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THE IMPORTANCE OF LOSS PREVENTION FOR DEVELOPING COUNTRIES

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About Loss Prevention in General

1. It is widely accepted that prevention is better than cure. This motto, which applies to all facets of life, applies particularly to risks and insurance. Everyone agrees that fire losses, road accidents, loss or damage to property and equipment, etc., do not entail only human suffering and tragedies, but in most cases also result in wastage and unnecessary depletion of wealth and resources which can seriously affect the economy and hamper its growth.

2. It is a fact that insurance makes good the economic loss sustained by the insured. Yet, even when each specific individual loss is eliminated for the policy holder through the insurance technique of spreading risks and paying claims, the overall burden of loss still remains with the community at large. This is because the indemnities paid by the insurer are entirely financed out of "premiums", i.e. contributions collected from the mass of the insured. Thus, so far as the community as a whole is concerned, there is no elimination of the loss. Besides, it should not be overlooked that conducting insurance business involves costs such as acquisition of new business, management expenses and reinsurance costs. These costs, which are by no means negligible, have to be added to the effective amount

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of claims paid by the insurer, and ultimately be charged to the insured and the community, as explained earlier.

3. Finally, when a loss occurs, it is not only life and property which can suffer from the impact of loss, since there can be a number of consequential losses which insurance cannot compensate adequately. For instance, a serious fire will not only damage buildings and equipment, but consequences can also affect workers put out of work, result in loss of production, loss of profit, loss of markets, as well as loss of other firms through interruption of supplies, etc.

4. Thus, when an insured transfers his risks to an insurer this does not mean that he is totally safe from the aftermath of occurrences, or that his community is adequately protected against the economic distress which loss can cause. However, insurance and loss prevention put together are the most appropriate and efficient safeguards. Loss prevention avoids or reduces losses, and insurance indemnifies what is not prevantable; neither can supersede nor replace the functions of the other.

Economics in Loss Prevention

5. Although prevention of all losses might seem very desirable, yet economically it is not feasible. A basic approach to loss prevention is that the cost of labour amd materials used to avoid or reduce losses should be less than the cost of repair or replacement, multiplied by the probability of loss if no prevention measures were taken. It is the element of saving which determines the economic feasibility of loss prevention measures. The potential gains from loss prevention action have to be weighed against the cost involved, and unless the gains equal or exceed the cost, it is uneconomical to engage in such loss prevention activity.

6. However, this principle cannot be applied to cases where human suffering is involved. On the other hand, it has to be realized that increased expenditure on loss prevention is likely to reach an optimum level after which

it becomes unlikely that further expenditure would achieve any improvement in the risks. At that level any additional expense on loss prevention becomes superfluous and adds to the total cost of any losses which may occur.

Beneficiaries of Loss Prevention

7. It is obvious that individuals, both persons and firms, are the first beneficiaries of loss prevention action, even if they are well protected by insurance. This is because their main concern is the conservation of their property and the continuation of their activities. Generally, they are inclined to pay a higher price for safety rather than facing uncertainties with regard to losses and filing claims against their insurers.

8. Loss prevention bestows a collateral benefit upon the community and the national economy as a whole, since losses impose a burden on the society, irrespective of who pays the bill. Economic consequences of losses go far beyond property damage and have social and financial implications which could threaten the very structure of the society and the well-being of the people. To illustrate this it is sufficient to recall the pollution catastrophes of Sevezo in Italy, and Amoco Cadiz in Britanny, France. These two occurrences, apart from the damage they caused to property and investments in these areas, have created extensive social andd economic problems which the Governments of the two countries had to face.

9. Loss prevention measures are also profit-making for the insurers. As these activities are primarily aimed at the lowering of insurance companies' losses, they increase their underwriting profits. This very consideration motivated the first fire insurers in Britain, early in the 14th century, to form and maintain their own private fire brigades to protect the buildings they covered. The same motive induced Lloyds underwriters, as early as the 18th century, to classify risks and ships' bottoms according to the degree of hazards involved, to bonify good risks and penalise bad ones.

10. However, to some insurers the interest in loss prevention does not seem always as obvious as it should be. In fact, some insurers believe that their interests lie in a bigger volume of premium, whilst the improvement of loss experience results in lower rates. However, these insurers should not forget that in the long run lower premium rates attract larger insurance portfolios, which produce more spread. This consideration is of great importance in markets characterized by small premium volume in which insurers face fluctuating results. Another effect is the levelling of risks to homogeneous portfolios which do not require extensive reinsurance arrangements.

Loss Prevention in Developing Countries

11. The importance of loss prevention for any economy can hardly be overestimated. However, in the context of developing countries, loss prevention assumes paramount importance because of their particular economic and financial conditions, which make them unable to bear the consequences of large or repeated losses, especially when considering the foreign exchange components of many of their investments. For instance, a large fire loss sustained by a developed country normally results in a minor setback to its overall economy, but for a developing country such an occurrence may amount to a national disaster. In addition, every day of production lost costs the economy dearly. In order to make the best possible use of their resources and manpower it is the duty of developing countries to take every step to ensure safety, preservation of continuity of production and the maintenance of income.

12. As regards domestic insurance markets in developing countries, loss prevention can indeed play an outstanding role in promoting the markets' growth and improving their performance. In order to realize the importance of this role, it is necessary to revert to the developments which took place in these markets, and to focus on some typical features which characterise these markets at present.

13. In most developing countries, intensive efforts are deployed to achieve

quick economic and social progress. These efforts are reflected and have resulted in a marked increase in the number of risks, whether insured or not. Along with the increase in the number of risks has gone increasingly the complexity and exposure due to the concentration of values at risk and the extensive resort to modern technology represented by the use of new materials, new processes and new methods of production, transportation, building, etc. The situation of risk exposure in developing countries is further aggravated by the fact that most of these countries are not yet endowed with up to date safety codes, protecting life, property, manufactures, etc. Even if they have such codes and regulations, they often lack the appropriate machinery which can adequately ensure their application. Moreover, the lack of modern and efficient loss prevention equipment and appliances, which often have to be imported from abroad at relatively high costs, is a negative factor in the risk situation in developing countries. Finally, there is the phenomenon of low level of loss prevention awareness due to the novelty of urban and industrial behaviour to the majority of people in developing countries.

14. Alongside with this development in the risk situation in developing countries, namely the emergence of new, more complex risks, there was also the establishment of domestic insurance sectors, comprising local insurance companies. The principal objective of the domestic insurance sectors was to cover local risks in the local markets, and to replace foreign insurance services in an endeavour to reduce insurance costs in terms of foreign exchange expenditure. The young domestic insurance sectors in most developing countries have to assume their responsibilities under extremely difficult circumstances. In addition to very limited capital resources and lack of know-how, these markets face the problem of premium receipts which are too restricted to allow a reasonable spread for the insurers. The insufficiency of premium receipts is generally associated with an insufficient diversity in the risks covered and the absence of a good volume of simple and ordinary risks known for their good results. This double anti-selection deprives the insurer of the possibility of compensating losses for larger risks from the income of a diversified portfolio based on ordinary risks. All these drawbacks result in an uncertain

situation for the insurer compelling him to load his premium to obtain a margin of security. This is the background for the relatively high insurance costs in developing countries as compared with developed countries.

15. Obviously, high premium rates discourage the public from covering their risks by insurance, particularly in the absence of sufficient awareness of insurance benefits. This discouragement leads to the contraction of the market resulting in a loss for the insurer. Moreover, when rates are high, the best class of the insured will find it uneconomical to ensure, a situation which could lead to a drop in the receipts of the insurer. The remainder of the insured, with inferior experience would render rates uneconomical once again by their bad results. Thus the maintenance or the lowering of premium rates should be the target of domestic insurers in developing countries to achieve a larger turnover and to attract wider spread. This, however, cannot be achieved unless there is a definite improvement in the loss experience. In practical terms this objective can be brought about particularly through loss prevention action.

16. The drawbacks explained above have also a direct impact on the way insurers handle risks. In view of the small volume of premium they write, and the consequent lack of spread, the underwriting results are generally subject to fluctuations. To safeguard themselves insurers retain for their net account a small share of the business they write, and reinsure the balance abroad. This behaviour is understandable because the dimensions of the retention are closely linked with the prospects of profitability. It is obvious that excessive reliance upon reinsurance deprives the insurer of his income and prevents him from achieving growth. On the other hand, it burdens the national economy and the balance of payments with unnecessary transfers of hard currency.

17. Loss prevention action in avoiding losses or reducing their severity contributes to the balancing of the portfolio of the insurer and the improvement of his profitability. These two results induce the insurer to maximise his retention and curb his excessive reinsurance. Moreover, the improvement in the profitability due to the loss prevention action can help the insurer

to earn the confidence of his reinsurers which, in turn, is translated into better reinsurance terms, and more stable relationships. Finally, improving the profitability through loss prevention action is an important factor in creating extra capacity. This consideration is of major importance for developing countries, where risks tend to increase both in terms of values and exposure due to developmental projects carried out. This situation requires additional capacities to absorb such increases and also to meet new requirements of cover.