

INSURANCE PROSPECTS AND CHALLENGES IN THE GLOBAL SCENARIO

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The global insurance scenario has undergone profound changes during the last few years, accentuated by the terrorist attack on the World Trade Center on 9/11/2001. Coincidentally, the major world stock markets suffered a steep decline in value towards the end of the last century, following the dot Com bubble burst and the unprecedented corporate scandals led by Enron and WorldCom. Hurricanes like the Katrina, the Wilma and the others, in addition, have bankrupted a substantial capitalization of insurers and reinsurers built up over decades. One estimate has put it that out of a total capitalization of \$750 bn the WTC attack and the stock market failures due to the burst of dot com bubble alone wiped out a capital of \$ 250 bn of the industry in one stroke.

These financial blows have resulted in a large number of insurers/reinsurers going bankrupt and several others suffering lowered ratings by reputed rating agencies. Despite these setbacks the industry has recovered from such serious and unexpected financial losses and the industry has begun to look as solid and resilient as ever.

The world insurance premium in 2005 was estimated at \$3400 bn by Swiss Re. Sigma. 60% of the premium came

from life insurance. The world's population in 2005 was estimated at 6450 mn and its GDP at \$ 44,450 bn. The life insurance market is growing faster in the emerging markets due to rising incomes and a growing younger working population.

It was also observed that the GDPs grew faster than the insurance premiums, both life and non-life, reducing the levels of insurance penetration (IP) in comparison with those of 2004. The combined ratio for the developed markets was slightly above 100% and the industry showed strong profitability. Insurance penetration is measured as the percentage ratio of premiums to GDP. Insurance density is measured as the gross premiums to population per capita. These measurements on a comparative basis show the insurance progress and sophistication of the insurance markets.

The African continent had a life premium of \$ 28,000 mn and a non-life premium of \$ 12,000 mn. The level of IP was 3.33% for life and 1.47% for non-life. The Insurance density was \$ 30.7 for life and \$ 13.5 for non-life. What are the global issues that have affected the international markets in recent times and what are the

challenges that would shape the future developments?

Issues & challenges:

1. The first consequence of the WTC attack was the sudden stoppage of acceptance of the risk of “terrorism” by the industry. The risk was regarded as akin to the risk of war on land and against the Govt. of the day. Since war risks on land are invariably excluded, the risk of terrorism was abruptly withdrawn.
2. The world witnessed unprecedented rate increases for almost all risks underwritten by insurers to recoup the huge losses suffered. The policy wordings and terms and conditions were tightened and primary insurers were put under pressure to pay higher reinsurance costs.
3. The WTC attack has also brought the issue of “contract certainty” to the fore, as the terms stated in the insurance slips by the brokers that placed the risks had used different “binders”. Swiss Re, several Lloyd’s insurers along with Chubb and seven other insurers/reinsurers had used a ‘binder’, which the Courts have held recently that the two plane crashes should be treated as a single loss claim; whereas the “binder” wording used by the brokers for St. Paul Travelers, Allianz, Royal insurance, Industrial Risk Insurers and five others had a different “binder” wording and the Courts have decreed separately that the two

plane hits were two separate recoverable losses. Consequently the insured was not fully indemnified as per his claim that both sets of binders should pay claims treating the WTC attack as two separate loss claims. This issue of “contract certainty” is still under a vigorous discussion in the UK market among the players.

4. Another controversial issue that suddenly came to the fore was the “contingency fees” that the brokers were collecting from the industry for several years, and the “bid rigging” allegations against the international brokers led by Marsh, Aon and Willis. The Eliot Spitzer investigation has now resolved the issue of contingency fees collection by the brokers under a new arrangement of Management General Agency between insurers and the brokers for doing the work of insurers, with brokers being recognized as agents of insurers for the specific duties they discharged for the insurers/reinsurers. But the broking industry suffered huge setback to its reputation and had to promise Eliot Spitzer, the then New York Attorney General, that the named brokers have voluntarily decided to discontinue collecting the contingency fees that formed almost half their earnings. In the UK and even in US the issue has not been finally put to rest.
5. There is a growing demand by international insurers/reinsurers that the age-old practice of

collection of brokerage from insurers should shift to the insured, who actually avail the services of brokers. And while this practice is increasingly gaining acceptance of large premium-paying insured, who insist that the premium rates should be based on fee collection from them to make the brokers work harder to negotiate only net rates from insurers. The FSA in the UK is asking for brokerage and other fee payments collected from insurers should be made known to the insured, not if asked by them, but without exception in the interests of financial transparency. If the industry does not come up with an acceptable solution, the FSA would prescribe a regulation.

6. The large number of mergers and acquisitions among brokers has led to the creation of more powerful brokers in terms of business volumes, expertise and negotiating power. Inevitably they have displayed a greater cost consciousness of taking on business subject to a guaranteed minimum fees or brokerage income, as one of the determinants to deal with a particular piece of business. Broker domination of the consumer market has led to a concentration of market power in their hands.
7. The huge losses that hurricanes like Katrina, Wilma and Rita have resulted in insurers suffering losses of about \$ 83 bn; and the European storms have added

another \$ 4 bn. Energy losses alone amounted to \$ 15 bn out of the total losses. About 50% of these hurricane losses were borne by the reinsurers; thus cushioning the primary insurers to remain financially stable. As the burden of cat. Losses, both in their severity and frequency, have risen, Swiss Re and other reinsurers have begun to raise fresh capital from the market to meet such contingencies by issuance of Cat Bonds that under circumstances they could retain the principal amounts of the bonds as well.

8. The US is unique among nations in that it is exposed virtually to all types of natural disasters—hurricanes, earthquakes, floods, tsunamis, and volcanic eruptions. In most disaster prone areas the size of the population growth and real estate prices are riding high. Insurers have begun to work with consumers and legislatures to improve the ability of those that are likely to suffer to prepare for, respond to, and recover from natural disasters.
9. A regulatory issue that concerns the duty of disclosure in contract law is under review by the UK Law Commission. On the issue of “misrepresentation”, the Commission is proposing the test for materiality for disclosure should be based on what the “reasonable insured” would have done rather than the “prudent insurer”. This proposal, if accepted, would shift the onus of

proof more stringently on the insurer. Also, the new remedies for breaches should include the proportionality of such lacunae. The duty of an insured to disclose is to be replaced with a duty on insurers to ask specific questions. It is not clear yet, if these applications would be applicable to reinsurance deals. These changes currently under discussion are likely to be implemented in 2010. Another issue under debate is about the legalities of warranties that are still under debate.

10. The high energy prices, the FDI and FII inflows and the outsourcing of jobs to low cost economies have changed the growth parameters of individual nations with China, India, Brazil, Russia and other East European countries leading the global changes. The shifting of income-levels have made the emerging markets of greater appeal to the insurers of the developed markets to enter.

11. The insurance penetration levels have dropped in 2005 compared to the levels as in 2004, as the insurance premiums, both life and non-life, did not keep pace with the growth of the World GDP. The booming stock markets, the high interest rates, the rising real estate values, the debilitating taxation policies of the Govts., the high energy prices affecting the cost of living indices gave potential savers alternative sources to invest their reduced

incomes. The insurers in the emerging markets seem also both unwilling and unable to influence Govt. policies. Insurance in most emerging markets is administered by Govt. directly instead of appointing Regulators to oversee the market progress and developments under new laws.

12. International credit rating Agencies have gained increased prominence and more public credibility is bestowed on the rating given to reinsurers. As everyone knows reinsurers are not subject to any national regulations. Their rating alone determines how sound a reinsurer's security to the cedant is. There is also a judgmental change in the standards used by the rating agencies in evaluating the financial and operational performances of reinsurers; no longer is the current financial strength, measured as the capability of a reinsurer to meet its claim obligations considered as a single factor of importance but how the management has performed on its core insurance operations; and if the enterprise in future would continue to be attractive to the current and potential future investors; particularly as insurance operations are highly volatile with a number of imponderables and the enterprise may have to resort to raising fresh capital.

13. Bermuda is emerging as a rival reinsurance market to the London and European markets. Those

new reinsurers numbering 9 entities that have set up their operations as new in 2005 with a capital of about \$ 7 bn now want to go public to raise additional capital but with a track record of just one or two years of relative clam on catastrophe claims. The period of going public that was about 5 or 6 years is getting shorter, due to hedge funds entering the insurance capital markets. The investors are asked to judge them on a short-term record of performance.

14. The relationships between the insurer and the reinsurer have undergone profound changes and reinsurers are now tending to become more contract-wording-

minded and not long term based relationship-minded. Stricter terms and higher deductibles, restricted markets for proportional treaties are gaining an upper hand.

What is the progress?

The following two tables show the comparative positions of China, India, Sri Lanka, Namibia, Kenya, Egypt, SA, Morocco and Tunisia in respect of their population, GDP, sizes of life and non-life premiums, the insurance penetration levels and the insurance density. These would provide the progress each country has made in the background of the world's progress. (Source: Swiss Re publication for 2005).

Comparative Status of Population and GDP Among Select Countries in 2005

<u>COUNTRY</u>	<u>POPULATION</u>	<u>GDP IN USD</u>	<u>LIFE PREMIUM</u>	<u>NL PREMIUM</u>
CHINA	1300 mn	\$ 2200 bn	\$ 40,000 mn	\$ 20,000 mn
INDIA	1100 mn	\$ 800 bn	\$ 20,000 mn	\$ 4,900 mn
SRI LANKA	21 mn	\$ 23 bn	\$ 144 mn	\$ 195 mn
<u>AFRICA</u>				
KENYA	34 mn	\$ 34 bn	\$ 153 mn	\$ 348 mn
NAMIBIA	2 mn	\$ 2 bn	\$ 350 mn	\$ 150 mn
SA	47 mn	\$ 240 bn	\$ 26,000 mn	\$ 7,300 mn
EGYPT	74 mn	\$100 bn	\$ 300 mn	\$ 460 mn
NIGERIA	132 mn	\$90 bn	\$70 mn	\$ 500 mn
MOROCCO	32 mn	\$51 bn	\$370 mn	\$1100 mn
TUNISIA	10 mn	\$29 bn	\$50 mn	\$ 540 mn
WORLD	6450 mn	\$ 44,450 bn	\$ 1974 bn	\$ 1450 bn

Sri Lanka, Kenya, Egypt, Nigeria, Morocco and Tunisia show that the share of non-life premiums is larger than the life component. The dominance of life sector in India when compared to non-life sector is very noticeable. So is South Africa's.

Let us examine the insurance metrics.

<u>COUNTRY</u>	<u>LIFE</u>		<u>NON-LIFE</u>	
	<u>Insurance Penetration</u> Premium/GDP	<u>Insurance Density</u> Premium per capita	<u>Insurance Penetration</u> Premium/GDP	<u>Insurance Density</u> Premium per capita
CHINA	1.78%	\$30	0.92%	\$15.80
INDIA	2.53%	\$18	0.61%	\$4.40
SRI LANKA	0.62%	\$7	0.84%	\$9.40
<u>AFRICA</u>				
KENYA	0.78%	\$5	1.79%	\$10.20
NAMIBIA	5.90%	\$172	2.46%	\$73
SA	10.80%	\$558	3.0%	\$156
EGYPT	0.34%	\$4	0.52%	\$6.2
NIGERIA	0.09%	\$0.50	0.62%	\$3.7
MOROCCO	0.71%	\$11.7	2.76%	\$35.3
TUNISIA	0.17%	\$4.8	1.90%	\$53.9
WORLD	4.30%	\$300	3.20%	\$220

Underwriting and deregulation of rates in India:

In countries like India, the Govt. seeks to raise higher budgetary revenues for itself from the industry through a levy of service taxes at over 12.24 % than to encourage expansion of the financial security net and reduce insurance costs in contrast to premium tax of 5 % levied in the UK.

Taxation has an important impact on the development of insurance sector. Unfortunately, in the emerging markets, the insurers are neither conscious of this fact nor are they strong enough to fight for the

consumers. Implicit obedience without raising even a pre-budget discussion on the development issues involved is seen to act as a hindrance. In the UK and other markets, insurers place their concerns and demands before the Govt. for budgetary support.

In Germany, one of the largest world markets, life premiums significantly dropped in 2005 due removal of tax advantages. With short-term interests riding high, people tend to invest their savings not in insurance but in other financial instruments.

In India, with stock markets booming and the real estate prices skyrocketing

with foreign inflows, the need for either life or non-life insurance for consumers has become a low priority. Coupled with the 12.24 % service tax, this situation gets even worse. But not a single insurer has raised his voice or brought any kind of coherence to their arguments for a change in the structure of service tax to one of premium tax; and how the high rate of taxation is affecting the consumer buying and how the insurers are unable to expand their business.

Another possible reason is the ignorance of Indian insurers of the global developments and practices in relation to protecting their interests that is intertwined with those of its consumers. The industry thinks strictly locally and in its own personal interests; and it has no global ambitions either for now or later, though a couple of Indian insurers have foreign presence.

The Indian non-life market has been detariffed and motor TP business has been put in a Pool from 1st January 2007. Indian tariffs were earlier based on homogeneous classification of risk categories. The data collection of the tariff structures did not keep pace with the changing risk profiles and with changing claims experience. In 2000, the fire tariffs were further simplified affecting the homogeneity of risk categorization.

Now, in a competitive environment insurers are asked to go back to basics of underwriting. Data collection, data capture electronically, data mining and data analysis are stressed to be done by Actuaries. Data alone, even if it is

available in all forms, is insufficient to fix rates; an underwriter should be able to interpret the data in the context of individual physical risk characteristics that should include the attitudes of an insured towards risk aversion and his risk- behavior, should an accident manifest. Uncovering more insightful combinations of risk characteristics provides a more optimal evaluation of risk and a better approach to the pricing process.

Not only risks need to be segmented, based on their homogeneity, as is the current practice, but segmenting the individual customers among the homogenized categories requires an underwriting appraisal. Risk identification and evaluation must precede risk transfer acceptance and not mere risk acceptance at pre-determined prices of risk categories. For these predictive models to work data mining is important. To cite an example, those that pay their bills regularly tend to drive more safely. Those who have been in business for more number of years tend to be better risks than those that are young. The data may be available but the correlation has to be seen. The underwriting should be based on the future financial and risk behavior of the insured or his business.

Risk classification, it is suggested, must reach individual risk level and not be confined to refining risk classification. The global underwriting practices are likely to change. Insurers must remember their core product marketed is risk identification, its evaluation and its management and the premium is the price for the risks

they knowingly accept, when transferred.

Final word:

With globalization, the insurance community in each country is becoming an integral part of the international insurance community. What happens in the developed markets has an impact on the domestic markets. There is a greater need to examine, study and understand how the developed markets have dealt with the problems that are likely to recur in our national markets. Understanding global scenario helps us to understand our markets with more clarity. As the national markets are more reinsurance dependent, and would remain so for long, they would be better able to

tackle reinsurers and the reinsurance markets, if the insurers are more knowledgeable of the logic, emotion and science of approach of reinsurers towards risks and their classification. The market information the domestic insurer would be able to exclusively provide is the individualized risk characteristics and the risk behavior of the proposer.

It is certainly an interesting challenge to insurers of all markets to enhance their risk perceptions of risk identification, evaluation and mitigation based on what the developed markets have already experienced. Insurers must keep in focus that their core business product is risk management. Everything that they do is in fulfillment of this goal. ■