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Insurance in developing countries: review of developments in 1986-1988

Study by the UNCTAD secretariat

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INTRODUCTION

(i) At its second session (April 1967), the Committee on Invisibles and Financing related to Trade requested the Secretary-General of UNCTAD "to carry out at least once every two years reviews of developments in insurance, with special reference to developing countries". 1/ The latest review, covering the period 1986-1988, has been prepared pursuant to this request.

(ii) The present study is a summary version of document TD/B/C.3/229, which bears the same title and which is being made available as a background document in order to conform with the secretariat's guidelines on reduction and limitation of documentation. That document contains detailed information on developments at the national and regional levels.

CHAPTER I

INSURANCE SYSTEMS AND MARKET CHANGES

1. During the period under review a tendency towards less strict conditions for the admission of new companies or the involvement of the private sector in insurance business has manifested itself in several developing countries. Most notable among these changes has been a general roll-back of policies instituted in the past to protect the insurance sector. In some countries, ownership of insurance companies has been opened to the private sector, domestic or foreign, in others the traditional rule that domestic property and liability may only be insured with companies in the domestic market has been relaxed. The obligation that local insurers have to take out reinsurance with a State-owned institution has also been removed in a number of countries and basic reforms on licensing, tariffs, contracts, and shareholding have been introduced.

2. This trend is in marked contrast to that of the 1970s, which saw the emergence of "domestication" policies for insurance in the developing countries. As a result, the dominance of foreign companies was gradually terminated, and many countries stopped the entry of new foreign companies. Others required the existing foreign companies to go into joint ventures with local companies. In line with an import-substitution policy, companies of the private sector, where it existed, were closely regulated: investment, tariffs, policy conditions and other activities were put into a rigid framework of internal rules. In some countries, the Government set up partial or total monopolies to handle reinsurance business. The companies' margin of freedom in respect of the selection of their reinsurers was otherwise tightly curtailed. As suggested above, the pendulum appears to have swung back in the middle of the 1980s, and more particularly during the period under review.

3. The specific motives behind this shift in approach are varied and not always clear to outside observers. Due to a lack of information from direct sources, it is also difficult to determine the pace, scope and the outcome of the reforms. Proper interpretation of available information is frequently rendered difficult by subjective reporting: the drafting of this document has had to rely intensively on trade journals, and only to a lesser extent on information from direct government or market sources.

4. A general conclusion, however, can be drawn: policy shifts, in the countries where they have occurred, are probably due to disappointment with traditional insurance patterns and reflect expectations that new concepts, giving larger room to reliance on market forces and outward-looking policies, will work better. More particularly, these concepts are based on the conviction that changes are indispensable if the market is to operate more efficiently and be able to provide the national economies and population with better insurance services - insurance services which should compare favourably, in terms of quality, policy conditions and price, to those available in other markets.

5. Two connected factors have often given impetus to these moves: on the one hand the insured community has become more demanding in terms of price and quality of the insurance covers and, on the other hand, the insurance industry

shaped by old market structures has proved less effective and competitive than expected. The alternative facing many developing countries was, and still is, whether to let the domestic companies overcome their learning period and keep them shielded from outside forces until they no longer qualify as "infant industries" and thus are able to stand up to international competition - or whether this course of action is too expensive for the country, in terms of losses by the insurance industry bearing on government budgets, costs to the insured community and poor quality of the services. The issue has often been raised by exporting industries in the countries concerned, for which reliance on the local markets resulted in higher insurance costs, which in turn increased production costs and resulted in a loss of competitiveness with a bearing on terms of trade. The issue was therefore part of efforts to improve the general effectiveness of economic policies.

6. Other influences seem also to have played a role:

(i) A major inducement for liberalization has been provided by international lending institutions, generally under "conditionality" programmes. This is particularly so in Africa, where "the World Bank is urging insurance monopolies to accept foreign participation in their shareholding". 2/ More generally, "about 30 World Bank financed projects are designed to assist Governments in privatizing State enterprises through sales, leases or management contracts"; 3/

(ii) Decisions to sell or privatize government-owned insurance companies have often been prompted by the financial losses that these companies incurred and by budgetary constraints - combined with adverse balance-of-payments positions and a growing debt burden. In one or two cases, the sale of companies has been directly linked to the need to raise foreign exchange to pay for external liabilities, sometimes within the framework of a "debt-equity conversion" programme. Also, sales of domestic companies have often been followed by renewed attempts by expatriate companies to establish subsidiaries in the markets, so that the country has been taken back to the situation where it stood before nationalization.

7. The African Insurance Organization (AIO), at its 15th General Assembly in June 1988, addressed an appeal to "all African Governments to recognize that insurance is a vital tool for economic emancipation and growth and as such its control and basic utilization should be in the hands of the nationals who are totally committed to the development of the country's economy". A widespread feeling at the above Conference was that the necessary assets for building up a genuine domestic industry were given up just when they started bearing fruit. In this context it has also to be noted that the World Bank itself has expressed strong reservations against privatization of financial institutions. 4/

8. These moves towards privatization on the other hand have been encouraged by the private industry, particularly but not only in Latin America. The "Declaración de Asunción", passed by the 21st Insurance Conference of the Southern Hemisphere (Asunción, Paraguay, 1987) for example refer to private insurance as "a key element in a democratic system, in that it guarantees the protection of persons, property and assets without requiring the high price of loss of liberty".

9. The process of liberalization might also be reinforced as a result of GATT's Uruguay Round of multilateral negotiations under way, which includes insurance, among other financial services. These negotiations may or may not result in fundamental changes in Brazil, India and probably other countries. However, designation of the former two countries as having "unfair trade practices" in the field of insurance under article 301 of the 1988 United States Trade and Competitiveness Act carries the possibility of economic sanctions and will increase pressures for liberalization. According to the World Bank's World Development Report 1989, it is often believed that countries which liberalize unilaterally (financial institutions) lose a bargaining chip that might be used at the GATT negotiations to increase their access to export markets.

10. It must be noted, however, that in certain countries, developments have gone in the reverse direction, i.e. measures have been taken to provide larger room for domestic companies or to admit only foreign companies if they are associated with domestic financial interests. This development has been particularly notable in markets where companies have mushroomed in the absence of any proper government policy.

11. Other structural changes of domestic insurance markets in developing countries have resulted from the expansion or the contraction of the domestic economies. The high income-elasticity of insurance makes insurance sales very sensitive to growth of GDP and sales volumes are in turn a major incentive for the creation of new companies — and the other way round. Stagnating or declining economies, particularly in Africa and Latin America, were reflected in a decrease in the number of companies in some countries, the same as expansive economies in a few countries of Asia resulted in a parallel expansion of their insurance markets. Several examples of structural changes of insurance markets are reported in the background document (TD/B/C.3/229).

CHAPTER II

OBSTACLES TO THE EXPANSION OF DOMESTIC INSURANCE COMPANIES AND OPERATIONS

12. The period under review has seen an aggravation of the obstacles to the expansion and the strengthening of domestic markets. This has resulted in several insurance companies becoming under-capitalized and under-reserved and has caused a considerable problem regarding their ability to perform properly the necessary functions.

13. In several countries, insolvency of insurance institutions, fragility of markets or their instability have been identified as the basic problems of the particular period under review. They are clearly related to one or more of the following issues:

(a) The influence of an adverse domestic macro-economic environment;

(b) The influence of specific technical factors, such as rates ceilings which are inadequate in view of claims in automobile insurance, excessive awards in courts, and the problems experienced by the marine insurance market in many countries;

(c) The influence of poor management, unsatisfactory regulation and supervision, and questionable business practices;

(d) The influence of a low risk-bearing potential, aggravated by important catastrophe-prone conditions;

(e) The influence of the external environment, particularly the international reinsurance markets and their operations.

A. <u>The macro-economic environment</u>

14. Prevailing economic conditions in many developing countries have resulted in a general decline in business activity in most sectors of the economy. In insurance, the decrease affected most classes of business, especially the motor, fire and marine business. Particularly affected have been countries of the Middle East hit by the slowdown of the economies of the oil States and the influence of the Gulf War.

15. Adverse economic conditions have also resulted in a dearth of foreign exchange and in monetary problems leading to currency devaluations. This has disrupted in many ways the normal business relations between domestic insurers and their foreign reinsurers. Difficulties in this respect have also prevented stronger co-operation among developing countries and an increase of their regional capacity.

16. Obstacles to the free and swift remittance of premiums to overseas reinsurers make negotiations with them even more difficult and erode the bargaining power of the reinsurance buyer. The situation encourages also the direct purchase of insurance abroad: foreign exchange for the payment of premiums is often more readily available to the local insured party (e.g. a shipping line) than to the insurer. Therefore there is a situation in which

dearth of foreign exchange prevents national insurers from underwriting local business and induces the insurance buyers to seek cover abroad, involving foreign exchange expenditure higher than before.

B. Technical factors

17. Motor, marine and some other branches have traditionally been difficult branches in many developing areas. In some of them, underwriting these classes of business has been more difficult than ever. Motor insurance is perhaps the most conspicuous example.

18. In spite of strong measures adopted by a few countries, the increase in accident rates and the absence of a corresponding rise in tariffs, have considerably worsened the underwriting accounts. Insurers often complain of antiquated tariffs, artificially held down by Governments in order to contain inflationary pressures, while Governments on their side often complain of the inability of insurance companies to manage their business better. One way or another, claims ratios (claims paid and due in relation to premium income) of more than 200 per cent are not unusual.

19. Marine cargo insurance has also given rise to concern. The problem here is usually not unprofitable underwriting, but a decrease of shipping activities. This is mostly felt in developing countries where Governments compelled importers to insure transportation risks locally and which have seen the provisions circumvented for all practical purposes through dubious business practices which increase the cost of imported goods. Poor communications have in the past led to much double insurance, with exporters considering the local coverage as a tax. The minimum coverage is purchased from the local insurer, frequently at the port of arrival (to comply with local legal provisions); the real insurance has been contracted with the exporter's own insurer on full conditions.

C. Other deficiencies

20. The slow pace in premium collection is a traditional difficulty in developing countries which has reached new heights in the period under review. At a recent general assembly of the Fédération des Sociétés d'Assurance de Droit National Africaines (FANAF), it was pointed out that the amount of unpaid premiums is reaching unacceptable levels: 70 per cent in some cases. Obviously, liquidity and solvency problems follow.

21. Inadequate supervisory systems are becoming a major obstacle to the soundness of the insurance markets. The World Bank has recently stated that "there is a growing recognition that effective prudential regulation and supervision are essential (to the process of liberalization of financial institutions)". 5/ Now, while the liberalization has not taken place in many countries, there has not apparently been an adequate effort towards meeting the essential condition of improving the supervisory systems. Some difficulties stemming from the inability of domestic insurers to collect indemnities from their overseas reinsurers surely result from shortcomings in the field of supervision and the lack of appropriate regulatory measures.

D. Low level of insurance capacity

22. The risk-bearing potential of the insurance industry has probably decreased during the period under review. Insurance capacity is largely based on a sound spread of the risks included in the portfolios of each of the companies participating in the market. The presence in the market of many small companies with a small premium income, coupled with an unprecedented accumulation of insured values and the threat of claims of catastrophic proportions are determinant factors for the low-risk bearing capacity of many markets.

E. External environment

23. Heavy reliance on international reinsurance markets has fortunately helped overcome a number of difficulties of developing countries in the field of insurance. The insurance industry in many of these countries can survive only thanks to the sharing of risks and the transfer of technology that reinsurance markets around the world provided. But this reliance has also brought with it some problems.

24. First of all, there has been a widespread problem of solvability of some international reinsurance companies - a systemic risk with potentially devastating effects, particularly for insurers in developing countries. 6/

25. Other problems relating to foreign reinsurance concern the so-called "reciprocity" business - reinsurance operations from international centres in which insurers can participate as a "reward" for the business they themselves cede to these centers. In general, reciprocity, which was meant to decrease the reinsurance costs or to offset these costs with reinsurance profits from inward business, has resulted in heavy losses. In particular, the quality of the risks being transacted appears to have been in many cases of the lowest quality.

CHAPTER III

MEASURES AIMED AT THE STRENGTHENING OF DOMESTIC MARKETS

26. The adverse conditions of the kind reflected in the above chapter affected many countries (not only developing ones) and by and large inhibited the expansion of domestic insurance markets. These developments did not, however, affect all developing countries. At the company level, efforts have been pursued to make management and administration more efficient. Many companies have begun or continued a process of computerization of their operations. This process has also been successfully introduced in some State insurance supervisory offices.

27. On a policy level, regional insurance associations have in several instances put forward new suggestions for the expansion and strengthing of the insurance sector. An example is the list of propositions put forward by the 14th African Insurance Organization Conference at Brazzaville (June 1987) which calls for:

- Consolidation of existing companies (especially reinsurers) before creation of new ones;
- International reinsurers to host a meeting of finance ministers to discuss settlement/exchange problems;
- African companies to recommend that their brokers place 25 per cent of outward reinsurance with African reinsurers;
- Companies to provide more statistics to back up African reinsurers; and,
- Encouragement to the development of African intermediaries.

28. The concern underlying these and similar recommendations is not only that present difficulties call for new approaches and a serious effort of adaptation of the domestic markets, but also that the risk-bearing potential of developing countries and regions must be fostered and improved.

A. New covers of particular interest

29. The last two years have seen the emergence of several insurance programmes that, beyond their commercial and profit-making interest for the underwriting companies and their usefulness for the insured community, had particularly stimulating effects on the economies as a whole. One of these programmes concerns agricultural insurance. Its importance has been highlighted at the World Insurance Congress (Quito, June 1988), where one of the resolutions adopted asked for the setting up of insurance companies specialized in that line of business in each of the countries concerned. Indeed, many of them are interested.

30. However, available information also shows that actual projects in this field have been rather scarce, and that some insurance programmes that were introduced have been totally or partially discontinued, due to the fact that

this cover is one of the most difficult to operate, particularly in developing countries. 7/ Crop insurance may also give rise to a considerable "moral hazard" or even fraud, and even without these it generally takes sizeable contributions from the Governments' budgets.

31. However, the possibility of setting up crop insurance programmes is given continued consideration in many countries, due to the potential benefits of rural covers on investment and output. Along with the traditional argument that crop insurance facilitates borrowing from credit institutions which enhances investments and crop outputs, it is also felt that crop insurance could help integrate into the stream of financial resources the sterilized assets (gold, etc.) that farmers are now hoarding in the expectation of crop failures that will inevitably hit them one day or another. At present, the benefits arising from these assets being made available to the domestic economy are generally not taken into consideration in the cost/benefit analysis of crop insurance projects and thus the overall advantages of this insurance for the national economies are often underestimated.

B. Other measures aimed at the strengthening of domestic markets: insurance education

32. The importance of insurance education was highlighted by the 15th African Insurance Conference (Harare, June 1988) which recommended that "in view of the present shortage of highly trained and experienced personnel in the African insurance business, concerted action should be taken by the industry to promote training and manpower development at company, national, subregional and continental levels and should be reflected in the annual budgets of all insurance companies and institutions". 8/

33. Examples of recent developments in the Asian region show a growing awareness that professionalism not only of key personnel of insurance companies but also of insurance intermediaries, brokers and agents is most necessary for the growth and development of the industry.

34. Meanwhile, it is also reported that, despite the recognition of the need for training, several existing insurance institutions have not been given the amount of support and financial means they need. Decreasing contributions from the industry and other funding sources - often stemming from decreasing premium incomes and less optimism about the growth of the industry resulting in cutbacks in training budgets - have affected the normal course of activities, or even threatened the very existence of these educational centres.

C. Self-regulatory measures, loss prevention and other measures

35. Several countries, particularly in South-East Asia, have started experimenting with self-regulation through inter-company agreements. In some of these and other countries, the Governments have also urged the insurers to police themselves. Negotiations to establish national loss prevention associations with the co-operation of the police, fire department and other authorities are also being undertaken by the industry.

36. New measures aimed at the expansion and diversification of the markets and the improvement of their insurance services are reported for a number of countries in the background document (TD/B/C.3/229).

CHAPTER IV

NEW REGULATIONS ON SOLVENCY, ADMINISTRATION, CONTRACTS

37. An increasing number of countries have come to realize that insurance can only grow and develop within the framework of effective legislation and a dynamic regulatory body, aimed at instilling discipline and cultivating business morality among insurers, professionalizing the business and developing insurance consciousness among the people. This philosophy has resulted in a number of countries putting more emphasis on prudential regulation and supervision, at the expense perhaps of product and price controls. More particularly, it has promoted the strengthening of insurance supervisory departments in some developing countries.

38. Insurance supervisory departments in the ASEAN countries have collectively set up an Early Warning System (EWS), patterned after the model set up by the National Association of Insurance Commissioners in the United States. The EWS comprises a set of financial ratio tests with which to detect those insurers likely to face financial difficulties. The EWS incorporates a point system to rank and prioritize the insurers for the purpose of review and inspections.

39. Meanwhile, the problems of undercapitalization and the need for action was taken up collectively at the 15th African Insurance Conference (Harare, June 1988). The Conference requested the African Governments through their regulatory bodies and insurance control authorities "to take urgent steps to ensure that all insurance companies are adequately capitalized so as to ensure their viability and ability to meet their financial obligations to policyholders ... in view of the importance of insurance in the social and economic development of the nation".

40. The Conference also recognized and supported the formation of the Association of Insurance Supervisory Authorities in Africa "to promote harmony of action in the supervision of the insurance industry which will work closely with the African Insurance Organization in promoting the growth and development of a strong, healthy and viable insurance industry in Africa". Thus, the request for properly supervised standards of business that apply to the whole market came in the first place from the market itself.

A. Share-capital

41. In a number of developing countries regulations have been laid down to the effect that minimum share-capitals be increased. In many of these countries, however, it is difficult to say whether the new amounts are just meant to offset currency depreciations or will effectively result in an increase of net worth in real terms, leading to the growth and expansion of the industry and its retention capacity and to an improvement of its services to the public. The new requirements have resulted in some market concentration, as small companies which could not meet an adequate level of capitalization had to merge with other companies.

B. Technical reserves and investments

42. Another field of regulatory action in certain countries has concerned the process of shifting from strict compulsory investments of the technical reserves and guarantee funds to a less rigid régime, where the initiative of the companies was allowed to play a larger role.

C. Contracts, tariffs, intermediaries, taxation

43. On the question of intermediaries, it is worth noting that the Association of British Insurers has introduced a new Code of Practice for the selling of general insurance. The code applies to all intermediaries, including employees of insurance companies, other than registered insurance brokers. It is felt that a number of developing countries, where the activities of non-regulated agents and other intermediaries is a cause of concern, might wish to consider a supervision mechanism that could be applicable to their own countries.

44. Several country examples on new regulatory issues and on new measures on compulsory insurance schemes are reported in the background document (TD/B/C.3/229)

CHAPTER V

NEW DEVELOPMENTS IN THE FIELD OF RETENTION CAPACITY AND REINSURANCE

45. New developments in the field of reinsurance have affected developing countries mainly in their capacity as buyers, mostly from abroad. Therefore, trends and policies of the international reinsurance markets have often a direct impact on their insurance sector. But developing countries are also concerned in their growing capacity as reinsurance sellers to local and foreign companies.

A. Developing countries as reinsurance buyers

46. Reinsurance markets have stiffened their conditions: reinsurance cover (treaties and facultative) is now more expensive and more difficult to come by; problems of insolvency of major reinsurers, however exceptional, do exist - sometimes calling into question the solvency of their clients and the very existence of some small markets in developing countries.

47. Insurers and reinsurers in Africa and Asia are also being faced with higher rates on their excess of loss protection. In some cases, the past loss-experience does not seem to justify the increase in these rates.

48. Governments, too, are not satisfied with the course of events on the reinsurance scene. Some of them think that the local markets have some responsibility in the situation, to the extent that these markets do not develop an adequate policy of optimizing risk retention - and saving reinsurance premiums paid in hard currencies. Some Governments have specifically expressed concern at what they consider an unwarranted outflow of foreign exchange resulting from the dependence on developed reinsurance markets to service their reinsurance needs. They point out that some domestic insurers have ceased to be risk carriers but have become instead the conduit for exporting premiums abroad through unnecessary reinsurance, fronting or similar arrangements.

49. The background document (TD/B/C.3/229) illustrates national policies in the field of reinsurance pertaining to (a) the setting up of new local reinsurance institutions; (b) recent developments regarding changes of market structures, compulsory reinsurance cessions and new regulatory frameworks; (c) other measures aimed at increasing local retention capacity and improving the effectiveness of reinsurance services.

B. Developing countries in their capacity as reinsurance providers

50. Developing countries have also experienced some hardships as reinsurance sellers. Their insistence on reciprocity has sometimes turned out to be a source of additional difficulties. The quality of the business (i.e. the average profit margin) accepted has generally not compared with that of the business ceded. The result has frequently been that operations accepted from the international markets in reciprocity to the business ceded have not offset to the degree anticipated the reinsurance costs for the latter; on the contrary, the two results have often been negative, adding up to unexpected losses.

51. The difficulties on international markets in developed countries would lend credibility to the concept of an increased reliance on reinsurance markets of the developing region as both an outlet for reinsurance and a source of inward business. Every market would be both ceding surplus risks to other markets in the region with idle capacity and making use of its own capacity for accepting business from those markets, whose characteristics would be better known by both ceding and accepting companies.

52. Exchange of business through pools and other institutional arrangements has received a strong impulse, often thanks to the initiatives carried out by international trade organizations and other bodies in developing countries concerned with such issues. As a result, the period under review witnessed the establishment of some pooling arrangements between different African and Asian markets, such as the African Insurance Aviation Pool, the WAICA Reinsurance pool and the East African Insurance fire pool. Discussions aimed at the establishment of the African Insurance Organization Oil and Energy pool and the African Insurance Clearing House also started during the period.

53. At its 14th Conference (Brazzaville, June 1987) the African Insurance Organization (AIO) urged a "progressive increase" of individual companies retention along with the establishment of continent-wide mechanisms to stem what is perceived as a massive flow of capital out of developing regions, particularly Africa. Similar initiatives have been taken during the period by the Organization of East African Insurers, the Arab Reinsurers Association and the ASEAN countries.

Notes

1/ See Official Records of the Trade and Development Board, Fifth Session, Supplement No. 3 (TD/B/118/Rev.1), annex I, sect. A, para. 6.

2/ The Review, London, August 1986.

3/ International Research Services, November 1988.

4/ See World Bank's World Development Report, 1989, p. 130.

5/ See World Development Report, 1989.

6/ See Reinsurance Security: Study by the UNCTAD secretariat, TD/B/C.3/221, February 1987.

7/ See the UNCTAD study on "Crop insurance for developing countries" (TD/B/C.3/163/Rev.1).

8/ See, WAICA Journal, August 1988.