



INSURANCE SUPERVISION IN DEVELOPING COUNTRIES

By :

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Mr. President, Ladies and Gentlemen,

1. As you all know, the subject on which I was requested to prepare a paper is "insurance supervision in developing countries". An uncomfortable subject - many of you might think - to speak on to managers of insurance companies, somewhat like talking to the sheep about the wolf. But you need not worry, because - as I have already explained to other insurance fora not very long ago and as I am going to prove today - the kind of insurance supervisors I have in mind are not really wolves; they are fully domesticated shepherd dogs, reliable friends and protectors of all sheep, as long as the latter behave.

2. Now that I have put you at your ease, I hope, let me explain how I intend to deal with my subject. I think, I must first define what, in my opinion, is the correct scope and purpose of insurance supervision, in particular as regards the specific needs of developing countries. Then, I shall refer to the various methods of practical insurance supervision. Finally, I will try to explain why in many countries, developing as well as developed, insurance supervision operates in a far from optimal manner.

Scope of insurance supervision

3. Gambling is a very selfish kind of a game. The gambler, confident - rightly or wrongly - of his particular skills, or simply trusting his good fortune, plays against a group of other gamblers and hopes to gain with a minimum of input a maximum return, to the detriment of the other participants in the scheme, i.e. the losers. The technique of correct (non-fraudulent) gambling can be explained by the theory of strategic games. One of the elements of strategic games is the accepted probability of ruin of any of the participants.

4. In principle, insurance is exactly the opposite of gambling. By joining a mutuality of risks - a so-called insurance portfolio - each insured seeks, together with the other members of the mutuality, - and not at their expense, as is the case in gambling - to minimise his potential losses due to events beyond his control. The probability of ruin of any of the participants and of the collectivity itself should be completely eliminated in a well functioning insurance scheme. The equity of terms and conditions for each of the participants and for the mutual scheme itself (be it a stock company, a cooperative or any other kind of institution) guarantees almost automatically the necessary stability.

5. In practice, insurance schemes do not always function in the above correct mutualistic spirit, because there is no automatic guarantee against any infiltration of gambling, or of strategic game attitude, to put it more mildly. It might happen that some groups or individual members of the insured public or some insurance companies do not respect the rules of the insurance game, either intentionally - by trying to extract undue profits out of the mutuality - or by sheer incompetence and ignorance. The primary rôle of insurance supervision is to prevent such speculative infiltrations and to keep insurance close to its true purpose.

6. You may have noticed that contrary to the more traditional explanation, according to which the sole purpose of insurance supervision is to protect the policy holders against possible abuses of untrustworthy or incompetent insurance concerns, my approach is a much broader one. It is insurance itself, as an institution and as an important economic and social service, which must be protected in the general national interest and in the interest of the public as a whole. In order to protect insurance, the supervisor must protect both the insured public and the insurance concerns, for instance against irrational consumerism, unhealthy competition, excessive taxation and so forth, points to which I shall revert later.

7. The following clear definition of the scope and purpose of insurance supervision was adopted a few years ago in Bangkok by the insurance commissioners of Asia and confirmed subsequently by their African and Latin American colleagues at separate meetings: "The scope and purpose of insurance supervision in a developing country is the establishment in the country of a sound national insurance market, providing adequate cover of risks at fair prices, contributing to the economic and social development of the country and reducing the outflow of foreign exchange due to insurance and reinsurance transactions."

8. This is a very modern definition. First, to the concept of solvency, contained in the expression "sound market", it adds that of equity, reflected in the words "adequate cover of risks at fair prices". Second, it puts the emphasis on supervision of the national market as a whole instead of, or in addition to, supervision of individual insurance companies. Finally, it refers to the economic and social development of the country and to the outflow of foreign exchange. It is clear that under these circumstances insurance supervision becomes a policy instrument aimed at moulding the national insurance market into an optimal shape, best suited to the needs of the public and of the country as a whole. It is a most worthy task, which requires a highly competent insurance supervisory service working in close co-operation with the insurance industry of the country.

9. Before turning to the methods of practical insurance supervision, I wish to recapitulate its main objectives by grouping them in the following manner:

- (1) Promotion of the structure of the national insurance market as regards the quantity and quality of insurance concerns operating therein, in particular as regards the increasing importance that domestic insurance concerns should have in this market.
- (2) Promotion of the national market in terms of volume of insurance business underwritten in the country, since a larger volume of business creates stability of the local portfolios and enhances national underwriting and retention capacities.
- (3) Supervision of the solvency of the individual insurance concerns as well as of the equity of terms and conditions of insurance contracts offered to the public and of tariffs applied. Promotion of the economic and social rôle of insurance in general.

When referring to these three groups of objectives, I should like to call them the structural objective, the capacity objective and the protection of the public objective.

Methods of practical insurance supervision

10. It is clear, that among the various activities of the supervisory authority some will be directed primarily towards achieving the "protection of the public" objective, whilst others will be aimed at one of the other two objectives. What is very important is that the supervisor keeps constantly all three objectives in mind and does not sacrifice the one for the other. This may sound very difficult, but it is not so in reality. In fact, there is a direct correlation between the three objectives, so that supervisory measures aimed at achieving any of the three generally tend to have beneficial repercussions on the other objectives as well. Some examples will follow which will illustrate the point I am making.

11. One of the basic features of practical insurance supervision is the licensing of insurance concerns. Authorisation to transact insurance business is in fact an indispensable pre-requisite of insurance supervision. By applying for a licence the insurance concern places itself under insurance supervision and becomes bound to observe the rules and regulations governing the local insurance market. For its part, the supervisory authority, whilst imposing on the licensed insurer these rules and regulations, assumes the obligation to prevent non-licensed concerns from transacting the same kind of business in the country, thus ensuring fair and equal terms of competition on the market.

12. The supervisory authority must have two main considerations in mind when dealing with an application for a licence : first, whether the applicant is a trustworthy and technically competent insurer; second, whether his presence in the national insurance market will be positive or negative, namely whether the new company will improve the market by offering new or better types of cover at fair prices, by injecting additional stimulus through sound competition and by creating higher underwriting and retention capacities; or, on the contrary, whether the new insurer will tend to harm a market already overburdened with too large a number of relatively weak insurance concerns.

13. Within the framework of their general insurance market policy, many developing countries recognise an additional element of exceptional importance to them : the need to increase the participation of their domestic insurance concerns in their own insurance markets, which are often preponderantly in the hands of branches and agencies of foreign insurers. Licensing is one of the means by which the insurance supervisor may guide the market towards a structure more consistent with the above aim. In other words, an adequate policy in the field of licensing may meet simultaneously all three main objectives on insurance supervision : the structural improvement of the market, the increase of local underwriting and retention capacity, and the effective protection of the public.

14. Next on my list after licensing comes the control of solvency of insurance concerns. The supervisory authority receives and scrutinises regularly the so-called annual returns of the insurance concerns under its supervision - provided that these returns are well conceived and comprehensive enough to allow valid conclusions - and tries to gain a clear picture of the solvency of these concerns. Furthermore, by comparing the various data, it also draws conclusions on the soundness of the market as a whole. It is clear that different action is required if an individual company becomes insolvent in an otherwise sound insurance market, than if the market as a whole tends to be unsound.

15. There are two elements in the balance sheet of an insurance concern which have a decisive influence on its solvency. The technical reserves, which represent an evaluation of the liabilities, and the assets, which cover these liabilities. Both, the value of assets in the balance sheet and the amount of liabilities, are estimates, and the supervisory authority may encounter serious difficulties in verifying the accuracy of these estimates, in particular those of the so-called technical reserves. There is no easy way out of this task; the supervisor must evaluate the accuracy of the technical reserves stated by the companies, because otherwise he cannot draw any valid conclusion on their solvency. In order to perform this task well, the supervisor needs a great deal of technical skill, ingenuity and imagination. He must constantly keep in mind that, whilst most insurance concerns do

their best to evaluate their assets and liabilities correctly, some may fail to do so either due to a genuine involuntary mistake, or for the purpose of hiding their insolvency.

16. In view of the difficulties arising in connection with verification of the technical reserves, there is lately a tendency to rely increasingly on so-called solvency margins, calculated in a rather schematic manner (percentage of premiums written, or of claims, etc.). This tendency is to be deplored in so far as it distracts the supervisory authority's attention from the core of the problem, which is, and will always remain, the accurate evaluation of the technical reserves. As long as the technical reserves and the assets are correctly evaluated, both evaluations containing some safeguards against adverse fluctuations, no additional guarantees are necessary. On the other hand, no schematic solvency margin can save an insurance concern which systematically under-evaluates its technical reserves.

17. Third on my list of basic features of practical insurance supervision is the control of tariffs. I do not call "control of tariffs" the freezing of these tariffs at some technically unsound level. On the contrary, I believe that the supervisory authority should be closely associated with the way the companies compute their tariffs and be ready to defend their adequacy against political pressure. In practice, tariffs can be controlled in three ways: individually, i.e. tariff by tariff submitted, in relation to the extent of cover and to the technical results of the company submitting it; semi-collectively, i.e. on the basis of the so-called minimal tariffs for each kind of cover, below which no insurer is allowed to reduce his rates whatever his individual experience may be; uniformly, by declaring a tariff compulsory for all insurance concerns transacting a certain kind of business.

18. On this point, I wish to put before you one of my theories, which links the three main features of practical insurance supervision, namely licensing, control of solvency and control of tariffs. I am convinced that in many cases, both in developing and developed countries, it is the Governments acting through their supervisory authorities who are more to blame for the insolvency of insurance concerns than the concerns themselves. By being too inactive or by taking inadequate measures, such as permitting the proliferation of weak and often "mushroom" insurance concerns, tolerating unsound and often cut-throat competition, freezing tariffs at uneconomically low levels, augmenting administrative expenses, the supervisory authorities contribute to rendering the entire market insolvent. No wonder that in a bankrupt insurance market insurance concerns become insolvent. To put it in a different way, insurance supervision should be preventive rather than corrective in order to achieve its objectives. A good market structure, adequate tariffs, etc., create a priori sound market conditions and solvency follows automatically as a bonus to both the insured public and the insurance concerns.

19. Another task of the supervisory authority is the control of contracts offered to the public. The theory that the terms of an insurance contract, like those of any other commercial agreement, should be left to the full discretion of the two contracting parties, the insurer and the insured, may have its merits, but it can hardly be considered compatible with one of the objectives of insurance supervision, namely the protection of the interests of the public. In fact, the idea that the great mass of policy holders, if left to themselves, would be able to negotiate the terms of their contracts and to obtain satisfaction, is hopelessly unrealistic. On the other hand, in a period of excessive consumerism the supervisory authority should prevent insurers from being exposed to the danger of unlimited claims going far beyond the scope of the cover they intended to provide and clearly incompatible with the tariffs applied. As I explained at the beginning of my speech, supervision should protect insurance as a whole, that is both the insured public and the insurance concerns servicing the public, which is in the public's own interest.

20. The necessity to supervise very closely the tariffs applied and the scope of cover offered to the public is imperative in the case of compulsory insurance. In fact, most forms of compulsory insurance create the largest possible community of interests affecting the entire population and it is only fair to secure correct terms and conditions, that is solvency and equity, for a public that has no choice but to buy these compulsory insurance covers. If the mechanism of compulsory insurance is properly utilised by the supervisory authority and operated on fair terms and conditions, compulsory insurance schemes not only in motor but also in accident, fire and other classes of insurance, may render excellent services to the public, promote the volume of insurance business underwritten in the country, stabilise the insurance portfolios through their non-selective cross-section effects and enhance the retention capacity of the national market.

21. Speaking of the retention capacity leads me straight to another task of practical insurance supervision, which is the control of reinsurance arrangements. Reinsurance cessions should be considered as an important factor of the direct insurer's solvency. In fact, insufficient reinsurance exposes the insurer to liabilities beyond his retention capacity and endangers the financial stability of the concern, whilst excessive reinsurance may swallow up too large a part of the premium income and become such a heavy burden that the concern may not be able to bear it for long. In addition, when premiums for excessive reinsurance are paid to foreign reinsurers, the country's balance of payments is adversely affected. All these considerations explain why the supervisory authority should be kept informed by each direct writing company of its main reinsurance plans and arrangements, as well as of the quality of reinsurance companies with which reinsurance is effected.

22. This method of controlling foreign reinsurers not directly but through regulations applicable to local direct insurers is very often applied. In fact, most supervisory authorities feel that giving direct instructions to international reinsurers might prove ineffective in the absence of legal ties between the local authorities and such reinsurers. The supervisory authorities prefer to give instructions to the local ceding companies affecting also their foreign reinsurers. For instance, by obliging the ceding companies to invest locally the gross amount of their technical reserves, the supervisor can oblige the foreign reinsurers to comply also because the ceding companies will not be able to set up gross reserves if their reinsurers do not deposit with them a part of the reserves corresponding to the reinsured risks. May I add a warning to national supervisors, not to be too inflexible as regards reinsurance regulations, because such an attitude might worsen considerably the terms on which the local companies could obtain foreign reinsurance cover.

23. Now I should like to conclude the part of my paper which deals with methods of practical insurance supervision by suggesting a very pragmatic approach in this field. Doctrinaire and schematic interventions should be avoided, first because they are generally ineffective and second because they are an unnecessary burden on both insurers and controllers. A good insurance supervisor must know precisely why he takes a given measure and what he expects the results to be. When investigating a company, the supervisor must listen very carefully to what the company has to tell him about its state of solvency and mode of operations and must also be able to read between the lines what it is the concern does not report to him. His subsequent action must then be tailored to the specific requirements of the company in question and to those of the market as a whole, as opposed to satisfying only purely formal requirements. Insurance legislation must of course give the supervisory authority sufficient discretionary power to carry out its tasks in such a pragmatic manner.

The rôle of insurance legislation

24. You may have noticed that it is the first time that I mention insurance legislation in my paper. I fully recognise the importance of adequate insurance legislation, without which insurance supervision cannot be implemented, but I honestly believe that a good supervisory authority should be much more than a mere police force implementing a law. Based on a solid legal background, that is on adequate insurance legislation, the supervisory authority should perform a highly political - I mean, policy-making - executive function in the economic and social sphere. The insurance market as a whole and the public in general should strongly support such an approach to insurance supervision and collaborate in its correct implementation.

25. Unfortunately, in many countries, both developing and developed, insurance supervision does not succeed in playing its rôle in the above optimum manner. On the contrary, even in some of those developing countries where insurance legislation is well formulated and provides the supervisory authority with all the necessary tools for doing its job properly, the supervisors fail to live up to the letter of the law, let alone to go beyond the letter and accomplish their task fully. I will finish my paper by referring briefly to the two main reasons for such failures.

26. First, the staff of many supervisory authorities often lacks technical insurance expertise, which handicaps them in performing their duties efficiently. Even when they suspect that something is going wrong in the field of solvency, or in that of tariffs applied - just to give two examples - the supervisors cannot prove their point, especially when they have to face highly educated and experienced insurance technicians working for foreign insurance and reinsurance concerns. Intensive insurance training is the key to solving this problem. In fact, when performing his duties the controller should be on an equal par with the controlled, as regards his technical qualifications and experience; this is an indispensable condition for effective insurance supervision.

27. The second main reason of failure is the relatively low administrative rank and precarious political position of the heads of many supervisory authorities. No government has ever considered putting as head of the National Bank of the country, which supervises the entire banking sector, a low ranking civil servant with many supervisors above him and who is open to all kinds of political and administrative pressures. Yet, as regards the insurance sector, the economic and social impact of which is often comparable to that of the banks, many governments believe - quite wrongly - that a simple chief of section of a ministry, without direct access to his Minister or to the Government itself, could play the rôle of the head of the country's insurance supervision and perform successfully the extensive executive and policy making functions involved.

28. The adverse effects of such an approach to insurance supervision are too obvious to need any further comments. I prefer to conclude here and wish to extend to all of you my thanks for your kind attention.

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