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Insurance in developing countries: Privatization of insurance enterprises and liberalization of insurance markets

Report by the UNCTAD secretariat

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CONTENTS

INTRODUCTION

1. The Standing Committee on Developing Services Sectors: Fostering Competitive Services Sectors in Developing Countries - Insurance established the work programme in the field of Insurance at its first session on insurance, from 1 to 5 February 1993. Under part "B. Fostering Competitive Insurance Services", the Standing Committee undertook, inter alia, to "Prepare a comprehensive study including: ... an analysis, based on contributions received, of the specific and general experience of developing countries and those countries in transition to market economies in fostering a market-oriented insurance sector and in privatizing and liberalizing insurance markets; ...". At the same session the Committee adopted a provisional agenda for its second session whereby under item 5(ii) it would consider "Privatization and liberalization in insurance" on the basis of a revised report prepared by the UNCTAD secretariat (UNCTAD/SDD/INS/3/Rev.1).

2. This revised report presents a discussion of issues related to privatization of insurance enterprises and liberalization of insurance markets, factors having a profound impact on the insurance markets of developing countries. This revision covers recent country developments and makes reference to the now completed Uruguay Round negotiations of the General Agreement on Tariffs and Trade and the establishment of the World Trade Organization. The basic analytical foci remain the same as in the initial report tabled at the first session.

I. PRIVATIZATION OF INSURANCE ENTERPRISES

A. Motives for privatization

3. In recent years, privatization in the insurance and reinsurance sector has been part of policies pursued by numerous governments in developing countries aimed at redefining the role of the State and increasing the efficiency of economic activities.

4. Privatization is defined here as the transfer of ownership and control of business entities and activities from State into private hands. To some extent the current wave of privatization represents a countermove to the expansion of public enterprises (PEs) in developing countries that had characterized the post-World War II period when many PEs were established as a consequence of nationalization policies which were the prevailing credo of the time. While ideological motives played a certain role, in many cases PEs were established in order to help governments pursue a variety of political, social and strategic economic objectives which were considered difficult to achieve through private enterprises.

5. As of early 1993, privatization programmes were proceeding in some 80 countries with about 8,500 State enterprises being sold during the previous 12 years. In 1992, global privatization transactions surpassed US$53 billion.[1]

6. Although there are numerous examples of well-performing PEs, in recent years many PEs in developing countries have come under scrutiny because of their unsatisfactory financial performance, one of the factors contributing to the severe fiscal crisis experienced by these countries in the 1980s. PEs were often managed poorly owing to the lack of effective systems of corporate control and budgeting and to political interference and corruption. Problems of bad management were often exacerbated by the absence of competition in the PEs' product markets. As a consequence, PEs have become a major target of economic reform in developing countries. In the public sector such reform has been approached through policies of liquidation, privatization and commercialization.

7. Privatization is often undertaken in the context of structural adjustment programmes or stabilization reforms which are a component of International Monetary Fund (IMF) conditionality or a precondition for obtaining loans through the World Bank. These policies usually place major emphasis on a rehabilitation of public finances through an improvement of the government revenue base and/or a reduction of public sector deficits.

8. In the insurance sector of developing countries, however, privatization is not necessarily a response to lack of profitability. Often, in fact, insurance firms in these countries are both profitable and relatively well capitalized. In many developing countries, State insurance companies have provided substantial finance to their Governments through taxes, dividends and

investment in government bonds and through financial transfers, as has been the case, for example, in Argentina, Benin, India and Zaire.[2]

9. In the case of insurance, it is usually the efficiency argument rather than that of improving public budgets that is advanced to plead the case for privatization. The belief that private firms will achieve superior cost efficiency in production is perhaps the strongest motive for privatization. Even if they do produce profits, State-owned firms are considered to be inherently less efficient because they are exposed to a combination of factors which tend to push the objective of profit maximization, the intrinsic rationale of private enterprises, into the background. It is in particular argued that:

- Politicians who supervise PEs tend to set political rather than economic objectives for these enterprises. The centralization of decision-making in the State apparatus does not allow for attentive and flexible management; commercially necessary decisions are often and easily delayed or overruled; it is also pointed out that key positions are often filled by government appointees who have little experience in insurance proper.

- Public enterprises are frequently burdened with social objectives. They may serve as a tool to create or maintain employment and are often expected to serve as models in respect of labour conditions, job security, health and other benefits, a role which necessarily implies higher costs. The encouragement of State-owned enterprises to pursue a mix of social and economic objectives often results in conflicting goals and unclear standards for evaluating performance. In the long run, this implies reduced efficiency.

- Governments are inclined to create a protective environment for their companies, sheltering them from, rather than exposing them to, competition. The State as entrepreneur is often more concerned with protecting national assets and resources, together with the interests of the employees of the companies it owns and runs, than with the interests of consumers who desire low prices and efficient services.

10. As a result of the operation of the factors mentioned above, management accountability for performance is reduced and often little incentive exists for good management. Besides impinging on efficiency, "...systems that lack sufficient accountability contain a greater than usual potential for political patronage, bureaucratization, irregular practices and corruption." [3]

11. In the case of insurance, the burden which public enterprises have to shoulder for social and/or political reasons is an important cause of reduced profitability. In some countries, the PE insurer is asked by the Government to engage in insurance schemes for special groups of the population or to offer protection at favourable rates in areas of public sensitivity.

12. Many PE insurers are asked to engage in insurance for rural and marginalized urban populations which private insurance companies would rather

avoid. The development of schemes for these social groups may, at least during an introductory period, cause losses until experience is built up and reliable data are collected. Thus a number of public insurance companies are operating schemes of agricultural insurance which need subsidization of one type or another, sometimes on a large scale. While in some cases losses from such schemes can be offset by other lines of business, so that the end result for a company is still positive, in years of natural calamities, such as widespread drought, the PE insurer may be faced with heavy losses that cannot be compensated by other covers. In countries where motor insurance rates are kept artificially low by the authorities and where there is a monopoly PE insurer which has to underwrite all motor insurance, the best management efficiency will not produce profits; again overall company profitability can only be safeguarded if losses can be compensated by profits from other lines.

13. The losses or low profits recorded by PEs are often taken as indicating a lack of efficiency. However, short-term profitability is not always an appropriate performance indicator. Companies can be efficiently run but unprofitable and can show profits without being managed efficiently. Numerous other factors can affect short-term profitability. They include:

- Ability to benefit from a monopoly position or from a favourable government pricing policy;

- The use of cash flow underwriting to gain short-term profits to the detriment of long-term financial performance and soundness;

- Access to subsidized inputs or finance.

14. Furthermore, micro-economic profitability does not necessarily imply macroeconomic benefits. Some of the social objectives which are now pursued by PEs in the field of insurance would be left unattended in their absence. Their assumption by PEs may, in fact, not increase overall economic costs. Often, in the absence of other economic actors, the provision of such benefits may indeed be in the overall macroeconomic interest of the country and may also strengthen social stability. The offering of certain commercially unprofitable insurance covers can have important external benefits which are reflected not in company income, but in income gains elsewhere in the economy; this may warrant public ownership, which focuses on macro- rather than micro-economic returns. The problem is that the assumption of the related costs makes an evaluation of PEs on purely business principles extremely difficult. What one observes are the costs, which can be quantified, while the benefits are often of an unquantifiable nature. High costs and financial losses are readily presumed by governments and the public to be evidence of bad management in public companies.

15. In many developing countries the conviction that private enterprise results in superior performance~~, together with a complex constellation of domestic and~~ international pressures and conditionalities, has created strong incentives to privatize State-owned insurance companies. However, in the implementation of such policies problems often arise.

B. Problems associated with privatization

(a) Mobilization of capital

16. The privatization process, and the economic reform programme of which it is a part, usually requires new finance. Domestic private funds are not always available in sufficient amounts to buy existing PEs or to establish new companies with sufficient capitalization. It should be remembered that the scarcity of domestic capital constituted one of the reasons why many developing countries had established State-owned companies in the first place.

17. Raising capital through equity would be the preferred option in many developing countries. This approach requires a working capital market and adequate financial infrastructure, however. Although many developing countries are planning to establish stock markets, achieving satisfactory performance of these markets usually takes considerable time. Furthermore, the economic base for "popular" capitalism is weak in many of these countries, since the emerging middle class is still insignificant. Therefore, it is unlikely that stock markets can be a major vehicle for privatization in many developing countries.[4] The lack of a developed financial market, for example, has been openly recognized as a major obstacle to implementing privatization in the insurance sectors of Guinea and Pakistan.[5]

18. Private entrepreneurs in developing countries have sometimes been unwilling to go public or to invest in publicly quoted enterprises because of the amount of disclosure that could be required.[6] In addition, local capital in these countries tends to prefer investments where a quick profit can be made and risks are of a relatively short-term nature. The provision of long-term services such as insurance is less attractive for an investor who faces an unstable economic or political environment and this factor limits the prospects of privatization.

19. Moreover, stock markets, particularly under the economic conditions prevailing in developing countries, may also have significant destabilizing effects and tend to encourage "short-termism" in management strategies and investment decisions, while the expected positive contribution - the encouragement of savings, more efficient allocation of resources and discipline in corporate management - may be elusive in practice.[7] Hence, fostering the development of bank-based financing systems could be a suitable option for developing countries.

(b) Insurance as a strategic sector

20. In many developing countries the State expects to augment its resources by selling its insurance companies. However, in order to operate satisfactorily, many companies would need an infusion of new capital. In the absence of enough nationals with sufficient capital to acquire the companies and provide new operating funds, a number of developing countries are opening the insurance sector to foreign investors. In such cases, concern has sometimes been expressed

by the respective local insurance sector that the majority interest in the new privatized companies will be acquired by foreign insurers. Apprehension has also been voiced that, owing to the present low asset value of many of the public companies concerned, they may be sold at prices which do not reflect the long-term value of the insurance portfolio and the full range of business opportunities. As a consequence, local business interests may be excluded from a domestic service market which may be promising and lucrative in the long term.

21. Recourse to foreign capital to overcome the shortage of domestic funds has sometimes been rejected when the sector is deemed to be of strategic importance to the country, which is often the case with insurance. But foreign investment and shareholding in the field of insurance is being re-evaluated in many countries. Pragmatic considerations are increasingly gaining weight at the expense of adherence to ideological positions. If foreign capital is admitted into the insurance industry, many developing countries make sure that it does not gain majority influence. In addition, the State may not be willing to refrain completely from influencing the insurance industry, in view of its strategic importance for capital formation and resource mobilization.

22. An interesting approach relevant to the latter issue has been adopted in Nigeria. In 1988, out of a total of 98 insurance companies operating at that time, the Government possessed equity in 14 and wholly owned two others. When it decided to sell its shares in these companies, the Nigerian Government introduced the concept of the "Golden Share", an earmarked share that the Government would retain in the companies it would be divesting. While of insignificant value and yielding no dividend, the share gives the Government the right to insist on being consulted about any changes in ownership or in company statutes and articles. The "Golden Share" is widely regarded as a monitoring mechanism of the Government in respect of an important component of its financial sector.[8]

23. There are other examples of the State retaining an interest in insurers to be privatized. In Argentina, privatization of the State-owned banking and insurance company Caja Nacional de Ahorro y Seguro (CNAS) will split it into four enterprises grouped under a single holding company. While the buyer is obliged to acquire a 50 to 60 per cent stake in the holding company, the State will retain the rest.[9] In Mexico, the State will privatize Aseguradora Mexicana (ASEMEX). Bids from private investors were due 10 September 1993. It was reported that the State will initially retain a 30 per cent stake in ASEMEX.[10] In Papua New Guinea, in early 1993, the privatization of the State-owned Niugini Insurance Corporation was approved. The State will initially retain 20 per cent of the stake and will consider a final divestiture in the future.[11] In Sri Lanka, in March 1993, it was reported that the Insurance Corporation of Sri Lanka would be privatized. The State would keep a 10 per cent share; 55 per cent would be partly sold directly to corporate buyers, 10 per cent would be distributed free to employees and the remaining 10 per cent would be placed on the Colombo Stock Exchange.[12]

(c) Market structure

24. Even in cases where PEs can be sold to private interests, it is questionable if a change in ownership alone will raise efficiency. Privatization by itself will not change the nature of the market in which the firm operates or the environment which shapes pricing decisions. When a public monopoly becomes a private monopoly, efficiency may not rise, since monopoly pricing will remain in effect while at the same time control of management may become more difficult.

25. The degree of competition that an enterprise faces is often more important for its efficiency than the nature of the ownership. In fact, privatization will usually yield full benefits only in a competitive market environment. The latter should normally exert sufficient pressure on management to encourage a constant drive to improve performance. Hence, wherever possible, privatization should be accompanied by policies which expose the respective company(ies) to an adequate degree of competition.

26. Creation of competition may not be enough, however. Since the functions of manager and capital owner are often separated, managers are not necessarily closely linked to the success of an enterprise. Management salaries are often paid irrespective of the results achieved, and management contracts may provide for a severance payment even when managers are obliged to quit their post because of the poor performance of the company under their leadership. The absence of direct financial incentives may induce managers to avoid the difficult or unpleasant decisions involved in the search for higher productivity. It has to be recognized that managers of private firms are also not free of clientelism and political aspirations and not immune to the temptations of corruption.

27. Three mechanisms have been identified which, under privatization, push managers to become cost efficient. These are: direct monitoring by the shareholders, the threat of external takeover of the firm, and monitoring by the creditor financial institutions which have an interest in preventing the bankruptcy of the firm.[13] In developing countries, however, where transparency regulations for publicly quoted companies are not yet in existence or enforced, the shareholders will have difficulty in obtaining sufficient information on the firm's situation and management performance. Where capital markets are poorly developed, takeovers via share acquisition are rare. Control of management efficiency by creditor financial institutions would seem to be a more realistic possibility and could probably be improved in many developing countries. How far the banking system could exercise such control would depend on the financial structure in place in the respective developing country. For a bank-based financing system to work well, monetary stability, prudential regulation and effective supervision are essential preconditions. In particular, firms should not be allowed to own and control banking institutions.[14]

28. There is the danger that once the establishment of private insurance companies is allowed, a sector which so far has been characterized by monopoly

or oligopolistic conditions will soon have too great a number of companies. Adequate capitalization and solvency margins therefore need to be stipulated for new insurance companies. One of the current problems of many developing country insurance markets is the existence of too many under-capitalized companies whose risk-bearing capacity is very low, and which not infrequently have to resort to fronting in order to survive. Some countries have indeed realized that care must be taken during the implementation of privatization to avoid the problem of monopoly supply being turned into a problem of over-supply.

29. If privatization takes place in a competitive environment, or is accompanied by measures to introduce or increase competition, care must be taken to establish or update the regulatory framework supporting the market. Government divestment will change the role of the State from that of an owner to that of a regulator. It would turn its attention from the control and cosseting of enterprises, which often surpasses its technical competence, to protection of the consumer and ensuring delivery of the goods or services concerned on a proper and fair basis.

30. To guard against negative consequences, the laws and regulations which determine the market structure and establish the rules of the game played within the confines of this structure should be in place as soon as monopolistic firms are privatized. The regulatory and legal framework should be clear, unambiguous and consistent. It would include, for example, laws on fair competition, restrictive business practices, cartel or monopoly legislation for enterprises, in general, and sound insurance legislation and supervision for insurance companies, in particular.

31. Once adopted, the regulations must be consistently applied. This demands an effective legal system. Without supportive regulatory measures, mere enthusiasm for a market economy and privatization and belief in their inherent merits will not by themselves be enough and may result in more chaos than progress in the short run.

32. The exposure of new domestic companies to foreign competition may require additional promotional and supportive measures for them. Care should be taken, however, that such measures do not degenerate into excessive protection and that the support is granted only for a transitory period.

33. The experiences of a number of developing countries, for example, <u>Chile</u>, <u>Colombia</u> and <u>Mexico</u>, show that even when competitive markets are established quickly, and management skill is exercised, it is questionable whether the privatization of the insurance sector will immediately enhance efficiency and company profitability.[15] A decline in profitability may be encountered by private insurers in the initial period after privatization and introduction of a competitive market because:

- increased competition may bring premium rates down;

- the higher skilled staff requirements of enterprises keen to raise productivity may not be met appropriately, causing a decline in the quality of underwriting, claims handling, etc.;

- greater competition and more advertizing may enhance the public's claims consciousness and lead to more claims being filed.

34. In Venezuela, a new law on insurance will liberalize the sector by allowing free pricing, discretion on policy terms, reinsurance procurement and the establishment of foreign insurers. It was reported that, in consequence and based on the experience of other recently liberalized Latin American insurance markets, rates for property insurance were expected to decline by 30 to 50 per cent.[16]

C. State insurance monopolies and public enterprise reinsurers

(a) State insurance monopolies

35. The creation of a competitive market environment for insurance is particularly difficult when the sector consists of a large national monopoly, as is, or was, the case in some developing countries (e.g. India, Tanzania, and Zambia).

36. Even if privatized, the existence of a large and market-dominant company may preclude the emergence of healthy competition. The State insurance companies often have established branches in key areas of the country, acquired technical and marketing experience and built up a network of business and consumer relations. Since insurance is largely a matter of confidence, it may be difficult for new insurers to compete, except by offering very low rates which may quickly lead to financial difficulties. Encouraging the development of such conditions would undermine the confidence of consumers and lead to a great loss of credibility for the insurance industry as a whole. This would prejudice the development of the sector as such. Opportunities for new insurers could be found through specializing in certain fields or becoming niche insurers in areas neglected by the monopoly insurer.

37. Several recent country developments provide examples for some of the problems encountered in introducing competition in the direct insurance market.

38. In Argentina, the privatization of Caja Nacional de Ahorro y Seguro (CNAS) attracted attention because it enjoyed a monopoly on State property and motor insurance, and was the compulsory life insurer for over one million civil servants. Private sector insurers urged the Government to remove CNAS's monopoly rights during the privatization.[17] The Government had postponed privatization to the end of 1993 because of the delay in the completion of the necessary audit for the privatization; meanwhile investors showed only a limited interest and proposed purchasing CNAS at a price substantially below that which the Government expected.[18]

39. In Bangladesh, it was reported in August 1993 that the controller of insurance had approved 40 applications for the establishment of private sector insurance companies. The applications would be reviewed under the conditions of the Revised Insurance Act 1993. For successful privatization of the insurance market, the new private sector insurers must have a sufficient amount of business to write. For this reason the Government has allowed 50 per cent of its risks to be insured in the private market, thus reducing the business volume of the State-owned insurer.[19]

40. In India, in January 1994, the Government Committee appointed to make recommendations on insurance sector reforms, submitted its report. Far-reaching changes of the country's insurance market have been foreseen. Life insurance was nationalized in 1954 and general insurance in 1974. Two public companies were responsible for all insurance business: the Life Insurance Corporation (LIC) for life and the General Insurance Corporation (GIC) for general insurance. The two State insurers had been criticized for charging high premiums, and for being overstaffed and inefficient owing to lack of competition.[20] The report recommended that GIC cease to be the holding company of the four subsidiary public companies, which should thereafter function as independent companies. GIC should stop writing direct business and in future function exclusively as a reinsurance company and as the Indian reinsurer under the Insurance Act. GIC's share capital should be raised; 50 per cent of it should be held by the Government, with the remainder being held by the public at large, including employees of the company. The Government should acquire the total holding in each of the four subsidiary companies and, in order to improve their competitiveness, raise the capital of each of the companies. The Government would hold 50 per cent thereof while the other half would be held by the public at large, including employees of the respective companies. The organization of the four companies should be reviewed in order to reduce excessive staff and the number of hierarchical levels. Extra staff which would become available should be posted to branch offices throughout the country where most of the business is transacted. The report states that "though nationalised companies are in a position to face competition, it is essential that they quickly upgrade their technology, reorganise themselves on more efficient lines and are enabled to operate as truly board-run enterprises."[21] LIC as well should be partly privatized along the same lines, according to the report.

41. So that the partly privatized companies do not become new monopolies, the report recommends that the private sector be allowed to enter the insurance business. No single company should, however, be allowed to transact both life and general insurance business. The number of entrants should be controlled. In order to guard against unserious business, it was proposed to put the minimum capital requirement at a billion rupees. The share of the main investor, the so-called promoter, should be limited to 40 per cent but must not drop below 26 per cent of paid-up capital. In order to prevent the domination by two or three powerful financial groups, any other natural or legal person would be permitted to hold only up to 1 per cent of share capital.[22]

42. As regards entry of foreign insurance companies, the same Committee recommends that this should be done on a selective basis. They should be required to float an Indian company for the purpose, preferably in a joint venture with an Indian partner. The report points out that "regulatory and prudential norms as well as conditions for ensuring level playing fields among insurers should be finalised early so that intending entrants into the insurance business would be aware of the stipulations they would have to comply with. These conditions should aim to ensure that life insurers do not neglect the small man or the rural business and that general insurers have balanced portfolios." Moreover: "Before the private sector is allowed to enter the insurance field, the Controller of Insurance should start functioning effectively."[23]

43. In Sri Lanka, in early 1993, following a debate in parliament, a decision was taken to privatize the Insurance Corporation of Sri Lanka (ICSL), a State insurance monopoly. During the debate on the issue, the finance minister pointed out that since ICSL's nationalization in 1962, it had not been successful in achieving a sufficient business volume and had been plagued by a series of ill-fated investments. Guarantees were given that, regardless of the privatization, the interests of all policy-holders would be upheld.[24]

44. In privatizing a PE monopoly insurer, an often considered but not easily applicable means of achieving truly competitive markets is to split up the portfolio and the obligations of the monopolistic insurer into several relatively equivalent parts; these are taken over by separate companies which then become competitors. This solution was envisaged in Tanzania where the Presidential Commission of Inquiry into the Monetary and Banking System recommended the break-up of the National Insurance Corporation (NIC) into two autonomous companies and the opening of the market to local private and foreign insurers. The development of a capital market was also recommended.[25] In January 1993, the activities of the NIC were decentralized throughout its 20 branches.[26]

(b) State reinsurance monopolies

45. Problems similar to those experienced in the privatization of large PE direct insurers arise in the privatization of State-owned reinsurance companies. In this instance, issues are even more complicated, as reinsurers by their very nature need sizable capital resources; furthermore, small markets will not be able to support more than one reinsurer.

46. In this context, one problem derives from the fact that PE reinsurers often benefit from a de facto State guarantee of their obligations. This enables them to do business on a relatively smaller capital base and sometimes weakens incentives to build up adequate capitalization and sufficient reserves. Privatization of such companies would probably require the infusion of new capital to enable them to take on business without the State guarantee, or at worst to finance their run-off, since new investors would not be willing to buy into a company with heavy obligations. In a number of cases, therefore, the State could not hope to improve its cash situation by selling the reinsurer but would, on the contrary, have to provide new finance.

47. Privatizing a monopoly PE reinsurer is rendered even more difficult by the practice of compulsory cessions on which many reinsurers still depend. In the case of privatization, it would not be in conformity with a market system to leave to the reinsurer the privilege of compulsory cessions, as this would provide undue advantages to one group of investors over others.[27] Conversely, if compulsory cessions were abandoned it is hard to predict how much business the domestic privatized reinsurer would still receive from local companies. Many foreign reinsurers would undoubtedly be more competitive, or offer better terms in order to build up long-term relationships. Having substantial investment income to rely on, they could accept underwriting losses, a policy a developing country reinsurer could not pursue for long. The newly privatized reinsurer might therefore not be able to compete. Thus, in a number of countries, the option of privatizing the domestic reinsurer may not exist, "because he may not be viable without the interventionist measure of legal cessions, which again can only be justified for public companies."[28]

48. Certain developing countries have strong insurance markets where the domestic reinsurer has built up sufficient free reserves, acquired technical expertise to enable him to provide advice and guidance to direct companies, established close business relations with the local insurance community and won the confidence of the market. In this position he may be able to acquire enough business on a voluntary basis. Privatization could be envisaged in such cases.

49. Under such conditions, it might benefit the insurance industry to abandon the practice of compulsory cessions and expose the reinsurer to full competition. Taking away the crutch of compulsory cessions would provide a healthy stimulus for some reinsurance corporations which may have become complacent.

50. Various options have been discussed regarding the privatization of national reinsurance companies. In the case of Kenya, the 1991 annual conference of the Insurance Association resolved that support should be given to private entrepreneurs so that they could set up a properly conceived, managed and capitalized private reinsurance company in the Kenyan market.[29] In discussions on the fate of the public reinsurer Kenya Re, it was suggested that the existing local insurance companies should acquire the shares of the corporation. Thus a type of voluntarily agreed compulsory cessions system could be maintained, possibly adjusted to the number of shares held by the respective companies. An incentive would exist for insurers to give cessions to the commonly-owned reinsurer, and the latter would be encouraged by its shareholders to distribute as much as possible back via retrocessions. To some extent, such a reinsurer would act like a pool. There is in fact a certain similarity between a pool mechanism and a system whereby a national reinsurer collects and redistributes cessions from and to the domestic market. The observation of the Brazilian Insurance Federation that privatization of the national reinsurer could lead to a greater reliance on pools of domestic companies which could eventually take over reinsurance may be of general relevance in such a context.[30]

51. It has been reported, however, that the proposals for the privatization of Kenya Re may be abandoned. This is attributed to the problem inherent in the

fact that the company's monopoly would be transferred intact into private hands. It has also been reported that the legislation protecting State companies has yet to be changed so as to enable a privatization reform and the introduction of a competitive reinsurance market.[31] At the end of 1992, there was reference to new aspirations to form Kenya's first private reinsurer. The initiative was presented by a group of private sector local insurers led by the Corporate Insurance Company. The new reinsurer would aim to complement the services of State-owned Kenya Re.[32]

52. In India, the proposals of the Government Committee on insurance reforms seem to take account of the fact that it can be advantageous for a country to keep the position of the public monopoly insurer basically intact, even if the latter is partly privatized. The Committee recommended that in view of the expertise, experience and goodwill which the General Insurance Corporation (GIC) had built up as a reinsurer, and its financial strength, it should remain the notified Indian reinsurer. The system of compulsory cessions should continue, with statutory cessions of 20 per cent of all insurance business written in India being ceded to GIC. Pointing out that the GIC at present manages fire and marine hull business domestic pools, promotes inter-company cessions, negotiates excess of loss treaties, places facultative cessions in respect of very large risks abroad, and accepts inward reinsurance business on its own account and for its subsidiaries, the Committee proposed that the arrangements should continue even in a liberalized environment, subject to any changes that may become necessary.[33]

53. In Argentina, in 1990, the Government, which had embarked on a general and drastic policy of privatization in almost all economic fields, decreed a liberalization of reinsurance.[34] In June 1991, the Deputy Minister of Economics announced a number of changes in the insurance field, including ending a paternalistic approach to insurance. The State would withdraw from the reinsurance business altogether and end discriminatory treatment of foreign reinsurers, limiting its own functions to solvency control of insurers and consumer protection. Executive branch Decree 171/92 called for a complete liberalization of reinsurance as of 1 January 1992. The Instituto Nacional de Reaseguros (INdeR) would cease its reinsurance activities on 31 March 1992 and would later be liquidated. INdeR's run-off costs (estimated at US$1 billion) would be financed from premium taxes averaging 7 per cent; it was assumed that this process would take at least six years, since many outstanding losses must still be settled by the courts.

54. Such decisions were expected to lead to a profound transformation of the market and modify the current atomized supply. Many companies existed only because INdeR had to provide 100 per cent reinsurance protection on a compulsory basis, irrespective of the quality of the business underwritten by the ceding companies. It also supported the market through other devices that were sometimes actual subsidies. Over the years, these practices led to significant losses for INdeR and weakened its reserves. As a result of the umbrella provided by INdeR, there was an explosive growth in the number of insurance companies. At one point there were more than 300 insurers. Many of them existed because

of the fronting arrangements with INdeR. With negligible net retention, many could be considered as little more than intermediaries between the insured and the reinsurer. These insurers were most vociferous in their defence of the insurance monopoly and INdeR's policies.

55. With reinsurance freedom having become a reality, all insurers doing business in Argentina must now seek private reinsurance. The disappearance of the former State reinsurer has greatly intensified competitive pressures in the market. The formation of groupings, the purchase of domestic insurers by foreign companies and the establishment of foreign reinsurers is creating a strong competitive drive affecting both terms and costs of covers, which may put the whole industry to the test, permitting only the most able to survive. Mergers, consolidations and bankruptcies are predicted, and insurance buyers are advised to pay particular heed to the "caveat emptor" principle.[35] Rates fell after deregulation and the sectors of fire, engineering and marine risks were severely affected as competing insurers wrote business indiscriminately in an attempt to survive the decrease of premium volumes.[36] A group of around 40 to 50 insurers was expected to emerge in control of the bulk of the market, with the 150 or so smaller companies gradually fading away through lack of reinsurance or for other reasons.[37] In addition, a United States company has already opened a subsidiary in the country and two Argentine insurers have applied for and obtained reinsurance licenses, although they have not yet started their activities.[38]

D. Commercialization

56. Privatization, as a recipe for improving efficiency in the insurance sector (and macroeconomic performance) has varying chances of success in different countries, depending on the specific constellation of economic, political and socio-historical conditions. A first step in the complex process of privatization can be the so-called "enterprise level restructuring" or "commercialization" of the State-owned firm(s). Its purpose can be twofold: first, to increase the efficiency of a State enterprise by introducing clearer objectives and performance criteria, as well as an effective monitoring system; and secondly, to increase its attractiveness to private investors in cases where privatization appears desirable and feasible.

57. If the company to be privatized is a loss-making entity and/or one whose long-term viability is not confirmed by rigorous and objective analysis, the Government may not find buyers among domestic investors. Even the sale to foreign investors may not be possible. Hence, commercialization and restructuring of the enterprise under unchanged ownership is often the only viable option, if liquidation is to be avoided.

58. Commercialization implies that the company in question will be managed as a profit-oriented and financially self-sufficient business and will be accountable to the State or some specialized holding institution as its single shareholder. Commercialization may be regarded as a possible option for State-

owned reinsurers which are not considered viable without compulsory cessions from the industry.

59. Commercialization and privatization change the order of priorities for the transformed enterprise. Private or commercial interests gain predominance. Such interest may not coincide with the welfare interests of the State. Since commercialized insurance companies have to perform the traditional functions of bearing and spreading risk, and play the role of an institutional investor, additional social objectives should not be imposed lightly on them. Regardless of their ownership structure, they should be enabled to operate on sound business criteria. Only then will both the long-run viability of the enterprises and the fulfilment of the intrinsic economic and social functions of insurance be sustained.

60. A distinction is usually made between full and partial commercialization. Under full commercialization, an enterprise is usually expected to (a) become financially self-sufficient on a commercial basis, (b) raise funds on the capital market without government guarantees, and (c) free management from government interference.

61. Under a partial commercialization, an enterprise is usually expected to be able to generate enough revenue to cover its operating costs, although the Government may provide capital grants to finance specific projects or investments, including funding for the attainment of general social objectives. If partial commercialization is implemented, care should be taken to keep all budgetary transfers or indirect concessions as transparent as possible. In order to ease the task of assessing the performance of the PEs, it is considered advisable to separate all transfers into the following categories: investment and project financing; funds to cover operating losses; and funds to cover the costs of social objectives. Commercialization requires the implementation of an explicit set of goals and objectives for the firm in question, as well as appropriate control and reward systems for management and staff.

62. In Nigeria two enterprises, the PE reinsurance corporation Nigeria Re and the Government-owned direct insurer NICON (National Insurance Corporation of Nigeria) are to be fully commercialized. The changes involve:

(a) redefining the role of the supervisory ministry to prevent it from interfering in operational issues;

(b) defining the role of the board of directors so as to distinguish its expected contribution from that of the management;

(c) expanding the role of management;

(d) introducing a performance contract to be signed between the supervisory ministry and the board of the enterprise which would define specific operational targets; and

(e) establishing procedures for the appointment and removal of boards of directors, chief executives and management staff.[39]

63. As regards NICON, which does not have the monopoly position enjoyed by Nigeria Re, it has been decided that it should continue to compete openly with the other insurers on the market.

64. A specific mix of market and regulatory reforms that must accompany privatization is also necessary if commercialization is to be implemented. Otherwise, efficiency improvements will be hard to achieve. Commercialized enterprises that remain in a monopolistic position without a market to test and prove their performance may quickly fall back to their previous "business-as-usual" management practices.[40] Therefore, it would generally be useful if when the company was commercialized the market was at the same time opened to allow the establishment of new private companies. Mixed-ownership insurance markets have in fact performed rather well in many developing countries, as the examples of Chile, Egypt, Kenya, Republic of Korea, Malaysia, Mexico, Morocco and Thailand show.

65. In many developing countries embarking on the road to privatization and market liberalization, the fate of the national reinsurer is not yet decided. Both options of privatization and commercialisation are often considered. In other countries, including those with numerous privately owned insurance companies, e.g. Nigeria, the State-owned reinsurer has not been ear-marked for privatization. In the context of the debate on the relative merits of purely private and mixed markets, it is often pointed out that in certain developed countries, private and PE insurers work efficiently side-by-side. This is, for example, the case in France where the leading reinsurer and the three major insurers are still in public hands.

66. Owing to various doubts and hesitations, in Africa no national reinsurer has yet been sold to private interests.[41] However, the direct insurance company SONAGAR of Gabon was sold to the French insurer UAP six years ago and there are expectations that the Société Centrale de Réassurance (SCR) of Morocco might be sold to private interests, mainly local insurance companies, with foreign participation a possibility. In Algeria, the PE insurance companies have acquired the status of shareholding companies.[42] The ownership of both Tunis Re of Tunisia and Sen Re of Senegal is diversified, the largest shareholders being the local banks and insurance companies, but since the shareholders include many companies which are State-owned themselves, one cannot speak of a truly private ownership structure.[43] Nevertheless, such cross-shareholdings may be more important than privatization alone in raising efficiency, since it could ensure a certain control over management.

67. In Latin America some reinsurance markets have been privatized. In Chile, for example, the insurance industry was totally deregulated in 1980, with the objective of reducing the State's participation in the economy. The reinsurance monopoly, which had been held for many years by the Caja Reaseguradora de Chile, was ended and the company transformed into a mixed corporation which then became

a fully private one. Today there are two domestic professional reinsurers operating in Chile: the Caja De Reaseguros De Chile (currently owned by the Spanish MAPFRE Group) and American Re (Chile). There are no limits or restrictions on foreign ownership of insurance and reinsurance companies.[44] In this context, it is interesting to note that even though insurance rates have been considerably reduced, the per capita premium in 1977 was under US$ 3,000, while in 1989 it amounted to more than US$13,600.[45]

68. In March 1991, Peru liberalized its reinsurance market, ending the 23-year reinsurance monopoly of Reaseguradora Peruana.[46] Whereas previously all business relating to domestic reinsurance had to be contracted exclusively through the public reinsurer, insurance companies then became free to place reinsurance with duly registered national or foreign insurance and reinsurance companies. While insurance and reinsurance companies are authorized to form domestic reinsurance systems, they are expected to disclose all necessary information to the office of the superintendent.[47] Reaseguradora Peruana has been offered for sale.

69. It has been reported that the ending of the State reinsurance monopoly was rather too sudden and traumatic for some Peruvian insurers. The local market remains very fragmented, with low minimum capital requirements, and, since Peruvians can now even place direct insurance abroad, domestic companies are being forced very rapidly into line with international standards of services and product quality. Meanwhile, international professional reinsurers are reported to have adopted a cautious attitude, fearing a price war similar to the one experienced in Chile, Mexico and Colombia after deregulation, in which loss and combined ratios deteriorated sharply.[48]

70. In Uruguay, the House of Representatives has approved a bill which gives the executive branch the power to liberalize all reinsurance business which, since 1911, had been virtually monopolized by the public Banco de Seguros del Estado. This move was part of a package aimed at reducing the State monopolies throughout the economy. An Insurance Supervisory Authority was expected to be established. During a transitional period domestic insurers or those with local majority shareholdings would receive certain advantages and would have time to adapt to the new situation.[49]

71. In Brazil, the liberalization of the market and the ending of the reinsurance monopoly of the State controlled reinsurer Instituto de Resseguros do Brasil (IRB) has been under discussion since 1989. Various proposals have been tabled, including one for the ending of IRB's monopoly on domestic reinsurance and for its transformation into a mixed (State/private) capital company.[50] The Institute has argued that this would mean the creation of oligopolies, the disappearance of smaller insurers, and would increase the transfer of premium abroad. So far, the Brazilian market has been noteworthy for its high premium income retention; it is reported that from 1984 to 1989 the retention of the direct market rose to almost 90 per cent of its income. Just over 7 per cent was retained by IRB while a mere 2.8 per cent was ceded abroad.[51]

II. LIBERALIZATION OF INSURANCE MARKETS

A. The Uruguay Round context

72. Privatization and/or commercialization of insurance companies are often undertaken in the context of a general liberalization of the economy and of the insurance sector in developing countries. They can also be the first step towards eventual liberalization. The liberalization of insurance markets is often perceived as a goal in itself. It figured among the objectives of the Uruguay Round negotiations conducted under the auspices of the General Agreement on Tariffs and Trade (GATT) that was concluded in December 1993 with the adoption of the General Agreement on Trade in Services (GATS). Insurance was included in the GATS in the context of financial services.

73. Further, it was agreed that a World Trade Organization (WTO) be established. The WTO would encompass "the GATT, as modified by the Uruguay Round, all agreements and arrangements concluded under its auspices and the complete results of the Uruguay Round."[52] WTO membership would require the acceptance of all Uruguay Round results, without exception. The WTO would establish several subsidiary bodies among which would be a Services Council.

74. In many countries, both developed and developing, insurance markets are subject to a multitude of restrictions and non-tariff barriers which make it difficult for non-domestic companies to do business. The United States International Trade Commission, for example, has identified the following restrictive practices applying to non-domestic companies: the maintenance of State-owned monopolies for insurance and reinsurance; foreigners being prevented from owning majority equity (controlling) shares in a company; denial of the right to invest insurance premiums outside a foreign country and/or restrictions on such investments even within a foreign country; denial of the right to repatriate profits.[53] Additional barriers which have been identified by the European Union include special capital and deposit requirements for foreign insurers and prohibitions against the operation of insurers owned or controlled in whole or in part by a foreign Government or State.[54]

75. The GATS establishes a multilateral framework of rules and principles governing trade in services with a view to the expansion of such trade under conditions of transparency and progressive liberalization and as a means of promoting the economic growth of all trading partners and the development of developing countries. The Agreement recognizes the particular needs of the developing countries, including the need to increase their participation in international trade in services and to expand their services exports, inter alia, through the strengthening of their domestic services capacity and its efficiency and competitiveness.

76. The GATS determines its scope and definition (part I) and contains a set of general obligations and disciplines (part II) that would be incurred by all parties upon their acceptance of the Agreement, relating to most-favoured-nation

treatment, increasing participation of developing countries in international trade in services, transparency and anti-competitive business practices, etc. These are separate from the initial commitments with respect to market access and national treatment that would reflect the result of specific negotiations through the establishment of the Schedules of Concessions. These commit signatories to precisely defined liberalization measures in specific sectors or sub-sectors (part III). They are supplemented by additional modalities for achieving progressive liberalization through future rounds of negotiations to enlarge the scope of the schedules of commitments (part IV).

77. The overall structure of the multilateral framework has been an issue of crucial importance in the negotiations, and the clear separation achieved in the General Agreement between general obligations and specific liberalization commitments was considered essential by the developing countries. It meant that their subscription to the framework would not in itself involve commitments to provide market access in particular sectors; these would be the subject of negotiations where they could offer access commitments with respect to those sectors or sub-sectors in which liberalization would be consistent with their development strategies. Concessions with respect to insurance could be made in this context by interested participants, in return for reciprocal concessions in other sectors.

78. The GATS has universal coverage and includes all four "modes of supply" of traded services, i.e. cross-border movement, movement of consumers, commercial presence and movement of natural persons suppliers of services. It establishes that the movement of persons across national frontiers to supply services constitutes "trade in services" and is thus an appropriate subject for the negotiation of trade concessions. The major issue which has been settled in the Agreement, under Article II, is that most-favoured-nation treatment (MFN) is unconditional and that it is to be treated as a general obligation to extend the benefits of any measure on trade in services from any country to all parties, regardless of whether specific liberalization commitments have been made. Possibilities of exemptions are, however, provided and conditions are defined in the Annex on Article II Exemptions.

79. The inclusion of a clear obligation relating to "increasing participation of developing countries" in Article IV of the GATS was central to these countries' efforts to obtain recognition of the basic "asymmetry" in the situation of services in developed and developing countries respectively. It implies a commitment that the developed countries would take concrete measures aimed at strengthening the domestic services sectors of developing countries and providing effective market access for their exports through negotiated specific commitments. The developing countries, for their part, would endeavour to correct the asymmetry through measures applied to foreign suppliers; the opening of markets to foreign insurers could be made conditional on the latter's acceptance of taking certain steps aimed at strengthening the competitiveness of the domestic insurance sector in general. Measures which might be taken by developing countries to strengthen their services capacity could include arrangements for access to technology, through, _inter alia_, training programmes

or access-to-network conditions imposed on foreign services suppliers, as well as national policy measures for this purpose, including the possibility of subsidizing services sectors. In addition, the GATS will provide for the establishment of contact points to facilitate access to information on commercial and technical aspects of the supply of services, the registration, recognition and obtaining of professional qualifications, and the availability of services technology.

80. The structure of the GATS provides that market access, national treatment and additional commitments are to be negotiated with respect to individual sectors or sub-sectors. The Agreement enables parties to seek liberalization in those sectors and sub-sectors where they possess a comparative advantage and to grant concessions in those sectors where liberalization is judged most compatible with their economic, social and development interests. Thus, developing countries are not required to liberalize their insurance markets. They have indicated their willingness to accept commitments in this area, if these are judged to be consistent with their development goals and if they can obtain reciprocal concessions in other sectors of interest to them. The negotiations on the Financial Services Sector have not yet been concluded and in accordance with the Ministerial Decision, included in the Final Act of the Uruguay Round, these negotiations should conclude no later than six months after the entry into force of the agreement establishing the World Trade Organization.

B. Competitiveness of third world insurance

81. The basic premise of the Uruguay Round negotiations was that the opening up in all countries of services markets, including those of insurance, would provide developing countries with new opportunities for trade expansion and enhance their prospects for economic growth. The principle of market access has two sides: foreign markets are to be opened to a country's own service industry while the country must open its own markets to foreign providers of services.

82. It is sometimes argued that the labour-intensive nature of many services, particularly in respect of their distribution, gives developing countries, with their abundance of low-priced labour resources, a competitive edge. In the case of insurance it is questionable, however, if this asset yields special advantages. The provision of insurance services requires high technical skills and competence in such areas as risk assessment, risk control, loss assessment, actuarial science, etc., which can only be acquired by professional education and/or the proper training. Much of this has to be undertaken in special training institutions whose establishment and operation require resources. Conversely the production of insurance services is not very capital-intensive, since it uses a kind of intermediate technology, and the computerization requirements of the insurance industry do not compare in capital-intensity with those of other industries or even other services sectors. This is an advantage for developing countries with generally small capital resources. However, an evaluation of the particular resources endowment of developing countries and the factor input needs of insurance suggests that, generally, there are no inbuilt

competitive advantages for insurers of developing countries. They are latecomers to markets which value experience and long-term relations and where confidence in the reliability and quality of the services supplied plays a great role. Many developing countries are not strategically located and lack the solid infrastructure necessary for the quick and efficient rendering of insurance services overseas, such as an efficient banking and currency exchange network and easy access to telecommunications.

C. Opening developed country insurance markets

(a) Cross-border trade

83. It appears therefore that developing countries have little or no prima facie advantage from the opening of markets by developed countries for their insurance services. This is true first of all of cross-border trade by primary insurance writers, since physical presence of the insurance provider is usually needed to sell covers, especially for personal and small commercial lines. Trust in the service supplier is an important element in buying insurance protection, particularly for long-term contracts such as life insurance, and consumers have little knowledge about the reliability of foreign companies. In any case, they would normally prefer to buy from a resident company since they would wish to have easy and quick access to pose questions or submit claims. Large commercial covers could theoretically be sold by developing countries through established brokers on developed country markets. The fact is, however, that in such lines, particularly if high value risks are concerned, developing countries are still weak suppliers and often insure their own such risks abroad.

84. As far as reinsurance is concerned, physical presence, while useful, is much less important. Reinsurance has traditionally been much less restricted or affected by regulation than direct insurance; international trade in reinsurance has been relatively free of interventionist measures; many markets that are closed to international trade in direct insurance are open to reinsurance trade. As the concept of reinsurance is based on a wide spread of risks and involves professional players, proximity is no decisive factor. However, despite the openness of markets and the absence of establishment requirements applying to reinsurance, the great majority of developing countries have made hardly any progress as international reinsurance suppliers during the last two decades. This demonstrates strikingly that market access as such is not a sufficient condition for the expansion of developing countries' trade in insurance services. Many other capacities and competences, as well as the right macroeconomic environment, are required to make a supplier competitive on world markets. Since these conditions are rarely met for most developing countries, they are disadvantaged as suppliers on international reinsurance markets.

(b) Establishment trade

85. The granting by industrialized countries of full and non-discriminatory market access for the establishment of insurance companies on their territories

might offer somewhat better possibilities for third world insurers to expand. Clients would be sure that the insurance services they receive from third world companies would conform to home conditions and be regulated by the domestic control authority. Establishment trade, however, requires considerable financial outlays for funding and operating a subsidiary or branch overseas. The capital and/or solvency requirements demanded in developed countries are usually considered high from the point of view of developing country insurers. Furthermore, many such insurers would have difficulty overcoming the formidable competition from well-established, well-capitalized insurers operating on their home territory. Companies of developing countries are already under-capitalized when it comes to insuring the larger risks arising on their own markets; such under-capitalization would be an even greater hindrance on markets where the value of risks is much larger. Accepting only a small number of such risks would be no solution, as this would constitute an unbalanced portfolio necessitating high reinsurance. Insurance companies of developing countries are frequently also lacking in technical skills, which are commonplace in firms of developed countries, and it will take them considerable time to achieve parity in this field.

86. The tendency towards mergers and acquisitions in the insurance industry of developed countries, which is leading to the emergence of many new transnational insurance corporations, is also worsening the competitive prospects of insurers from developing countries. Last but not least, vulnerability to foreign exchange problems affecting operations of insurers and reinsurers, which could prevent developing country insurers from quickly settling large foreign claims that exceed premiums in foreign currency received, reduces their competitiveness decisively. The weak competitive position of developing country insurers is shown by the fact that very few have underwriting offices for reinsurance purposes in London, although it is an important centre for international insurance business.

87. Concessions of market access by the developed countries do not seem at this stage to offer great potential for the insurance industry of the majority of developing countries.

D. Opening developing countries' insurance markets to foreign suppliers

88. For many developing countries, the opening of their insurance markets would imply the dismantling of numerous restrictions placed on both cross-border and establishment trade. The reasons for having set up these restrictions in the first place are manifold; they relate to fiduciary aspects of the trade, infant-industry considerations and to the constraints inherent in the economic structure of developing countries.

89. The fiduciary angle concerns regulations and restrictions for the protection of consumers. The infant-industry argument maintains that newly established domestic insurers should be protected from foreign competition until they are able to compete on a roughly equal footing. This argument may be

extended to justify protection for small companies against large multinational corporations, which enjoy benefits of scale from their extensive global operations and have easy access to the facilities of international financial markets. It is also argued that a high density of insurance companies operating in a market leads to wasteful competition and disadvantages the weaker domestic companies.

90. Macroeconomic reasoning underlies the recognition of the strategic importance of the insurance sector for the mobilization of savings and as an institutional investor, and explains the insistence of Governments that funds generated by insurance operations should be channelled into the local capital market. An important consideration behind the development and protection of the insurance sector in developing countries has been the foreign exchange shortage. Developing country Governments have been adamant in insisting that any unnecessary loss of foreign exchange - either through the purchase of too much foreign insurance/reinsurance or through the remittance of funds abroad by foreign or foreign-owned insurance companies - should be avoided.

91. While foreign exchange savings realized through the activities of domestic insurance companies are difficult to quantify, they may be smaller than expected or claimed, since a substantial part of the exchange saved by the activities of domestic insurers usually flows out for reinsurance. Moreover, when the outflow of foreign currency over the years is balanced against the inflow of claims payments received from abroad, the loss of foreign exchange may not be substantial enough to justify the opportunity costs involved in running and upgrading national insurance corporations. Exchange controls and restrictions may "<u>prima facia</u> have the effect of reducing foreign exchange costs for (insurance) importing countries, but such savings may be wholly or partly offset by foreign suppliers requiring higher premiums to offset any losses they may incur" as a result of delays in premium remittance.[55]

92. The opening of markets poses different problems in cross-border and establishment trade. Regarding the former, the fiduciary aspect creates complex problems since a government has a duty to protect policy-holders from fraudulent and inefficient foreign insurers, which is difficult if not impossible to do in the case of cross-border trade. This applies also to reinsurance, as the insolvency of a reinsurer could start a domino effect upsetting small insurance markets. In this area the fiduciary aspect is, however, less important as commercial companies can be expected to observe the <u>caveat emptor</u> principle better than private consumers. Nevertheless, in recent years great concern has been expressed by developing countries regarding the security of their foreign reinsurance arrangements.[56]

93. Developing countries are not alone in restricting cross-border trade. Many European countries and Japan, despite their highly developed insurance markets, also employ numerous trade barriers. It is significant that even within the European Union, where a long-standing commitment has existed to create a free market in insurance, the liberalization of direct insurance supplied on a cross-border basis has proved difficult, despite the much greater mutual

opportunities involved.[57] But while competitive developed-country insurers have a keen interest in seeing protective barriers diminish in partner countries, and have therefore been somewhat prepared to support an opening of their own domestic markets, insurers of most developing countries would not have the same interest, since they would have difficulty to exploit the potential generated by market access. In reality, insurers from developing countries often circumvent their own countries' barriers to cross-border trade through the practice of fronting for foreign insurers. This means, however, that the price of domestically offered insurance services is augmented by additional administrative and transaction costs to the detriment of insurance consumers, be they local industries or multinational investors.[58]

94. One developing country which has taken important steps towards liberalizing its cross-border trade is the Republic of Korea. Its reinsurance market is to be liberalized in stages leading to a complete opening in 1998. Cross-border trade for export marine cargo covers has been permitted as from January 1993 and for marine cargo imports and aviation as from 1995. Foreign insurers will be permitted to sell motor policies as from April 1993 under the same conditions as domestic insurers and will be allowed to purchase real estate for business purposes.[59] Nevertheless, domestic insurers have expressed apprehension over the possibility of excessive competition and premium dumping, which would be to the detriment of all concerned.[60]

95. As regards establishment trade, the opening of markets on a non-discriminatory basis would require that countries grant entry to foreign insurance companies on the same conditions as those pertaining to domestically-owned companies.

96. Apprehensions regarding the ability of local companies to compete effectively against foreign companies established on their home markets as a local subsidiary or a branch office cannot easily be put aside. Multinational companies could effect a kind of dumping through the income they achieve on their capital funds and by subsidizing initial operations in developing countries from gains in other countries. At times of high interest rates there are indeed special incentives for cash-flow underwriting owing to the high returns on capital; under such conditions short-term underwriting losses may seem acceptable. Even apart from any dumping (whose exact delineation would be complex in the case of insurance), it is indeed difficult to see how companies in developing countries could adapt rapidly to foreign competition when they have neither the same capitalization as foreign companies, nor the same skill basis and technical expertise, nor the foreign exchange resources required in this trade which well-established companies can command. There is, thus, a risk that the advances which domestic companies have made during recent decades might be wiped out by the introduction of a quick and full-scale liberalization of insurance markets. Irreversible losses of capital, labour skills and technological capabilities may be the result.

97. In 1992 the then Managing Director of Africa Re expressed apprehension about the dangers of opening up African markets to the big foreign insurers,

since these could easily absorb most of the relatively small and medium to large risks, leaving very little for the small national insurers. He noted: "...Immediate and full liberalization of insurance trade is bound to quickly marginalize the domestic companies, thus transferring effective control of their markets to the transnationals."[61] A similar situation could develop regarding reinsurance. "The experience of the African Reinsurance Corporation in African markets dominated by foreign interests clearly shows that cessions to African reinsurers will (be) reduce(d) drastically both in volume and quality, increasing the imbalance in their portfolios and their dependence on reinsurance."[62] The latter observation is confirmed by developments in Chile, one of the few insurance markets which already allows an evaluation of liberalization experiences, since the insurance sector was privatized as far back as 1980. As a consequence of this liberalization, the retention level of insurance companies fell substantially, declining from 79.9 per cent of net retained premium in 1979 to 47.7 per cent in 1989.[63]

98. There may therefore be reason to approach the liberalization of insurance with particular caution and to maintain a certain degree of protection for a sector which has been developed at considerable expense and which, since it is geared to the satisfaction of domestic needs, is less dependent on outside influences than, for example, production for exports. It should also be recognized that criteria which prompted the development of the sector, such as the benefits of economic diversification and the strategic role of insurance in the mobilization of savings and in financial intermediation, have not lost their relevance. Concern not to expose this sector to a competition which it could not endure seems therefore legitimate not only from the perspective of the domestic insurance industry but also from a developing country's overall macroeconomic viewpoint.

99. It is also questionable whether the opening of markets to foreign companies (together with a possible abandonment of tariff rating) will necessarily bring about better services and/or prices for domestic consumers, as in smaller insurance markets there is a high probability that strong foreign insurers may enjoy a dominant market position. The initial low premium rates offered to penetrate the market may soon give way to oligopolistic or monopolistic pricing, and consumers may not be better off than before. Many developing countries also fear that subsidiaries of foreign companies may transfer much of the premium income back to their headquarters instead of investing it in the host country, a fear which was often an important motive for the establishment of domestic companies in the first place. As regards advantages to be gained by a possible technology transfer through multinational companies, it has been pointed out that there is no high technology specific to insurance to speak of and that whatever exists is already readily accessible (for example, through acquisition of software and training in its use obtained by direct purchase and/or as part of technical assistance by major reinsurers).[64]

100. Moreover, insurance has certain domestic tasks of a social and welfare nature which foreign companies would not necessarily undertake, unless obliged to do so, which would require new restrictive regulations. Agricultural

insurance is a case in point. While the driving force behind the provision of agricultural covers is often the Government, more and more private insurers of developing countries are making efforts to provide producer and consumer services for rural areas in the realization that in the long run this could open the door for the introduction of a variety of other insurance services to a potentially very large clientele. It is, however, questionable whether foreign insurers would be willing to undertake such long-term development efforts, particularly as this requires a knowledge of the rural areas and their specific conditions seldom available in foreign firms. Domestic companies, public or private, working in protected markets, have often been able to balance initial development losses arising in rural areas with gains from more established and profitable lines. Entry of foreign companies well placed to compete in their customary lines and fierce competition on their traditional markets could deprive them of these more secure sources of revenue, and force them to abandon the costly development of new and initially daunting fields, despite the fact that they would have a long-term competitive edge on such markets.

101. In this context, the following deliberations of the Indian Government Committee on insurance sector reforms are of interest: "In case new entrants come to the general insurance field there is a likelihood that they would concentrate their efforts on the lucrative urban business and may not like to extend their activities to the less profitable rural business, specially non-traditional rural business. This may give rise to a complaint that existing companies who would continue to operate in the rural sector would be placed at a disadvantage vis-à-vis such new entrants. The new entrants may, therefore, be required to undertake a specified proportion of their business as rural non-traditional business. Those who fail to achieve the prescribed requirement in this regard may be subjected to a penal assessment by the insurance regulatory authority."[65] The requirement to do business in rural areas has been assessed by overseas insurers as an important disincentive for establishment in the Indian market.[66] Motor insurance, where tariffs are frequently subject to government approval, is another area which foreign insurers might be hesitant to touch.

102. While such considerations should be borne in mind, it should also be acknowledged that it may sometimes be better to substitute dynamic and competitive markets for inefficient protected ones and to develop and provide insurance covers that include social elements through a subsidization mechanism (for instance through a public agency which provides only agricultural insurance covers) that allows the inherent costs to be clearly registered. Competitive markets may also encourage domestic insurers to seek out new market potentials more energetically and to specialize in areas where competition is less severe, for example in the largely untapped rural insurance markets. Nonetheless, the liberalization of insurance within the European Union demonstrates that the removal of trade barriers is necessarily a lengthy and phased process. It may be argued that provisions should be made for developing countries, particularly those that have nationalized their industries, to proceed at a slower pace. As one specialist noted: "Here is the opportunity for the industrialised nations, which also continue to maintain, and in some instances create new, obstacles to insurance trade, to lead by example."[67]

103. Owing to apprehensions over admitting new foreign and domestic companies, many developing countries while pursuing the deregulation of their insurance markets and the adoption of more liberal conditions for market entry have at the same time taken care to avoid market fragmentation and the creation of possibilities for majority ownership of incorporated insurers by foreign investors. Singapore, Thailand and Malaysia for example, at present do not issue new licences as the size of the domestic markets are deemed not suitable for allowing new insurers.

104. Similarly, the insurance superintendent of Argentina, during a meeting of the International Insurance Council in Washington D.C. in July 1993, explained that the Argentinean Government did not plan to issue any new licenses. Rather, it expected foreign insurers to buy equity interests in domestic insurance companies or to purchase their licenses from them. Furthermore, Argentinean insurers would be allowed to split their general business authorization into separate property/casualty and life/health licenses.[68]

105. Conversely, the Philippines, in 1992, lifted a ban on granting new licences that had been in force since 1966. At the same time, new regulation was issued governing questions of ownership, reserves and capital requirements. While it is expected that this liberalization would ultimately strengthen the market, the insurance sector remained cautious about short-term prospects.[69] In an unsurprising move, the insurance industry, numbering more than 120 companies, addressed the President arguing that only insurers backed by strong foreign interests would benefit from this policy and questioning the prudence of allowing a further fragmentation of the market.[70]

106. Many developing countries are also trying to prevent foreign investors from gaining majority ownership of domestic insurance companies. Foreign equity limits for insurance have been reported to be set in Malaysia (up to 30 per cent), Thailand (up to 25 per cent), Indonesia (up to 80 per cent but all foreign investment into joint ventures must include a plan for a reversion to total Indonesian ownership over time), and the Philippines (up to 40 per cent, but all insurers and reinsurers must invest 25 per cent of the required paid-up capital in government securities). Egypt has waived restrictions concerning foreign shareholding of companies established in its Free Zone, but these companies are restricted from doing business on the domestic Egyptian market.[71]

107. In Mèxico, the foreign equity limit was increased in 1989 from 15 per cent to 49 per cent. Following the NAFTA agreement, Mexico would allow insurers from Canada and the United States of America which already have an equity stake in a local insurer to attain full ownership of their ventures by 1996. New joint ventures will be allowed a 30 per cent non-Mexican equity participation at the outset, which will be augmented to 51 and 100 per cent in 1998 and 2000, respectively.[72]

E. The Uruguay Round negotiations

108. Negotiations on an initial set of liberalization commitments among parties to an eventual multilateral agreement concluded on 15 December 1993, with participating countries making specific offers with respect to market access and national treatment and requesting concessions from their trading partners. Offers constituted essentially commitments to "maintain or improve current levels of openness of market access and operating conditions."[73] In this context, negotiated concessions were set out in each country's schedule of liberalization commitments and have become an integral part of the final agreement. About 50 countries have been advancing liberalization commitments in one or more sub-sectors of insurance, as defined in the Annex on Financial Services, while almost all countries have listed reinsurance and retrocession, thereby recognizing their international character. However, most countries chose not to offer market access to their life insurance sector in realization of its close relationship with the domestic savings and investment complex.[74] The OECD countries' offers were made in the context of their acceptance of the Understanding on Commitments in Financial Services, an integral part of the GATS, described below.

109. Two special provisions of the GATS dealing with financial services apply to insurance. The first is the Annex on Financial Services, which is an integral part of the agreement and which covers all insurance and insurance-related services: direct insurance (life and non-life); reinsurance; insurance intermediation, such as brokerage; and auxiliary services, such as actuarial, risk assessment and claims settlement services. In the Annex, the right of each country to domestic regulation is recognized. A country party to the Agreement must not be prevented from taking measures for prudential reasons, in order to protect policy-holders, investors, depositors or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial system. It is explicitly stated that such measures should not be used as a means of avoiding commitments or obligations under the Agreement, that is, they should not be used for protectionist purposes.

110. The second provision applying to insurance is an Understanding on Commitments in Financial Services. The Understanding provides a special framework for parties to the Agreement to undertake a phased liberalization involving more onerous obligations. Liberalization measures specified under the Understanding relate to standstill, market access, cross-border trade, commercial presence, new financial services, temporary entry of personnel, non-discriminatory measures, and national treatment. Articles 3(a) and 3(b) specifically refer to cross-border trade in insurance. They ascertain that non-resident insurers have to be permitted to supply, as a principle, an intermediary or through an intermediary, several categories of insurance, namely: maritime shipping and commercial aviation and space launching and freight, hull cargo and liability insurance, and the insurance of goods in international transit. As regards establishment trade, Articles 5 and 6, under the heading of Commercial Presence, are entirely relevant to the insurance sector. The commitments implied by acceptance of the Understanding would apply to all parties to the Agreement on Services according to the MFN principle. This is an important point for

developing countries since parties (notably developing countries) making commitments on insurance in their schedules, rather than by accepting the Understanding, would nonetheless benefit from the greater liberalization of insurance markets granted by countries in the context of the Understanding.

111. The ongoing negotiations on liberalization commitments are considered by some developed countries to be of considerable significance and the view is sometimes taken that "the agreement on the framework and sectoral annexes would have little operational value in the absence of commitments to liberalize on the part of all signatories"[75] and that a Services Agreement is productive only if substantial liberalization commitments are made. Insurers, particularly those of the United States of America, have been pointing out that multilateral trade liberalization is not the only way in which many of the goals of market access and liberalization can be achieved. It has, for example, been argued that "The U.S. holds a powerful unilateral instrument for opening foreign markets to fair competition through use (or threatened use) of the Section 301 provision of its Trade Act. This has already shown its effectiveness, for example, with regard to the (Republic of Korea's) insurance market."[76] It has also been reported that as regards India, where the State-owned General Insurance Corporation (GIC) holds a monopoly position and controls all insurance, the United States of America in 1992 instituted a "Super 301" trade action in order to persuade the country to open its insurance market. Action was, however, postponed pending the outcome of the Uruguay Round negotiations.[77] After the finalization of the GATS, officials of the United States of America are reported to have remarked that section 301 would be used in unilateral efforts to compel market access in countries claiming MFN exemption. Other parties to the agreement commented that MFN exemptions, governed by the Annex on Article II Exemptions, are an integral part of the GATS and should be protected from unilateral action.[78]

F. Options for developing countries

112. Many developing countries have already deregulated their insurance sector in the context of structural adjustment programmes and partly in response to pressures from donor countries. The GATS provides for a mechanism that will allow them to obtain "credit" for such liberalization in terms of market access in other sectors, or of special conditions from foreign insurers, while protecting them from the bilateral approaches described above.

113. For many developing countries whose insurance sector has progressed well, the opening of markets, together with a relaxation of internal restrictions, would be both feasible and useful, as the stimulating effects of competition on innovation and efficiency would be beneficial to insurance and other sectors of their economy. More open markets may attract both additional domestic and foreign investment into insurance, particularly if such access is "bound" in the Uruguay Round.[79] The question may be raised why these benefits could not be secured by unilateral decisions of individual developing countries to liberalize their insurance markets, rather than within a multilateral framework which might limit developing countries' room to manoeuvre and create obligations which they

could otherwise avoid. The structure of the GATS agreement may, however, have allayed concerns of developing countries that they might be obliged to liberalize sectors where they did not consider this consistent with their development needs. The Agreement will enable them to select those sub-sectors where liberalization is judged most desirable as subjects for inclusion in their lists.

114. Generally, a well-planned step-by-step approach is advisable to make insurance liberalization a success. This should be accompanied, or even be preceded, by selective incentives that support the search for competitiveness by the companies exposed to foreign competition, and by congruent wider policy measures to create a favourable climate for expansion and growth. It is frequently argued that "the most speedy progressive lowering of trade barriers could be achieved by first concentrating on those classes of insurance business where consumer protection is of the least importance and which are of greatest significance for promoting economic growth. Reinsurance, trade-related insurances, and the insurances of very large-scale risks (especially those of multinational enterprises) and major construction and engineering projects, fall into that category."[80]

115. Of particular importance is the creation, prior to liberalization, of an appropriate insurance legislation, which takes due account of the characteristics of individual countries. Liberalized insurance markets require stricter control and more comprehensive supervisory regulation than do restricted markets.[81] As a consequence of this realization, a considerable number of developing countries have in recent years made important changes in their insurance legislation and regulation. One example is Venezuela where the law governing insurance and reinsurance companies is being modified. Once adopted, it will allow a gradual liberalization of the insurance sector that would grant national treatment to wholly or partially foreign owned insurers within less than five years and will also give its insurance companies access to foreign investment. Other examples of a gradual implementation of liberalization reforms are the Republic of Korea (see para. 94.) and Uruguay (see para. 70.). Peru has also introduced major changes in its insurance regulation (see para. 68.). Subsidiaries of foreign insurance companies are now subject to the same requirements that are imposed on national insurers and may conduct all types of operations proper to the insurance field.[82]

116. In addition to adaptations of insurance legislation and regulation, Government support for insurance training, including high-level training, would be decisive for the success of a liberalization of insurance markets, inasmuch as it would ensure that domestic enterprises could recruit locally the qualified manpower required in an internationally competitive environment. As liberalization will increase the role of insurance supervisory offices and since their staff will be required to oversee increasingly complex operations, it is particularly important that Insurance Supervisory Offices are strengthened, and that they are enabled to recruit and retain qualified manpower in order to assure an adequate and efficient control.

117. Other measures to be considered in support of liberalization would be the provision of long-term finance on favourable terms and the granting of tax incentives, so that companies can increase free reserves and have more capital at their disposal for an expansion of their capacity. Domestic companies should also not be heavily disadvantaged in terms of foreign currency availability nor as regards rules for the investment and placement of funds. While the laws that allow foreign insurers to enter the market can be relatively quickly adopted, an improvement of the insurance environment so that it provides fair competitive possibilities for both local and foreign insurers takes far more time. In many countries, structural changes of insurance markets will be very difficult to bring about before greater macroeconomic stability has been attained. Insofar as obligations concerning insurance services are entered into under a GATT framework, the invocation of safeguards and exception clauses might therefore be necessary for certain periods until the most basic supportive measures that should accompany a liberalization can be introduced. However, protective measures should be limited in time and be well-targeted, since it is very costly to protect permanently a sector which fails to become competitive.[83]

118. It is also important that the insurance sector of each individual developing country be well aware of the likely long-term benefits of liberalization, as well as the potential problems and costs associated with it. In such an evaluation, not only narrow sectoral effects but also the wider economic implications have to be taken into consideration. Once the sector has arrived at policy conclusions it should make its viewpoint clear to the Government and underscore its position with well-framed arguments. There is a certain risk that the GATS will prompt concessions at the expense of a sector which has not been able to make its economic contribution and development potential sufficiently clear to the Government and the public administration. While from the point of view of the Government, which has to take the overall economic interest of the country into account, the granting of concessions in one area for benefits in other areas is legitimate, the insurance industry must ensure that the Government is well briefed on what is at stake as regards the insurance sector and on the wider economic and political role the latter could play. Only on that basis can the Government make choices which take the interests and potential contributions of all sectors duly into account. The responsibility for arguing its case conclusively and consistently lies with each country's insurance sector itself and cannot be delegated. National insurance associations and regulatory offices have an important responsibility in this respect.

119. It must be acknowledged that the comprehensive nature of the GATT negotiations has made it difficult for members of the insurance sector to follow them closely and to argue their case at the right time. There is a danger that concessions in insurance may be granted too quickly, or, conversely, that a liberalization of the industry, which would be advisable for economic reasons and for which there is wide domestic support, may be retarded in order to conserve bargaining chips for the negotiations.

120. Many insurers from developing countries where the insurance sector is more advanced have expressed support for greater competition. Even if a country ultimately decided not to make concessions in the insurance sector during the Uruguay Round, adherence to the General Agreement on Trade in Services and its provisions for progressive liberalization may encourage it to evaluate critically the restrictions affecting its insurance markets and to abandon a number of unnecessary constraints. Such liberalization measures could be included in the list of concessions submitted in the future.

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