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INVISIBLES: INSURANCE

The promotion of life insurance in Developing Countries

Study by the UNCTAD secretariat

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CONTENTS

Introduction and Summary

1. In 1975, at its seventh session, the Committee on Invisibles and Financing related to Trade requested the secretariat of UNCTAD to study the subject of the "Development and Expansion of Life Insurance in Developing Countries" 1/. At its ninth session in 1980, the request was made again 2/. This report is in response to these requests 3/.

2. Life insurance can serve the interests of developing countries in numerous ways. Individual citizens who purchase life insurance policies provide their families with a measure of protection against the adverse financial consequences of premature death. This can provide individuals with a greater sense of security and can help minimize worry and distress both prior to and after the death of a family breadwinner. Life insurance can also serve as a vehicle through which individuals can save money for emergencies and for retirement.

3. Besides the benefits that accrue directly to individuals and their families, a strong life insurance market can aid development by:

(a) contributing to social stability by permitting individuals to minimize financial stress and worry;

(b) reducing the financial burden on the State of caring for the aged and for those made financially destitute because of the death of a family breadwinner; and

(c) mobilizing domestic savings and serving as a source of development funds.

4. Even so, conditions within each country must be such as to favor this growth. An inadequate infrastructure renders the best of development plans difficult to implement. Demand for life insurance must be sufficient to support its continued growth. Unfortunately, conditions in some countries are such that, at the present time, life insurance cannot add much to the economic security of the people.

5. Even when favorable conditions exist, the support of government in the promotion of life insurance is essential. A fair and reasonable government supervisory system is necessary for the protection of the public.

1/ TD/B/590, TD/B/C.3/133, para. 157.

2/ TD/B/833, TD/B/C.3/174, Resolution 19 (IX), para. 7.

3/ The secretariat gratefully acknowledges the contributions of Dr. A.R.B. Amerasinghe of Sri Lanka, Mr. P.I. Majmudar of Kenya, Mr. A.F.M. Safiyyullah of Bangladesh, Mr. C.M. Stewart of the United Kingdom and the Insurance Development Bureau.

6. Government's role as regulator of the insurance industry involves:

(a) assuring that life insurance is available to those who desire and can afford the coverage. This concerns the form, organization and licensing of insurers. The types of products and systems used to market life insurance products are important considerations also;

(b) minimizing the chances of insurer insolvencies. To accomplish this role, supervisory authorities must take an active interest in reviewing the financial condition of insurers;

(c) assuning that policyholders are accorded fair treatment by insurers. Fair treatment includes not just interest in the quality and fairness of products and their pricing but also the sales and claims practices followed by insurers.

(d) encouraging the industry to regulate itself.

7. Government policy regarding business to be written, capital requirements, and the taxation of consumers and companies related to premiums, benefits and investments is particularly important. A complete framework of supervision may not exist in some developing countries. It is essential that supervisory laws and systems be developed on the basis of the needs and conditions of the particular country rather than those which may exist in developed countries.

Chapter I

THE SOCIAL AND ECONOMIC ROLE OF LIFE INSURANCE IN DEVELOPING COUNTRIES

8. The growth of the life insurance business is inextricably interwoven with economic development. Economic development usually brings about increased personal savings and need to ensure a stable personal income.

9. The presence of these two factors are key aspects of the demand for life insurance. In turn, growth of the life insurance industry can add momentum to economic development, which explains the interest of many developing countries in developing a strong and efficient life insurance market. Some of the economic benefits expected therefrom are:

(a) Through the accumulation from thousands of policyholders of small amounts of private savings, life insurers can accumulate sums to be invested in the public and private sectors. This can benefit an economy by creating a source of financing for new businesses, for new homeowners and for farmers and their equipment 4/.

(b) The life insurance business generates employment. Not only must insurers hire staff and sales personnel, but they also foster employment in related fields such as banking, accounting,and legal, actuarial and health care.

c) Life insurance can permit more favorable credit terms to borrowers - both individuals and businesses - and can decrease the risk of default. Life insurance benefits can also minimize the financial disruption to business caused by the death of key employees and owners.

4/ For example, in the United States, domestic life insurers supplied $34.5 billion out of a total of $419.0 billion of new funds to the United States money and capital markets in 1980. At year end 1980, United States life insurers held assets totaling $479 billion. These assets were invested as follows:

Corporate bonds	$180	billion
Private mortgages	131	"
Corporate stocks	47	"
Policy loans	41	"
Govt. securities	33	"
Real Estate	15	"
Miscellaneous	32	".
Total	$479	Billion

Interestingly, at the end of World War II, United States life insurers' investment in government securities stood at slightly over 50 per cent (in contrast to slightly under 7 per cent today) of all their assets; thus reflecting how insurers can be a source of financing to government in time of need. Life Insurance Fact Book (Washington, D.C.: American Council of Life Insurance, 1981), pp. 69-70.

d) The life insurance business can be a source of revenue to governments through taxation and licensing fees. Also, by offering insurance services locally, foreign exchange is conserved. Moreover, life insurance benefits reduce the burden on governments and taxpayers in supporting the aged and the unfortunate.

10. At the individual level, life insurance can serve the interests of the people and businesses of developing countries in numerous ways:

a) Individual citizens who purchase life insurance policies provide their families and themselves with a measure of protection against the adverse financial consequences of premature death. Life insurance stimulates thrift and self sacrifice. It can be the vehicle through which individuals accumulate savings.

b) By carefully restricting the admission to membership and by requiring answers to questions relating to health and character, life insurers help direct individuals' attention to the benefits of good health and temperate living habits. Also, physical ailments are frequently discovered as a result of physical examinations applicants are sometimes required to undergo 5/.

c) By making available a variety of employee benefit plans - including group life insurance and retirement plans - life insurance companies can promote better employee/employer relations and can provide low cost benefits to a broad spectrum of persons who may otherwise have been unable to obtain such protection.

11. Because of the foregoing reasons, the expansion and development of life insurance have been actively encouraged in many countries. Even so, some governments, for ideological or religious reasons, regard life insurance as irrelevant or inappropriate. Others may conclude that, while life insurance is important, their human and financial resources are, for now, best used in other areas.

5/ S.S. Huebner and Kenneth Black, Jr., Life Insurance (10th ed., Englewood Cliffs, New Jersey, United States: Prentice-Hall, Inc., 1982), pp.38-39.

Chapter II

CONDITIONS FAVORING THE GROWTH OF LIFE INSURANCE

12. For life insurance to achieve much importance as an economic security device in a country, certain conditions must point favorably in that direction. First, a country's infrastructure must be sufficiently developed to permit essential transactions to take place without undue difficulty. Second, sufficient demand must exist within a country to sustain the orderly growth of the business. Third, institutions and companies must be present to provide suitable policies to meet the demand. Fourth, an environment favorable to the development of life insurance must exist. Each of these is discussed below.

Adequate infrastructure

13. The extent to which life insurance can be successfully promoted in a country is a function of the stage of development of the country's infrastructure. An inadequate infrastructure - i.e., inadequate communication, transportation, health care, legal and education systems - hinders life insurance development.

14. Poor road conditions, limited postal and telephone facilities, an inadequate number of motor vehicles, and a wide dispersion of populated centres can impede communications and transportation. Widespread illiteracy causes further difficulties.

15. Health care facilities must be sufficient in terms of both quality and quantity An insufficient number of health care providers and facilities can make the medical examination required for some plans of life insurance difficult. Furthermore, if physicians must work under pressure, their reports can be unreliable. The lack of sufficient medical staff and facilities coupled with the problems of malnutrition also can mean that mortality is likely, or assumed by insurers, to be high. This in turn increases rates.

16. Life insurance, like all insurances, flourishes best within a society in which legal relationships are well organized, known to all, and fairly enforced. An impartial, honorable system of justice is essential.

Sufficient demand

17. The demand within a country for life insurance must be sufficiently large if the growth of the life insurance business is to be meaningful. Certain factors inhibit this demand while others foster demand. Generalizations in these areas should be recognized as hazardous as most developing countries exhibit inhibiting factors along with many positive factors.

1. Factors inhibiting demand

18. Many developing countries have large populations and, therefore, sufficient numbers of potential insureds, per se, does not pose a barrier to future growth. Some countries, however, have relatively small populations and size itself may inhibit demand.

19. Even with a sufficient population, one must accept that not everyone is a candidate for life insurance. The most likely potential candidates are those who: (a) need and desire coverage; (b) have the financial capacity to pay the premium; and (c) are insurable. From the potential buyers' perspective the insurance sector should also enjoy a reputation for solvency and for providing insurance on fair terms.

20. Many persons in developing countries have a need for and desire to secure life insurance protection. Others, however, may not desire coverage or the need for it may be lacking. For example, for many persons in developing countries their security is provided through their extended families.

21. Premium affordability may pose a problem for many who desire life insurance. Generally to pay premiums the proposed insured must be employed on a regular basis and earn enough to have a disposable income from which to purchase life insurance. But many individuals in developing countries are unemployed or underemployed.

22. An insurer, prior to the issuance of an individual life insurance policy, will determine the insurability status - including the health status - of the proposed. The rigors of life in many developing countries mean that many persons are uninsurable or insurable only at substantial rate. Even if a given individual appears to be in good health, mortality experience or borrowed mortality tables may suggest the imposition of high, unaffordable premiums. Of course, when one is considering group life insurance, the question of establishing insurability becomes less of an obstacle.

2. <u>Circumstances that foster demand</u>

23. Many factors can inhibit the demand for life insurance. Worth noting, however, is that inhibiting factors exist to varying degrees in all countries. While these factors <u>inhibit</u> demand, it is rare for them completely to suppress all demand. The challenge, of course, is constantly to work to improve conditions which foster demand and, at the same time, to work creatively within existing constraints.

24. While developing countries have an abundant share of factors inhibiting demand, it is also true that there exists many circumstances that foster demand. Many persons need life insurance, especially given the typically low levels of security afforded by national assistance schemes. Many can afford to pay a life insurance premium; although it often may be modest in size.

25. Most circumstances that foster demand exist in communities that have fairly well-developed manufacturing and service industries. In such communities, life insurance is usually purchased as a proxy for the economic security that otherwise would have been provided by one's extended family. Generally, coverage is purchased for family or personal purposes, although some is bought for business purposes.

26. The centres of economic production in such communities are the factory and the office. Families cannot work as units. The wages of fragmenting families often entail anxiety caused by the possible financial hardships of dying too soon or living too long; for others, including relatives, often cannot be depended upon for support. Each family must look after itself 6/.

27. Those who cannot make appropriate financial arrangements to meet the contingency of premature death or to provide for old age run the risk of destitution. A widow left to carry on alone often loses control of her children because she lacks the financial means for keeping the family together, or worry and overwork lead to poor health and result in inadequate care and attention for the children. The children may be forced to abandon or neglect their scholastic work to contribute to family income.

6/ Efforts of some developing countries to restrict mobility and to encourage three-generation households respond also to the necessity to pool financial resources and thus to make available services that life insurance provides on a larger scale and on a commercial basis.

28. While the primary purpose of life insurance is to protect the family against the financial consequences of the death of the family's income producer, it is clear that business enterprises likewise may have need of protection against the loss of the valuable lives that give them vitality and success. Life insurance can serve the business community in a variety of ways, such as indemnification to the business if a particularly valuable employee dies. Life insurance owned by a business can enhance its creditworthiness. And life insurance-funded business continuation agreements are popular means by which the smooth transition of business ownership can be assured following the death of the owner(s).

29. Life insurance and life insurance companies can also play a vital role in the lives of rank and file employees. Persons working in manufacturing and service industries, on leaving their extended families, forgo the financial security inherent in them. The lack of self-discipline, inadequacy of income or poor health may make it difficult or impossible for individual employees to provide personally for the security of themselves and their nuclear families.

30. Businesses, therefore, often provide benefit plans for their employees, out of competitive necessity or out a sense of social responsibility. Such group arrangements are usually less costly than individual plans since expenses of underwriting and administration are lower. Individual underwriting typically is not involved and this too reduces costs. This also means that persons who might otherwise be uninsurable at reasonable rates can be protected.

31. Employee benefit plans include group hospital and surgical expense coverage, profit sharing plans, retirement plans, disability income coverage, group life insurance coverage and other forms of non-salary benefits to employees. Given the scope of this study, further discussion on employee benefit plans will be limited to group life insurance, although one should be aware that life insurance companies often offer several other forms of employee benefit plans.

Adequate supply of life insurance services

32. Life insurance policies are sold by life insurance companies through various marketing systems. Together these three components - companies, policies and marketing systems - can be considered as constituting the "supply" side of life insurance services. Each is necessary.

33. Two major elements are required for the establishment and functioning of a life insurance company: (a) an acceptable level of capital and surplus and (b) adequate, trained personnel. Paragraphs 68 to 70 discuss the first point. On this last point, a study by the UNCTAD secretariat highlighted the need and importance of human resources in the context of insurance markets in developing countries 7/.

34. Adjustment of the insurance product to the needs and requirements of developing countries calls for a well established and dynamic insurance sector and for a constant search for new types of covers that accord with needs and circumstances. The following paragraphs are intended to include information on existing covers. They do not provide an exhaustive review of all possible programmes nor do they necessarily fit the situations of all developing countries.

7/ Insurance Education for Developing Countries (Bryn Mawr, Pennsylvania, United States: McCahan Foundation, 1976) (published for UNCTAD).

35. Most persons own life insurance to pay the costs associated with dying (medical and funeral expenses), to provide income for dependants, to pay debts, or to provide funds for emergencies or old age. Functionally, there are four basic types of individually-issued insurance policies which meet these needs - term, whole life, endowment and annuity policies. Annuity policies are, strictly speaking, a reverse application of the life insurance principle: payments cease when the insured dies, and they are concerned with estate liquidation rather than estate creation.

36. Individually issued life insurance policies are often further classified as to whether they are participating or non-participating. Participating policies provide that part of any surplus funds generated by the policies will be distributed among the policies in the form of dividends or bonuses. A non-participating policy is one in which the insurer does not distribute to policyholders any part of its surplus. Premiums for non-participating policies are usually lower than for comparable participating policies 8/.

37. Insurance companies issue a wide variety of policies based on these forms. Group life insurance may also be considered an alternative for some persons. Each of these types of products must be "delivered"; i.e., marketed to the public. Several different systems for doing so exist.

38. Industrial life insurance is sometimes promoted as being particularly suitable for developing countries. Industrial life insurance policies are usually defined by law to be those with small face amounts and with premiums generally paid weekly or monthly to an agent who calls at the policyholder's home or place of employment. These policies usually have provisions that are more restrictive than those found in so-called ordinary insurance policies and, because of high mortality and expenses, they are more costly per unit of insurance.

39. Industrial life insurance has been the subject of controvers in some developed as well as developing countries 9/. Marketing abuses are said to be associated with this type of life insurance. Its cost is said to be too high and some have questioned the present day need for a separate life insurance classification simply because the policy face amount is small and premiums are collected at one's home. For example, in recent years, many insurers have continued to collect premiums at the policyholder's home but have begun, where the law permits, to issue ordinary policies instead of industrial policies.

8/ The usefulness of the traditional participating/non-participating distinction has been questioned by some as the distinctions between the two forms has blurred in some countries. See, for example, the report of the Virginia Bureau of Insurance, Life Insurance Products, Disclosure, and Marketing Practices (Richmond, Virginia, 1981), pp. 35-40.

9/ See Sandra T.W. Davis, "The Insurance Industry in Kenya" Best's Review (Sept. 1981) and Hearings on Industrial Insurance before the United States Senate Judiciary Antitrust Subcommittee, March 1979.

40. The system of collecting premiums at the policyholder's home or place of employment is referred to as the "home service" or "debit system". It can be viewed as being distinct from industrial life insurance, although some problems are alledged to exist with this method of marketing.

41. While one may question the wisdom of and need for a separate "industrial" life insurance classification, the debit system should not be excluded as a marketing system if (1) one recognizes that home service will normally be more costly than many other methods of premium payment, (2) government finds the additional cost not to be too high in relation to benefits provided, and (3) it is believed that any abuses will be minimal or can be controlled.

42. In considering life insurance products and marketing systems for developing countries, the advantages and disadvantages of group life insurance and individual contract life insurance systems should be examined. Advantages of group life insurance include:

(a) Low cost;

(b) Relatively simple and liberal qualification standards for coverage for members of the group;

(c) High efficiency of coverage: i.e., the ratio of paid benefits to administrative expenses should be relatively high;

(d) Coverage and standardized benefits are simple and easy to understand; and

(e) Easy payment systems such as payroll deduction or premium payment by group sponsor; e.g., employer.

43. From the life insurer's point of view, group life programmes are relatively easy to underwrite and inexpensive to administer. No large sales force is necessary, and fewer employees are required to manage the system.

44. Potential disadvantages of group coverages to the institution are mostly financial. Profit margins and necessary reserves are usually low, limiting the potential growth of assets and availability of surplus funds for investment. Also, the group mechanism requires the existence of some central co-ordinating unit (e.g., an employer) 10/.

45. The advantages of individual life insurance programmes to insureds include greater options in amounts of coverage, automatic contractual linkage of savings with insurance protection, and guaranteed long-term insurance coverage. Disadvantages include typically higher premiums per insured sum and less efficient coverage.

46. The advantage of individual life contracts to the life insurance institution is greater potential cash flow for investment, resulting in asset and surplus accumulation. Since long-term individual contracts are believed to be more difficult to sell, a sizable sales force usually is considered necessary.

10/ Group life insurance also can be arranged through a creditor. For example, farmers could purchase life insurance from their bank or other creditor on a group basis to cover their debts.

47. In addition to the above marketing systems, consideration should also be given to the so-called "salary savings" method of purchasing insurance. This approach has characteristics of both group and individual insurance. Specially tailored individual policies are purchased voluntarily by employees or members of an association or other common group. The prospective insureds usually determine how much they would like to spend for the insurance each pay period. Usually they select from a set of predetermined amounts. The insurance policy face amount is a function of the person's age and the amount of periodic payment selected. Amounts purchased are usually modest.

48. The employer or other co-ordinating organization is authorized by the individual to withhold the amounts from the person's pay and send the total of all such withholdings to the insurance company. Underwriting requirements usually are less rigid for this type of insurance than individual policies and some cost reduction should be realized because of lower administrative expenses.

49. The final marketing method to be discussed in this study is the direct response method, under which insurance is sold directly to consumers without involvement of any intermediary. This system may use the mail, the newspaper or other "direct" methods. Amounts purchased are usually small and underwriting is streamlined. The extent to which this method could be successfully used in many developing countries is questionable at this time, given the level of insurance awareness and the lack of infrastructure elements in some developing countries. In other developing countries, it can be an effective method for marketing policies of modest amounts, although adequate advertising safeguards are probably necessary 11/.

50. Whatever mechanism is used to market insurance products, of special concern, in many countries, is the problem of product design in an inflationary era. In the face of persistent inflation individuals find it increasingly difficult to plan and to organize their financial affairs to provide adequately for the future. As a vehicle for savings and for providing a constant level of (real) protection in such times, many traditional insurance policies may be inappropriate.

51. In response to consumer demands, the life insurance industry has in certain countries developed a variety of products that guarantee minimum death benefits and the potential for insurance benefits to increase with inflation. Index-linked, equity-linked, and "new money" products, such as universal life, are examples. They provide a means by which policy values can increase with inflation.

52. Also, many consumers are shifting to term life insurance products in an effort to avoid some of the erosion in savings inherent in many traditional cash values policies. Developing countries are encouraged to place more emphasis on the marketing of term life insurance.

11/ For a more thorough presentation of this system, see Gerald F. Beavan and Colon S. Braybrooks, "The Sale of Insurance Through the Mail", The Journal of the American Society of Chartered Life Underwriters, Vol. XXXVI (April 1982).

For up-to-date discriptions of these and other marketing systems, see Nancy Strickler, ed., Marketing Life and Health Insurance (Atlanta, Georgia, United States: Life Office Management Association, 1981).

Favorable environment

53. For life insurance to achieve much importance as an economic security device in developing countries, there must also exist an environment conducive to its growth. A favorable environment involves the people of a country having an insurance awareness and involves a positive or at least not hostile attitude by government towards life insurance.

54. Many persons in developing countries simply are not aware of the potential advantages of insurance in general or of life insurance in particular. It can be anticipated, however, that this situation will change automatically with increasing development and as insurers engage in advertising and other techniques to promote awareness.

55. The attitude and policies adopted by government towards the promotion and role of life insurance in the country can be crucial to its success. For example, a country's tax laws can have an impact on the desirability of purchasing life insurance.

56. Besides having a favorable tax law as relates to life insurance buyers,the tax law as relates to the sellers (the insurers) can be important. Laws in many countries do not tax life insurers in the same way as other commercial ventures, on the theory that life insurance companies perform a worthwhile social function and that the bulk of the assets of the typical insurer actually belongs to the policyholders. As a result, taxation of life insurers attempts to recognize these differences.

Chapter III

REGULATION OF LIFE INSURANCE COMPANY FORMATION

57. Because of the vitally important role it plays, the life insurance business is generally regarded as one affected with a public interest. Governments, therefore, have been anxious to ensure not only that the industry exists and grows but that it does so in a healthy and orderly manner and that policyholders are protected.

58. Government's role sometimes extends to co-ordinating insurer investment activities with governmentally determined economic policies. Also, minimizing the outflow of foreign exchange may be of concern to authorities as might be suggesting or implementing certain measures to concentrate the domestic insurance market through temporary protective measures.

59. Besides any possible role affecting the structure of the market, government's areas of insurance supervision may extend to assuring availability, minimizing insurer insolvencies, and minimizing unfair treatment of policyholders. Numerous aspects of these subjects have been dealt with in previous UNCTAD studies, so their discussion here and in the next two chapters will be limited 12/.

60. Decisions about the preferred types of insurance suppliers may be based on political or other grounds and be subject, as the experience of some countries shows, to changes with time and circumstances. In some countries, competition is encouraged. This course is said to make for a more efficient marketplace. In others the business is restricted to one or a few companies. This course is said to secure a better utilization of insurance resources.

61. Only authorized insurers should be permitted to transact business. Neither the economy nor policyholders can be effectively protected against the activities of unauthorized insurers.

62. Complete freedom of entry of new concerns is not desirable because of the fiduciary nature of the policyholder/insurer relationship and the resulting opportunities for fraud and financial speculation by unregulated promoters. The life insurance business should not be undertaken by an individual or partnership. The form of the organization should be one that will provide permanence. The form taken by private insurers may be stock, mutual, cooperative or any other type permitted by the laws of the country concerned.

63. The question is sometimes asked whether mutual companies should be preferred to stock companies. Mutual companies are organized and owned by policyholders, whereas stock companies are organized to make profits for their stockholders. The debate revolves on control and cost. In practice, effective control is generally in the hands not of policyholders or stockholders but of management. As for cost to policyholders, this largely depends on the efficiency with which the company is run and the types of policies issued. The form of the insurer may have little to do with the costliness of its products. Low cost may reflect good management, poor service or a restrictive contract.

12/ *Ibid.*, and Part II; Report by the UNCTAD secretariat, Establishment of a Unified International System of Insurance Statistics, (TD/B/C.3/85) United Nations publication, Sales No. E.72.II.D.9.

64. Co-operatives may also be an appropriate vehicle for selling life insurance, as a previous UNCTAD study discussed 13/. They have been successfully used in both developed and developing countries throughout the world and are said to offer special advantages to developing countries 14/.

65. Depending upon the form of insurer (State-sponsored, private or mixed), the formation of an insurance company may be governed largely by the law applying to the organization of corporations in general. This law, however, is usually insufficient in itself and government should supplement this general law with specific requirements for the organization of insurers.

66. Supervisory authorities should satisfy themselves that individuals concerned with the formation of an insurance company are of high moral and ethical character and are competent.

67. A company may be restricted to write only life insurance or only life and health insurance or it may be permitted to write all lines of insurance depending on local conditions and requirements. In some countries, an insurer is constrained from writing more than one line of insurance. In others, they are permitted to write all lines although assets are usually required to be segregated by line.

68. One of the most important factors that can influence the organization of life insurers is capital requirements. High capital requirements serve as a barrier to the formation of new insurers. Thus, if government desires to encourage the organization of new life insurers, or to restrict the number of existing companies, the capital requirement becomes an important determinant 15/. On the other hand, capital requirements are necessary to preserve the solvency and solidity of the insurance enterprise.

69. The minimum capital and surplus that a new insurer should possess must be distinguished from that which should be maintained for an established company. Initial capital provides security to policyholders when an adequate spread of risk has not been obtained and the initial surplus provides for the necessarily high "start up" expenses. It is important that supervisory authorities recognize the distinction since a new company can quickly deplete its paid in surplus on organizational and administrative expenses before a sufficient premium volume is written.

70. In general the more lines an insurer is permitted to write, the greater should be the initial capital and surplus.

13/ Study for the UNCTAD secretariat, Co-operative Insurance: A Suitable Form of Insurance for Developing Countries, TD/B/C.3/138.

14/ *Ibid*., paras. 59-103.

15/ See the UNCTAD report Insurance Legislation and Supervision in Developing Countries, United Nations publication, Sales No. 72.II.D.4 Paras. 29 to 31 deal with the financial requirements in respect to share capital of insurance concerns. See also Reinsurance Problems in Developing Countries, United Nations publication, Sales No. 74.II.D.2 (TD/B/C.3/106 and Corr.1 and Rev.1). Chapter II (2nd part) deals with the impact of share capital requirements as a means to concentrate the market and reduce reinsurance costs.

71. All companies doing business in the country should be required to obtain a license. The requirements for licensing domestic companies may be identical with those for their formation. If foreign insurers are permitted to write in the domestic market, the requirements for their licensing could be similar to those for domestic insurers, or they could be more stringent.

72. Problems exist if private insurers are unwilling to sell life insurance to local persons or are only prepared to do so on an accommodation basis. Such business is usually placed outside the country and, of course, neither the domestic insurance market nor the economy fully benefit. On the contrary, the premium outflow can have detrimental effects on both the economy and the insurance market. In such a situation the government should consider establishing its own institution to provide the required services.

73. The first step by government in this direction should be a feasibility study. Should the government expend its resources in this manner or could they be more effectively used elsewhere? Will market conditions support an insurer? Careful consideration needs to be given to the structure of any proposed organization, the policies of government and the prevailing circumstances, including the quality of local expertise.

Chapter IV

SOLVENCY REGULATION

74. Financial stability is the foundation of public confidence in the life insurance industry. It has been historically the primary objective of regulation. Regulatory authorities are interested in solvency for the following, among other, reasons:

(a) Insurer bankruptcy could result in failure to satisfy policyholder contractual obligations.

(b) In a market with few insurers, the choice of consumers will be limited by the disappearance of a competitor. Insurance availability is a key to consumer satisfaction.

(c) As major sources of development finance, survival of insurers is vital to the government and the economy.

(d) Insurer failure, by shaking the confidence of consumers, adversely affects the industry by hindering the sale of new policies and triggering the surrender and lapsation of existing policies.

75. Insurer formation requirements can help insurers avoid solvency problems. However, more is necessary. First, the ongoing financial condition of insurers should be of concern to regulators. Second, insurers should avoid undue underwriting risk through appropriate use of reinsurance. Each area is discussed below.

Financial condition

76. Specific provisions to ensure the viability of insurers vary from one country to another but they often include the power to (a) license only insurers meeting prescribed minimum financial requirements; (b) revoke licenses; (c) rehabilitate or liquidate companies; (d) examine insurers; (e) require scientific and regular valuation of liabilities and assets; (f) approve classes of investments; (g) require adequate rates; (h) require frequent filing of financial statements; (i) require adequate reinsurance protection; and (j) regulate expenditure.

77. Life insurer troubles are often related to investment problems. Qualitative and quantitative restrictions should be enforced. This can ensure that optimum use is made of funds and also can help balance the investment portfolio. Insurer investments should take account of (a) security, (b) liquidity and (c) income [16/]. Of these three factors, security is the most important. Life insurance funds often constitute the only savings of policyholders, and assets representing reserves must be adequate for the future fulfilment of obligations.

78. Liquidity and income usually need only attain a good average level, as their need in extreme form seldom arises. Adequate investment income is important because an assumed rate of return is built into the calculation of premiums and reserves. The payment of dividends and excess interest

16/ UNCTAD recommended that adequate conditions of security, liquidity and inco me must be assured. (Trade and Development Final Act E/Conf. 46/141, Vol.1 , United Nations Publication, Sales No. 64.II.B.11), p.55, Annex A.IV.23. This was recalled by UNCTAD at its Santiago de Chile meeting in 1972 in its resolution 42 (III) on Insurance and Reinsurance.

depends on the investment return. Also, life insurance policies that contain a savings element need to be competitive with other savings media. Yet the temptation to seek high yields through hazardous investments must be resisted.

79. Investments should, if feasible, be made in the country which provides the premiums. UNCTAD, at its first meeting in Geneva in 1964, recommended that "technical reserves and guarantee deposits of insurance and reinsurance companies or institutions should be invested where the premium income arises"17/.

80. Since life insurance growth is closely related to socio-economic development, out of sensible self-interest, insurers that wish to increase their business should invest funds into the economy. In addition, policyholders may enjoy greater protection from local investments because they may be easier to evaluate and it avoids transfer problems. This, of course, is subject to, "taking into account all the relevant characteristics and technical requirements of the risks involved and the kind of insurance and reinsurance cover provided as well as the criteria of security, liquidity and income" 18/.

81. A practical problem for many developing countries is the absence of an organized investment market. This limits local investment opportunities. Supervision over investments should, therefore, reflect this condition by being relatively flexible.

82. Some governments have required insurers to invest in government securities or particular sectors of the economy; e.g., housing. Such requirements, if the resulting rates of return are artificially depressed, could mean that the insurer's overall investment return may be substantially lower than that which it might have been otherwise or perhaps lower than the rate of inflation. These would result in a higher cost of insurance and in policyholders subsidizing other sectors of the economy. In the extreme, this could threaten the financial condition of the insurer or, as more often happens, it renders life insurance less attractive to prospective purchasers and thereby hinders its growth.

83. Finally, regulators should be concerned about how insurers arrive at the amounts shown as liabilities. Typically the largest and most important liability item will be policy reserves. Policy reserves represent the amounts that, together with future premiums, will be sufficient to pay future claims of policyholders 19/.

84. The process of determining policy reserves is somewhat complicated, involving assumptions as to future interest, mortality, and sometimes expenses. These assumptions must be applied to actuarial formulae each year to derive the necessary liability amounts. If the assumptions are too liberal then insurer solvency may be endangered.

17/ Trade and Development, Final Act and Report, vol.1, 1964, Annex A.IV.23, recommendation 3(a) (E/Conf.46/141, vol.1, United Nations publication, Sales No.64.II.B.11) and recalled in Conference resolution 42 (III) on Insurance and Reinsurance at the third session in 1972.

18/ UNCTAD, third session, 1972, vol.1, Conference resolution 42(III).

19/ To be technically correct the above formulation would include not only future premiums but also interest earned on assets and an element known as the benefit of survivorship. See, for example, Huebner and Black, op. cit. ,chap.25 for a verbal description of many of the technical aspects of reserve computation.

85. Misunderstanding often surrounds reserve computation and the need for insurers to maintain what may appear to be substantial assets to cover these reserves. Part of this misunderstanding may stem from the word, "reserve". In ordinary business, a reserve is often synonymous with "excess funds" or "surplus". This is not the situation with respect to life insurers. The policy reserve is a technical measure of the insurer's obligation to its policyholders.

86. Thus, it is important that regulators understand and help others to understand the importance and role of policy reserves. Regulators also should assure themselves that reserves do not involve unreasonable assumptions. In some countries, the most liberal permissible assumptions and the methodology to be used to derive reserves are established by law. Such an approach warrants consideration by developing countries.

The role of reinsurance

87. The role of reinsurance in connection with the life insurance business is important, although less so than in non-life insurance. The UNCTAD secretariat study, Reinsurance Problems in Developing Countries, reflected the interest of developing countries in optimal reinsurance planning [20]. Adequate reinsurance is necessary to avoid potentially ruinous loss fluctuations. However, it is a major expense item. Thus, its use should be appropriately limited. These two conflicting goals - preventing excessive losses yet minimizing costs - are discussed generally in that study.

88. To obtain adequate reinsurance cover at a low cost, a company must be able to assess its reinsurance needs correctly and to seek the right type of cover, both in quantitative and in qualitative terms. This "reinsurance planning" is of major importance to every insurance company. Unfortunately, in many developing countries the domestic insurance companies are not very successful in their reinsurance planning.

20/ United Nations publication, Sales No.E.74.II.D.2 (TD/B/C.3/106 and Corr.1).

Chapter V

ENSURING FAIR TREATMENT OF POLICYHOLDERS

89. Insurance regulatory authorities in many countries are also charged with the responsibility to see to it that insurance consumers are not treated unfairly in their dealing with life insurance companies and that they have a right of access to sufficient information to make informed decisions. The methods through which this objective can be promoted are many. Four are discussed below: (a) rate regulation, (b) surplus distribution requirements, (c) product regulation, and (d) trade practice regulation.

Rate regulation

90. In some countries rates must be approved by the supervisory authority. This is the technique through which they ensure that rates are adequate, not excessive and not unfairly discriminatory (so that one class of policyholders does not subsidize another). In other countries, the supervisory authority takes no direct action with respect to the rates life insurers charge, instead relying upon management reasonableness and marketplace competitiveness. This latter approach may be supplemented through requirements that insurers must maintain certain "deficiency reserves" if the rates changed are below statutorily established minimums. Governments should follow the approach consistent with domestic conditions.

91. Life insurance rate calculation involves estimates as to future interest rates, mortality, expenses, and lapse rates. Since many life insurance policies are long term, the interest rate assumed to be earned in the future must be one that the insurer is reasonably confident of earning for many years. This suggests the appropriateness of a conservative assumption. Alternatively, contemporary rates of return may be used if the policy premium or values can be changed as future conditions warrant. Since the higher the interest assumption, the lower the premium, pressure exists to assume relatively high interest rates to make insurance more affordable. This can be illusory, however. Insurers and regulators must not be unduly influenced by prevailing high interest rates.

92. The loading component, which includes expenses, must contain margins for future increases in costs or provision must be made to cover such increases through the surplus distribution formula or other means. Naturally, the higher the expense assumption the higher must be the premium.

93. Every effort should be made to minimize expenses. Extravangance not only increases the cost of insurance, but can endanger the viability of the insurer. The mere existence of a large pool of funds can sometimes encourage extravagances. Some countries have laws limiting the amounts that life insurance companies may spend on expenses.

94. The introduction of computers and other new technology to hold costs down is sometimes resisted on the grounds that they will exacerbate unemployment and underemployment. Others, however, argue that greater efficiencies will result in better service and that cost reductions would make life insurance more affordable and attract capital which would generate employment.

95. Another method of minimizing cost increases is to reduce reliance on physical examinations as a basis for establishing good health. Such exams are expensive to insurers, involve much time for applicants, and often are difficult to arrange. Thus, insurers may benefit by increasing their use of

the non-medical method of underwriting, wherein no physical examination is required. Rather the agent makes formal health inquiries directly of the applicant. Mortality experience is somewhat higher for insurers but, within appropriate limits, the lower expenses more than make up for the difference.

96. Assumptions must also be made as to future mortality experience. The higher the assumed mortality, the higher must be the premium. Again, some conservatism should prevail here. However, as with interest and expenses, some method should exist to monitor actual mortality to be able to take appropriate action in the event of deviation.

97. Most developing countries do not have their own mortality tables and depend on tables borrowed from developed countries. Arbitrary adjustments, to take account of local conditions, are usually made. Domestic insurers may not monitor their own mortality with the result that premium rates are rarely revised. Steps should be taken to collect data on a systematic basis with a view to developing more realistic insured lives mortality tables based on the actual experience of one or a group of similar developing countries which do not yet have their own tables.

98. Finally, realistic lapse (voluntary policy termination) assumptions are necessary. High lapse rates mean higher costs. And higher costs mean that the insurance is more likely to be replaced by lower cost policies. In other words, a vicious circle can be created where high costs mean more policy terminations and more terminations must mean higher costs. Low lapse rates result when policies are sold to cover specific, well understood needs and the mode and amount of payment are suited to the policyholder's circumstances. Policies exhibiting low lapse rates exhibit good mortality and generate surplus. Also lower lapse rates produce more agents' commissions, especially if commissions are not excessively heaped at policy inception. Good persistency therefore is an important factor in the process of the life insurance business.

Surplus distribution requirements

99. The use of conservative assumptions for premium computation is not of grave concern with respect to participating and other non-guaranteed element policies. As actual results materialize, adjustments can be made within the policy to render its cost reasonable. This option does not exist with policies whose every element is fixed at time of issue and not subject to future adjustment. Of course, regardless of policy type, if assumptions are too optimistic, the insurer could be inviting financial trouble.

100. Consideration should be given to the need to ensure that the aggregate amount of surplus funds accumulated on behalf of a block of non-guaranteed policies is distributed reasonably. This involves two areas. First, supervisory authorities should be satisfied that the total distributable funds represent an amount that is not so great as to endanger the future solvency of the company. On the other hand, authorities should also be concerned if the amount is unfairly small, thus depriving policyholders of a meaningful right to share in the insurer's good experience.

101. Consideration may be given to requiring stock companies issuing participating policies to limit the extent to which the stockholders benefit from the participating business, as is done in Sweden, in Australia, some states in the United States, and in the United Kingdom. Some countries also place limits on the amount of surplus a mutual insurer may accumulate.

102. The second area of concern is ensuring that, once the aggregate amount of distributable surplus is ascertained reasonably, the resulting allocation among policies is fair. This involves the so-called contribution principle which argues that aggregate divisible surplus should be distributed among policies in the same proportion as the policies are considered to have contributed to divisible surplus 21/.

Product regulation

103. In a perfectly competitive environment, market forces would take care of those insurers that did not respond adequately to consumer needs. Unfortunately, such utopian conditions do not exist. Supervisory authorities should, therefore, actively encourage and assist insurers that are striving to extend the range of suitable alternative policies, especially those designed to meet the social and economic requirements of the market. Note is made, in this connection, that most life insurers in developing countries focus their sales efforts on whole life and endowment plans. More effort seems to be called for in marketing term plans. They seem particularly appropriate for many persons in developing countries, especially in today's uncertain economic times.

104. Further, particular encouragement to the marketing of group insurance plans is advisable. These plans are an efficient and low-cost means of providing basic life insurance benefits to many persons.

105. Group life plans probably require less government supervision than do individual plans. The bargaining relationship between the insuring organization and the policyholder differs from that of individual insurance programmes. The policyholder under a group contract can be an employer, union, lending institution, co-operative or other type of organization. In most cases, such organizations can be presumed to wield more bargaining power and protect the interests of the members of the group.

106. In some countries, the insurance statutes required insurers to meet various standards as to types of groups, minimum size of group, minimum participation, etc., before a group insurance contract could be written. Such a regulatory approach should be carefully examined before adoption in developing countries. The need for and effectiveness of these statutes today are subject to question, and increasingly they are being liberalized.

107. To ensure fairness, supervisory authorities could insist that every contract of life insurance has certain minimum provisions relating to (a) a grace period, (b) incontestability, (c) entire contract, (d) misstatement of age, (e) surplus distribution, (f) options available on premium default, (g) reinstatement, (h) loan, (i) non-forfeiture values and (j) deferment of loan

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21/ For some idea of how this issue is being dealt with in the United States, see the Report of the NAIC Advisory Committee on Manipulation, Detecting Manipulation of Policy Values and Dividends (June 1980) in NAIC Proceedings, Vol.II, and Recommendations of the Committee on Dividend Principles and Practices (American Academy of Actuaries, January 1981).

Not considered in this or the above studies are the increasingly important issues related to the determination of appropriate adjustments in policies that contain non-guaranteed elements other than dividends (e.g., policies that credit excess interest to the cash value).

and cash value payments 22/. Such minimum common provisions introduce some uniformity. They minimize the necessity of bargaining and render mass production possible. This reduces costs, leads to more understanding, and facilitates the exercise of an informed choice.

108. At least in the initial stages of a country's insurance industry development, it is probably wise to require policy forms to be filed with and approved by the supervisory authority. This is intended to ensure that the provisions contained therein are not inequitable, misleading, or deceptive and that they do not lend themselves to misrepresentation or misunderstanding.

109. Supervisory authorities may want to consider prohibiting the sale of policies that are unsuitable, as judged by local political, economic, social, and moral standards. Such policies may include not only those that are determined to be unfair or inequitable, but also those that are not feasible because of local conditions, or those whose benefits are too small in relation to premiums charged as determined by fair and reasonable criteria.

110. Regulatory authorities also may want to consider imposing clarity and readability tests and moving towards requiring simpler contracts. This can reduce irritants and the mystery with which insurance is shrouded in the public mind.

111. The quest for suitable policies for each market must continue. Preferences will of course vary from one country to another depending on social and economic circumstances. So long as the demand exists, regulatory authorities should ensure that suitable policies are available to meet those needs. Worth remembering, however, is that suitability is in many ways an individual matter. This is why supervisory authorities in many countries ensure that the public is provided with information on the financial position of insurance companies, their products and their prices.

Trade practices regulation

112. Regulators should be concerned with several aspects of marketing and other trade practices engaged in by insurers and agents. One is a general grouping of practices collectively referred to as "unfair trade practices". Some countries have laws and regulations relating to the following practices:

- Misrepresentation and false advertising of insurance policies;
- False information and advertising, generally;
- Defamation;
- Boycott, coercion, and intimidation;
- False financial statements;
- Stock options and advisory-board contracts;
- Unfair discrimination;
- Rebates;
- Unfair claim-settlement practices;
- Failure to maintain complaint handling procedures; and
- Misrepresentation in insurance applications.

22/ It is beyond the scope of this study to discuss these and other potential policy provisions. For additional information on the justification for and content of such provisions, see Janice E. Greider and William T. Beadles, Law and the Life Insurance Contract (4th ed.; Homewood, Illinois, United States: Richard D. Irwin. Inc., 1979).

113. "Unfair" trade practices laws define those practices that insurers and agents should avoid. Another dimension of the regulation of trade practices focuses on those practices which must not be omitted. Arguably, the right to information goes beyond the right not to be deceived and includes the provision of performance information that will foster considered purchases. Regulatory authorities can be the source of performance information. Alternatively, regulatory authorities can require companies and agents to provide certain information directly to prospective purchasers either automatically or upon request only.

114. Despite information that may be provided to consumers, if they are inexperienced or poorly educated, product features and costs may remain below the threshold of perception, Thus, providing sufficient time for buyers to consider their purchases and to consult others seems reasonable. A statutory unconditional refund period of from 10 to 30 days may help protect policyholders. Such a "cooling off" period is a reasonable period of time after the delivery of the policy when, if the policy is deemed inappropriate, it may be returned with no obligation and at no cost.

115. Different approaches to assisting consumers will be followed from country to country. Each, however, should strive to (a) assist buyers in selecting the most suitable type and amount of life insurance or annuity for their needs; (b) improve policyholders' and prospective policyholders' understanding of the basic features of life insurance and annuity policies; and (c) enable policyholders and prospective policyholders to evaluate fairly and easily the relative merits of competing policies.

116. The importance of permitting only trained, competent agents to sell life insurance cannot be too strongly emphasized. The practice of permitting only licenced agents to operate is worthy of consideration. Agents should be subject to disciplinary action if they engage in unethical practices such as misappropriation, misrepresentation, rebating (i.e., giving the applicant part of the premium in return for the application) or "twisting" (i.e., inducing a policyholder through misrepresentation to abandon a contract already owned and replace it with a new policy).

117. Often more time, money and effort are expended by an agent selling life insurance than one selling other types of insurance. As a result, many life agents fail. It may be desirable to encourage "multiple line" agents and to dissuade persons from being licensed in one area only. Also, persons should not be permitted to take out agency licences merely to earn commisions on their own business. This deprives genuine agents of commissions.

118. Other things being equal, the more educated and knowledgeable a population, the less supervisory authorities should feel the need to interfere directly with consumer decisions. The "let the buyer beware" philosophy is inappropriate with respect to life insurance purchases by most citizens.

Chapter VI

PROMOTING SELF REGULATION

119. Government regulation of the life insurance business, despite occasional strident complaints, has resulted in high public confidence in the business. Furthermore, it has protected the ethical company against unfair competition from reckless institutions. While State regulation may be necessary to ensure the continued stability, security and orderly growth of the life insurance business, a large area of self regulation will always remain.

120. It is hoped that the industry will in its own interests continue to demonstrate that a certain measure of self regulation is both desirable and workable. Government, for its part, has an interest in promoting meaningful self regulation. Additional regulation adds to the cost of insurance and to the economic burdens of the State. It will only be necessary if market imperfections fail to receive adequate attention from the insurance industry itself.