Distr.
GENERAL

UNCTAD/SDD/INS/3
19 January 1993

Original: ENGLISH

UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

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

Report by the UNCTAD secretariat

GE.93-55122

TABLE OF CONTENTS

INTRODUCTION

The eighth session of UNCTAD held in Cartagena in February 1992 gave a new direction to the work of UNCTAD which is being expressed in the Cartagena Commitment. It was decided to suspend the existing main Committees of the Trade and Development Board, including the Committee on Invisibles and Financing related to Trade (CIFT), one of whose two sessions was devoted to insurance. The work on insurance was to be incorporated in the newly-created Standing Committee on Developing Services Sectors: Fostering Competitive Services Sectors in Developing Countries. In implementing the decisions of UNCTAD VIII, the second part of the thirty-eights session of the Trade and Development Board adopted the new terms of reference of the Standing Committee.

For insurance paragraph 4 of these terms of reference apply, which asks the Committee "to analyse prospects for developing and strengthening the insurance sector and enhancing the trade of developing countries in this sector." In addition, paragraph 2(b) is of relevance according to which the Committee should focus on "the impact of progressive liberalization in the development of competitive service sectors". Paragraph 5 of the terms of reference states that "the Committee... should pay due attention to the role of services in market oriented development, including issues related to privatization and deregulation". The report presents a first discussion of some of the issues involved in privatization of insurance enterprises and liberalization of insurance markets, both of which have had a profound impact on insurance markets of developing countries.

I. PRIVATIZATION OF INSURANCE ENTERPRISES

A. MOTIVES FOR PRIVATIZATION

1. In recent years, privatization in the insurance and reinsurance sectors has been part of policies pursued by numerous governments in developing countries in order to redefine the role of the state and to increase the efficiency of economic activities.

2. 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 has 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.

3. Although there are numerous examples of well-performing PEs, in recent years many PEs in developing countries have come under attack 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. The 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.

4. Privatization is often undertaken in the context of structural adjustment programmes or stabilization reforms which are a component of IMF conditionality or a precondition for obtaining World Bank loans. 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.

5. In the insurance sector in 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 <u>Argentina</u>, <u>Benin</u>, <u>India</u> and <u>Zaire</u>. <u>1/</u>

6. 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 a 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 and 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 be used 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 which leads in the long run to 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.

7. 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." 2/

8. 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.

9. Many PE insurers are asked to engage in insurance for the rural and marginalised urban population 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 on a sometimes 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 in other lines.

10. 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 such as:

- 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.

11. Furthermore, micro-economic profitability does not necessarily imply macro-economic benefits. Some of the social objectives which are now pursued by public enterprises in the field of insurance would be left unattended in their absence. Their assumption by public enterprises 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 macro-economic interest of the country and may also increase 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 focusses on macro- rather than micro-economic returns. However, the problem is that the assumption of the related costs makes an evaluation of public enterprises 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 easily taken by governments and the public as evidence of bad management in public companies.

12. 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, the implementation of such policies is often encountering problems.

B. PROBLEMS ASSOCIATED WITH PRIVATIZATION

(a) <u>Mobilization of capital</u>

13. The privatization process, as well as 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 was one of the reasons why many developing countries established State-owned companies in the first place.

14. The concept of raising capital through equity would be a preferred option in many developing countries. This approach would require a working capital market and adequate financial infrastructure. But while many developing countries are planning to establish stock markets, achieving satisfactory performance of these markets usually takes considerable time. Also, 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. 3/ The lack of a developed financial market, for example, has been openly recognised to be a major obstacle to implementing privatization in the insurance sectors of Guinea and Pakistan. 4/

15. 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. 5/ 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.

16. 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 - is uncertain to materialize in practice. 6/ Hence, fostering the development of bank-based financing systems could be a suitable option for developing countries.

(b) Insurance as a strategic sector

17. In many developing countries the State hopes 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 local insurance sectors that in many cases the majority interest in these companies will be acquired by foreign insurers. Apprehension has also been voiced that due to the present low asset value of many of the public companies concerned they are sold at prices which do not take the long-term value of the insurance portfolio and the business opportunities into account. As a consequence local business interests may be excluded from a domestic service market which may be promising and lucrative in the long term.

18. 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 share-holding 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 ensure, however, that it does not gain majority influence.

19. In addition, the State may not be willing to refrain completely from influencing the insurance industry, considering its strategic importance for capital formation and resource mobilization. An interesting approach of relevance to this 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 fourteen 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. The share is of insignificant value and brings no dividend but it 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. 7/

(c) Market structure

20. 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 and the environment which shapes its 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.

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

22. But creation of competition may not be enough. Since the functions of manager and capital owner are often separated, managers are not necessarily very closely linked to the success of an enterprise. Management salaries are often paid irrespective of the results achieved, and management contracts may foresee 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. Managers of private firms are also not free of clientelism and political aspirations and not immune to the temptations of corruption.

23. 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. 8/ 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 uncommon. 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 a control would depend on the financial structure of the developing country concerned. 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. 9/

24. 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.

25. In order to avoid 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 therefore be in place once monopolistic firms are privatized. The regulatory and legal framework should be clear 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.

26. 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. Already at present one of the 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 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 oversupply.

27. Once adopted, the regulations must be consistently applied, which 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.

28. 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.

29. The experiences of a number of developing countries, for example Chile, Colombia and Mexico, show that even if competitive markets are quickly established, and management skill is exercised, it is questionable whether the privatization of the insurance sector will immediately enhance efficiency and company profitability. 10/ A decline in profitability may be encountered by private insurers in the initial period after privatization and the 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 increased advertising may enhance the public's claims consciousness and lead to more claims.

C. STATE INSURANCE MONOPOLIES AND PUBLIC ENTERPRISE REINSURERS

(a) State insurance monopolies

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

31. Even if privatized, the existence of a large and market dominant company may preclude the emergence of a healthy competition. The State insurance companies have often 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 will abuse the confidence of consumers and lead to a great loss of credibility for the insurance industry as a whole. New insurers could, however, specialize in certain fields or become niche insurers in areas which may have been somewhat neglected by the monopoly insurer.

32. 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 is reported to be envisaged in Tanzania where the Presidential Commission of Inquiry into the Monetary and Banking System

recommended the break-up of the National Insurance Corporation 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. 11/

(b) State reinsurance monopolies

33. Problems similar to those experienced in the privatization of large PE direct insurers are posed when the privatization of State-owned reinsurance companies is examined. The issues here are even more complicated as reinsurers by their very nature need sizable capital resources and smaller markets will not be able to support more than one reinsurer.

34. In this context one problem is that PE reinsurers often benefit from a de facto State guarantee of their obligations. This has enabled them to do business on a relatively smaller capital base and has sometimes taken away incentives to build up an adequate capitalization and sufficient reserves. Privatization of these companies would often require the infusion of new capital to enable them to take on business without the State guarantee, or at worst to finance their runoff, 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.

35. The problems of privatizing a monopoly PE reinsurer are made even more difficult by the practice of compulsory cessions on which many of them still depend heavily. 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; this would provide undue advantages to one group of investors over others. 12/ Conversely, if compulsory cessions are abandoned it is uncertain how much business the domestic privatized reinsurer would still receive from local companies. Many foreign reinsurers would undoubtedly be more competitive, or would offer better terms in order to build up long-term relationships. Having substantial investment income to rely on, many are prepared to accept underwriting losses, a policy a developing country reinsurer could not pursue for long. Such a 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. 13/

36. There are certain developing countries with 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, won the confidence of the market, and has established close business relations with the local insurance community. This may provide him with the position to acquire enough business on a voluntary basis. Privatization could be envisaged in these cases.

37. It is to be considered whether under such conditions it would not 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 too complacent.

38. Various options have been discussed regarding the privatization of national reinsurance companies. In the case of Kenya, the 1991 meeting of its 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. 14/ In the discussions on the fate of the public reinsurer Kenya Re it was also suggested that the existing local insurance companies should acquire the shares of the corporation. In this case 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 the 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. In this context the observation of the Brazilian Insurance Federation that privatization of the national reinsurer could lead to a greater reliance on pools of domestic companies who could eventually take over reinsurance may be of general relevance. 15/

39. However, it has been reported 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 in order to make possible a privatization reform and the introduction of a competitive reinsurance market. 16/

40. 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. 17/ In June 1991, the Deputy Minister of Economics announced a number of changes in the insurance field, including the end of the State's paternalistic approach to insurance. The State would withdraw from reinsurance business altogether and end the discriminatory treatment of foreign reinsurers, limiting its own functions to solvency control of insurers and consumer protection. The executive branch Decree 171/92 called for a complete liberalization of reinsurance beginning 1 January 1992. The Instituto Nacional de Reaseguros (INdeR) was to cease its reinsurance activities on March 31 and later be liquidated. INdeR's runoff costs (estimated at US$ 1 billion) will be financed from premium taxes averaging 7 per cent; it is assumed that this process will take no less than six years, since many outstanding losses must still be settled by the courts.

41. It is expected that these decisions will lead to a profound transformation of the market, which will modify today's 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 retentions, and 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.

42. 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 to the test the whole industry, 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 . 18/ It is expected that a group of around 40 to 50 insurers will 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. 19/ In addition, a U.S. 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. 20/

D. COMMERCIALIZATION

43. Privatization, as a recipe for improving efficiency in the insurance sector (and macro-economic performance) has varying chances of success in different countries, depending on the varying constellations 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.

44. If the company which is 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 find divestiture problems compounded. Even the sale to foreign investors may not be possible. Hence, commercialization and restructuring of the enterprise under unchanged ownership often presents itself as the only viable option if liquidation is to be avoided.

45. 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. It can be regarded as a possible option for State-owned reinsurers which are not considered viable without compulsory cessions from the industry. Commercialization and privatization change the order of priorities for the transformed enterprise. Private or commercial interests often do not coincide with the welfare interests of the State. While 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 and they should be enabled to operate on sound business criteria, regardless of their ownership structure. Only then will both the long-run viability of the enterprises and the fulfillment of the intrinsic economic and social functions of insurance be maintained.

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

47. Under a partial commercialization it is usually expected that an enterprise will be able to generate enough revenue to cover its operating costs, although the Government may consider providing 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.

48. 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.

49. In <u>Nigeria</u> 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 it 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. <u>21</u>/

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

51. The constellation 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 and are without a market to test and prove their performance may quickly fall back to previous 'business-as-usual' management practices. 22/ Therefore it would generally be useful if, when the company was commercialized, the market were 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.

52. 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 many countries with numerous privately-owned insurance companies like Nigeria, the State-owned reinsurer is not considered 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 next to each other. This is for example the case in France where the leading reinsurer and the three major insurers are in public hands.

53. Owing to various doubts and hesitations, in Africa no national reinsurer has yet been sold to private interests. 23/ 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. 24/ 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. 25/ Nevertheless, such cross-shareholdings may be more important than privatization alone in raising efficiency, since it could ensure a certain control over management.

54. In Latin America on the other hand, 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 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 concerning foreign ownership of insurance and reinsurance companies. 26/ 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. 27/

55. In March 1991 Peru liberalized its reinsurance market, ending the 23 year reinsurance monopoly of Reaseguradora Peruana. 28/ Whereas previously, all business relating to domestic reinsurance had to be contracted exclusively through the public reinsurer, insurance companies are now free to place reinsurance with duly registered national or foreign insurance and reinsurance companies. Insurance and reinsurance companies are authorized to form domestic reinsurance systems, but they are supposed to disclose all necessary information to the office of the Superintendent. 29/ Reaseguradora Peruana has been offered for sale.

56. It has been reported that the ending of the State reinsurance monopoly has proved 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 place even 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. 30/

57. 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 has been virtually monopolized by the public Banco de Seguros del Estado. This move is part of a package aimed at reducing the State monopolies throughout the economy. An Insurance Supervisory Authority is to be established. A transitional period will be introduced during which domestic insurers or those with local majority shareholdings would receive certain advantages and would have time to adapt to the new situation. 31/

58. 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. 32/ The Institute has argued that this would mean the creation of oligopolies and the disappearance of smaller insurers, and increase the transfer of premium abroad. So far the Brazilian market has indeed 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. 33/

II. LIBERALIZATION OF INSURANCE MARKETS

A. THE URUGUAY ROUND CONTEXT

59. 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 first steps towards a later liberalization. While the liberalization of insurance markets is often perceived as a goal in itself, it is also among the objectives of the Uruguay Round negotiations being conducted under the auspices of the General Agreement on Tariffs and Trade (GATT). These negotiations include trade in services and insurance has been included in the context of financial services.

60. 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; preventing foreigners 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. 1/ Additional barriers which have been identified by the European Community include special capital and deposit requirements for foreign insurers and prohibitions on the operation of insurers owned or controlled in whole or in part by a foreign Government or State. 2/

61. The draft General Agreement on Trade in Services (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 draft 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.

62. The GATS contains a set of general obligations and disciplines that would be incurred by all parties upon their acceptance of the Agreement (Parts I and II), 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, which commit signatories to precisely defined liberalization measures in specific sectors or sub-sectors (Part III). These 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).

63. The overall structure of the multilateral framework has been an issue of crucial importance in the negotiations, and the clear separation achieved in the draft 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 in return for reciprocal concessions by interested participants.

64. 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 draft Agreement 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 current negotiations are aimed at circumscribing the scope of derogations from MFN.

65. The inclusion of a clear obligation relating to "increasing participation of developing countries" in Article IV of the GATS was central to the developing 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 on their side would endeavour to correct the asymmetry through measures applied to foreign suppliers; the opening of markets to foreign insurers could be made conditional on their accepting to take 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.

66. The structure of the draft 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.

B. COMPETITIVENESS OF THIRD WORLD INSURANCE

67. The basic premise of the Uruguay Round negotiations is 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 it has to open its own markets to foreign providers of services.

68. 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. On the other hand 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 service 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 on markets which value experience and long-term relations and where confidence in the reliability and quality of the services supplied play a great role. Most developing countries are also not in any way 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) <u>Cross-border trade</u>

69. It appears therefore that developing countries have little or no <u>prima facie</u> 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 for questions or for submitting claims. Large commercial covers could theoretically be sold by developing countries through established brokers on developed country markets, but in such lines, particularly if high value risks are concerned, developing countries are still weak suppliers and often insure their own risks of this type abroad.

70. 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 and 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 macro-economic environment, are required to make a supplier competitive on world markets. Since these conditions are not met for most developing countries they are disadvantaged as suppliers on international reinsurance markets.

(b) <u>Establishment trade</u>

71. 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 domestic 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, there is little reason to expect that developing countries companies can overcome the formidable competition from well-established and well-capitalized insurers operating on their home territory. Companies of developing countries are already undercapitalized when it comes to insuring the larger risks arising on their own markets; their undercapitalization is all the greater a 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 that would require 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. 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 worsening

further the competitive prospects of insurers from developing countries. Last but not least, vulnerability to the foreign currency problems by which the operations of insurers and reinsurers are often affected, and which could prevent developing country insurers from paying quickly large foreign claims which exceed premiums in foreign currency received, reduces the competitiveness of the latter decisively. The weak competitive position of developing country insurers is shown by the fact that only very few have underwriting offices for reinsurance purposes in London, although it is an important centre for international insurance business.

72. Therefore 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

73. 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. Reasons for having instituted 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.

74. 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 is usually 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.

75. Macro-economic 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 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. While foreign exchange savings realized through the activities of domestic insurance companies are difficult to quantify, they may be smaller than expected and claimed since a substantial part of the exchange saved by the activities of the domestic insurer has been flowing 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.

76. 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 its 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 have a domino effect on small insurance markets. But in this area the fiduciary aspect is less important as commercial companies can be expected to observe the caveat emptor principle better than private consumers. Nevertheless great concern has in recent years been expressed by developing countries regarding the security of their foreign reinsurance arrangements. 3/

77. 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 Community, 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. 4/ But while competitive developed country insurers have a keen interest in seeing protective barriers diminished in partner countries, and have therefore been more prepared to support an opening of their domestic markets, insurers of most developing countries would not have the same interest.

78. One developing country which has taken important steps for liberalizing its cross-border trade is the Republic of Korea. Its reinsurance market is to be liberalized in stages leading to a full opening in 1998. Cross-border trade for export marine cargo covers will be 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 Korean insurers and will be allowed to purchase real estate for business purposes. 5/

79. 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.

80. Apprehensions regarding the ability of local companies to compete effectively against foreign companies established 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 due 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 foreign 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.

81. The Managing Director of Africa Re has 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. "... 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." 6/ 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 reduce drastically both in volume and quality, increasing the imbalance in their portfolios and their dependence on reinsurance." 7/ 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, 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. 8/

82. 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. Criteria which prompted the development of the sector, such as the usefulness 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 an overall macro-economic viewpoint.

83. 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, a fear which was an important motive for the establishment of domestic companies in the first place. As regards a possible technology transfer through multinational companies, it has been pointed out that there is no high insurance technology to speak of and that whatever exists is already readily accessible (through acquisition of software and training in its use obtained by direct purchase and/or as part of technical assistance by major reinsurers). 9/

84. Moreover, insurance has certain domestic tasks of a social and welfare nature which foreign companies would not necessarily undertake, except if obliged to, which would require new restrictive regulations. Agricultural insurance is a case in point. Although 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 their more secure sources of revenue, and force them to abandon the costly development of new and initially not promising fields, despite the fact that they would have a competitive edge on such markets. Motor insurance is another area which foreign insurers might not want to touch.

85. While such considerations should be taken into account, it should also be acknowledged that it could 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 (e.g. a public agency which provides only agricultural insurance covers) that allows the costs involved 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.

86. Owing to apprehensions connected with the admittance of 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 a 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 it is deemed that the size of the domestic markets does not allow for new insurers. Foreign equity limits for insurance have been reported to be set in Malaysia (up to 30%), Thailand (up to 25%), Indonesia (up to 80% but all foreign investment into joint ventures must include a plan for a reversion to total Indonesian ownership over time), Mexico (where the foreign equity limit was increased in 1989 from 15% to 49%), and the Philippines (up to 40%, but all insurers and reinsurers must invest 25% 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. 10/

E. PROGRESS IN THE URUGUAY ROUND NEGOTIATIONS

87. Negotiations on an initial set of liberalization commitments among parties to an eventual multilateral agreement were undertaken in 1992 with participating countries making specific offers with respect to market access and national treatment and requesting concessions from their trading partners. Offers constitute essentially commitments to "maintain or improve current levels of openness of market access and operating conditions." 11/ In this context, negotiated concessions will be set out in each country's schedule of liberalization commitments and become an integral part of the final agreement. About 30 parties (counting the EC as one) have so far made offers in the field of insurance, including many developing countries. The OECD countries' offers have been made in the context of their acceptance of the "Understanding" described below.

88. 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 claim settlement services. In the Annex, the right of each country to domestic regulation is recognized. A country party to the Agreement shall 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. But it is explicitly stated that such measures should not be used as a means of avoiding commitments or obligations under the Agreement, i.e. that they should not be used for protectionist purposes.

89. The second provision applying to insurance is an Understanding Relating to Financial Services, Article 3 of which refers to insurance. The Understanding provides a special framework for parties to the negotiations to undertake a phased liberalization involving more onerous obligations. It covers most (although not all) categories of insurance. 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 none the less benefit from the greater liberalization of insurance markets granted by countries in the context of the Understanding. 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.

90. 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" 12/ and that a Services Agreement would be acceptable only if substantial liberalization commitments are made. Insurers, particularly those of the United States, are 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. "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 Korean insurance market." 13/ 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 has, however, been postponed pending the outcome of the Uruguay Round negotiations. 14/

F. OPTIONS FOR DEVELOPING COUNTRIES

91. 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 special conditions from foreign insurers, while protecting them from the bilateral approaches described above.

92. 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. 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. 15/ The structure of the GATS agreement may, however, have allayed the concern 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.

93. 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 efforts of the companies exposed to foreign competition, and by congruent wider policy measures to create a favourable climate for expansion and growth.

94. 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 restricted markets. 16/ 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 78.) and Uruguay (see para 57.) Peru has also introduced major changes in its insurance regulation (see paragraph 55). 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. 17/

95. 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.

96. 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 and 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 a greater macro-economic stability has been reached. 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. But 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. 18/

97. It is also important that the insurance sector of each individual developing country is well aware of the likely long-term benefits, as well as the potential problems and costs associated with liberalization. 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 in the Uruguay negotiations concessions may be made 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 bureaucracy. 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, so that it can make a choice which takes the interests and potential contributions of all sectors duly into account. The responsibility for arguing its case conclusively and consistently lies with the insurance sector itself and cannot be delegated.

98. It must be acknowledged that the comprehensive nature of the GATT negotiations makes 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, and, 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.

99. Many insurers from developing countries where the insurance sector is more advanced have expressed support for greater competition, irrespective of what may be negotiated in the Uruguay Round. 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 in future rounds may encourage it to critically evaluate 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 future rounds.

Bibliographical Notes on Privatization (paragraphs 1-58)

1/ L'Argus, 18.08.1989; L'Argus, 26.04.1991; The Review, March 1990, p. 34.

2/ UNCTAD Trade and Development Report, United Nations, New York, 1992, p. 131.

3/ Henry Bienen and John Waterbury, "The Political Economy of Privatization in Developing Countries", World Development, Vol. 17, No. 5, 1989, p. 620.

4/ Raphael Yomba Touré, "Note sur le secteur de l'assurance en République de Guinée", report submitted at the African Insurance Reassessment Workshop, Casablanca, 8-11 October, 1990; South, May 1991, p. 52.

5/ Henry Bienen and John Waterbury, op.cit., p. 617.

6/ Ajit Singh: "The Stock Market and Economic Development: Should Developing Countries Encourage Stock Markets?", UNCTAD Discussion Paper No.49, October 1992, p. 24.

7/ F.C. Nwokolo, "Privatization of the Insurance Industry", paper presented to the 19th AIO Conference, Nairobi, Kenya, 1992, p. 14.

8/ V. Bhaskar, "Privatization and the developing countries: the issues and the evidence", UNCTAD Discussion Paper No. 47, August 1992, p. 4..

9/ For a more detailed description of different systems of financial organization see Yilmaz Akyüz, "On Financial Deepening and Efficiency", UNCTAD Discussion Paper No.43, January 1992, pp. 18-24.

10/ World Insurance Report, No. 420, 13 September 1991, p. 4.; World Insurance Report, No. 376, 24 November 1989, p. 2.

11/ ReActions, December 1990.

12/ William Olotch, "The Role of National, Sub-regional and Regional Reinsurance Organisations", paper presented at the 19th AIO Conference, Nairobi, Kenya 1992, p. 18.

13/ Marion Gallis-Quednau: "State Intervention in Reinsurance Activities - Motives and Form", Reinsurance Market Report, 13 August 1991, p. 20.

14/ The Insurance Institute of Kenya: Sixth Annual Conference Resolutions, Resolution No. 4, p. 3.

15/ World Insurance Report, No. 361, 28 April 1989, p. 8.

16/ World Corporate Insurance Report, No.87, 28 February 1992, p. 3.

17/ Insurance Research Letter, July 1990, November 1991 and July 1990.

18/ Best's Review, April 1992, p. 94.

19/ World Insurance Report, No.439, 19 June 1992, p. 5.

20/ Insurance Research Letter, August 1992.

21/ William Olotch, op. cit., p. 18.

22/ West Africa, 2-8 March, 1992.

23/ William Olotch, op. cit. p. 19.

24/ Algerian Mission in Geneva, correspondence No.178, 26 June 1991.

25/ William Olotch, op. cit. p. 19.

26/ Best's Review, December 1990, p.102.

27/ ibid., p.104.

28/ Insurance Research Letter, July 1990.

29/ World Insurance Report No.409, 12 April 1991, p. 7.

30/ World Insurance Report No.420, 13 September 1991, p. 4.

31/ World Insurance Report No.401, 23 November 1990, p. 5.

32/ World Insurance Report 372, 29 September 1989.

33/ The Re Report, February 1989, p. 4.

Bibliographical Notes on Liberalization (paragraphs 59-99)

1/ The U.S.A. International Trade Commission Industry and Trade Summary for Insurance, referred to in Reinsurance Market Report, 20 October 1992.

2/ Commission of the European Community, Report on United States Trade and Investment Barriers, 1992.

3/ Reinsurance Security for Developing Countries, study by UNCTAD Secretariat, TD/B/C.3/228, Geneva, 1989.

4/ Carter, Robert L. and Dickinson, Gerard, "Obstacles to the liberalization of trade in insurance", Thames Essay No. 58, Harvester Wheatsheaf, London, 1992, p. 102.

5/ World Insurance Report, No.448, 23 October 1992, p. 5.

6/ Eyessus W. Zafu, "Proposed liberalization of insurance trade: The case of Africa", Background Paper for the AIO Sub-Committee on Liberalization, Nairobi, Kenya, 1992, p. 7.

7/ Eyessus W. Zafu, "Reinsurance in the nineties", discussant's supplement, presented at the Third World Insurance Congress, New Delhi 1992, p.5.

8/ World Insurance Report, No. 376, 24 November 1989, p. 3.

9/ Eysessus W. Zafu, "Proposed liberalization...", op. cit. p. 7.

10/ Reinsurance Market Report, 20 October, 1992.; Asia Insurance Review, May-June 1992, p. 4; Insurance Research Letter, November 1992.

11/ Mario A. Kakabadse, "The Uruguay Round and the liberalization of trade in insurance services", The Geneva Papers on Risk and Insurance, No. 63, April 1992, p. 211.

12/ ibid.

13/ Oakle Johnson, "How the Uruguay Round services negotiations will affect worldwide insurers", The Geneva Papers on Risk and Insurance, No. 61, October 1991, p. 416.

14/ Reinsurance Market Report, 20 October, 1992.

15/ Carter, Robert L., Economic Issues in Trade in Services - Insurance, Unpublished Paper.

16/ Eyessus W. Zafu, "Proposed liberalization..., op. cit., p. 10.

17/ World Insurance Report, No. 420, 13 September 1991, p. 4.

18/ Eyessus W. Zafu, "Proposed liberalization...., op. cit., p. 10.