to get premium receipts to the insurer as quickly as feasible. Direct billing also would accomplish this.

86. Once funds are received by the insurer, they should be promptly put to use. Since the motor business provides a reasonably steady stream of receipts, adequate advance investment and cash flow planning is possible to make optimum use of the funds.

87. Some portion of the assets held by the insurer must, of course, be highly liquid. However, some portion could be less so, resulting in a higher rate of return. The key to establishing this optimum balance lies in a sound analysis of past and projected cash flow needs.

88. Most developing countries have laws governing the types of securities that may be purchased for investment. Often the dual objective of these laws is to protect the solvency of insurers and to promote some government policy. These objectives may be in conflict, even to the point of possibly endangering insurers' solvency and thereby causing them to fail to meet promptly their obligations. Motor claims can take several years to settle. Most insurers contemplate that the assets standing behind loss reserves should earn sufficient interest to cope with any inflation-induced increase in the cost of claims. Thus the ability of insurers to meet their claims often depends on the adequacy of these earnings. Yet governments sometimes require insurers to invest heavily in certain securities (e.g., government bonds) whose yields are artifically depressed. This can have serious negative effects on insurers' overall financial condition and ability to meet commitments. Governments are encouraged to examine such limitations critically so that they do not place an inequitable development burden on insurers, and ultimately on policyholders.

89. Government investment restrictions should take into consideration whether the country has an organized securities market. If one does not exist, consideration might be given to liberal limits for real estate investments and for loans for residential, commercial and industrial construction.

Chapter V

CONCLUSION

90. Motor insurance is an integral part of most countries' motor vehicle accident reparations systems. Because it occupies this central position, motor insurance results are vulnerable to changes in the environment in which it operates. Thus, the recent increases in accident frequency and loss severity experienced in many developing countries have a direct and immediate negative impact on results. Moreover, insurers have been far from immune to inflation-induced increases in operating costs.

91. Insurers can probably do more themselves to improve overall results. This study has discussed ways of minimizing expenses, increasing investment yields and cash flow and holding the line - to an extent - on claim costs. It has highlighted the important role that can be played by regulatory authorities in securing and promoting adequate premium levels and equitable rating systems for compulsory insurance. This course of action can yield positive results for a country's national insurance industry (particularly when it is in the initial stages of development) as the motor insurance branch often provides the necessary underpinning for the other areas of non-life insurance. Several proposals were made in this study to develop a more equitable rating system which would permit a fairer distribution of costs among insureds and allow authorities more flexibility in granting necessary rate changes.

92. It is believed that the adoption by insurers and insurance supervisory authorities of the proposals made in this study should result in the more efficient functioning of motor vehicle insurance as practised under present insurance and liability systems. However, this study has focused only on proposals for possible changes within the insurance mechanism and has avoided recommendations for more fundamental changes which may be needed in the many external factors (e.g., tort law system) bearing on insurance results and on society. 9/

9/ See TD/B/C.3/176/Supp.1 (*op.cit.*) for a discussion of some of these issues.