

# HORUS

## Insurance Newsletter

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### Exploiting the growth potential of emerging insurance markets

#### Swiss Re

Economic growth of emerging markets has time and again outpaced that of industrialized nations. Alongside the rising importance of emerging market economies, their evolving insurance sector is also drawing more attention, not least because of its robust growth of late: life and non-life insurance premiums in emerging markets have grown annually by 10.4% and 7.3% respectively in real terms over the past 10 years, against industrialized nations' average of 3.4% and 2.6%. Growing apprehension of market saturation in industrialized economies and further liberalization and deregulation in emerging markets continue to keep the latter in the spotlight.

Emerging insurance markets vary in size and structure. Despite this multiplicity, a number of common trends and characteristics can be observed among these markets.

- Strong economic growth will continue to drive development. Increasing affluence will give room for new products. New distribution channels will help to tap growth potential.
- Supervisory authorities will further realign local regulations to international best practice, particularly in terms of solvency, corporate governance and transparency. This will foster confidence in insurance. At the same time, insurers will find stronger incentives to maintain sound underwriting standards.
- Emerging insurance markets are moving towards a more liberal regime with fewer entry barriers, reduced micro-management of business practices by regulators and growing competition. The process is arguably more advanced in Latin America and Eastern Europe than in Asia and the Middle East.
- These developments will also entail further transformations in the insurance corporate landscape, characterized by the gradual privatization of state companies, consolidation in some fragmented markets and higher penetration of foreign players in previously reclusive markets.

The most important emerging insurance markets in the regions, ordered by their total insurance premiums in 2003, are listed below. They collectively account for at least 85% of the premium volume of their respective region. Regional aggregates will always include the following markets.

- Asia: South Korea, China, Taiwan, India, Hong Kong, Singapore, Malaysia, Thailand, Indonesia and Vietnam.
- Latin America: Brazil, Mexico, Chile, Argentina, Venezuela and Colombia.
- Eastern Europe: Russia, Poland, Czech Republic, Hungary, Ukraine, Slovenia and Slovakia.1
- Africa: South Africa, Morocco and Egypt.
- Middle East: Turkey, Iran, United Arab Emirates, Saudi Arabia, Lebanon, Kuwait.

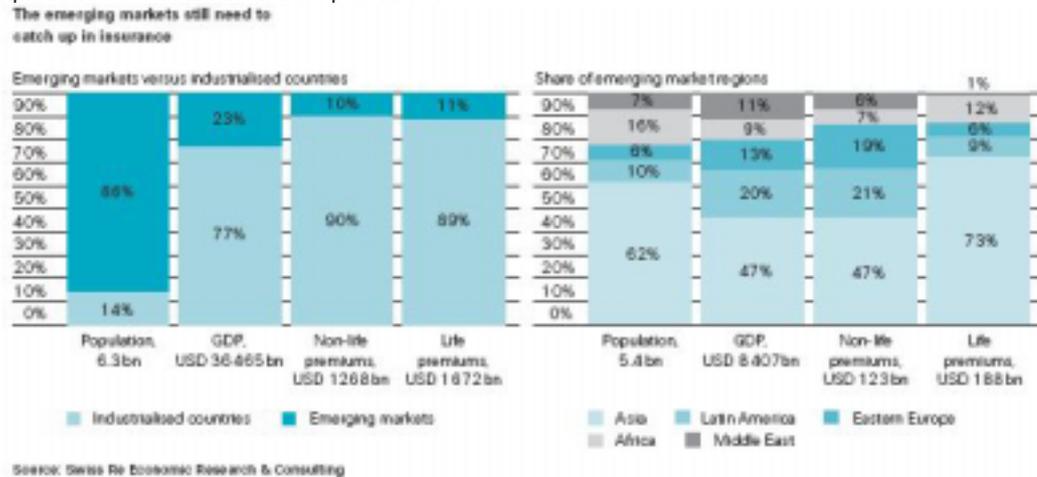
### Heightened interest in emerging markets

This is particularly the case for the insurance industry: the saturation of industrialized markets contrasts sharply with the high growth potential in emerging markets. International insurance companies also look to emerging markets for better risk diversification while at the same time fulfilling the need to follow their global clients beyond national borders. The trend towards investing in emerging insurance markets has a long history and has arguably, due to regulatory considerations, been more advanced in Latin America and Eastern Europe. In Asia, a multitude of activities erupted in the aftermath of the 1997 financial turmoil but enthusiasm among foreign insurers has been muted since the global stock market collapse in 2000. Nevertheless, as the global insurance market begins to recover and emerging markets move further to lower entry barriers, there has been a general revival of interest in these markets.

### Importance of emerging markets

Emerging markets are home to 86% of the world's population, including some of the most populous nations like China (1.3 billion), India (1.1 billion) and Indonesia (0.2 billion). Collectively, emerging markets account for 23% of global economic output,<sup>2</sup> with some of them being among the biggest economies worldwide, for example China (7th), South Korea (10th) and Mexico (11th).

Emerging markets collectively accounted for 10% of global non-life and 11% of life insurance premiums in 2003.<sup>3</sup> These percentages are clearly lower than the emerging markets' share in output (GDP), not to mention population, which implies huge catch-up potential (see Figure 2). Asia is by far the most important region in the emerging world, accounting for 62% of population, 47% of GDP and non-life premiums and an impressive 73% of life insurance premiums.



### Insurance business is concentrated in a few markets

The insurance business in emerging markets is concentrated in certain areas. The top ten countries account for 87% of life and 66% of non-life premiums.

Life insurance	Premium volume (in USD million)	Share of emerging markets	Non-life insurance	Premium volume (in USD million)	Share of emerging markets
South Korea	41 998	22.4%	South Korea	17 760	14.4%
China	32 442	17.3%	China	14 468	11.8%
Taiwan	23 739	12.6%	Russia	9 257	7.5%
South Africa	20 728	11.0%	Taiwan	8 662	7.0%
India	13 590	7.2%	Brazil	8 259	6.7%
Hong Kong	10 117	5.4%	Mexico	6 690	5.4%
Brazil	6 306	3.4%	South Africa	4 670	3.8%
Singapore	5 561	3.0%	Poland	3 946	3.2%
Russia	4 887	2.6%	India	3 712	3.0%
Mexico	4 230	2.3%	Singapore	3 337	2.7%
<b>Top 10</b>	<b>163 598</b>	<b>87.1%</b>	<b>Top 10</b>	<b>80 762</b>	<b>65.7%</b>

Source: Swiss Re Economic Research & Consulting

**Non-life penetration – big impact of structural factors**

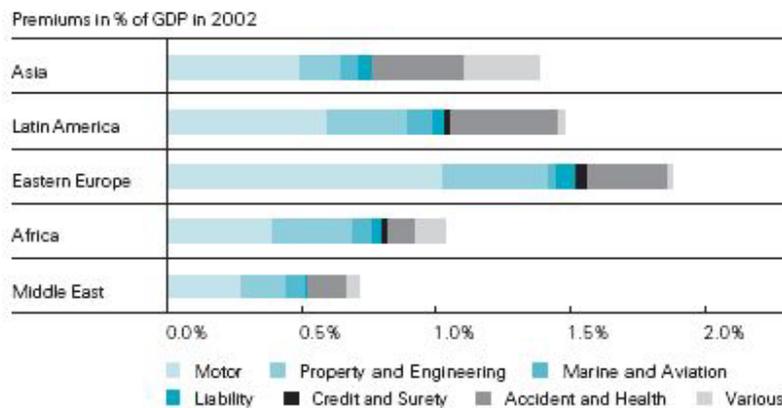
As in the life insurance sector, non-life insurance penetration on average increases with average per capita income. Other factors influencing demand for insurance are compulsory insurance schemes and a region's exposure to natural catastrophes. Structural factors, however, may also prohibit a market from ever reaching the "expected" level of penetration for a certain level of income.

<b>General factors</b>	
<ul style="list-style-type: none"> <li>■ Economic growth</li> <li>■ Wealth; distribution of income</li> <li>■ Religion; culture</li> <li>■ Education</li> <li>■ Property rights; legal certainty</li> </ul>	<ul style="list-style-type: none"> <li>■ Products offered</li> <li>■ Distribution channels</li> <li>■ Risk awareness</li> <li>■ Insurance regulation</li> <li>■ Trust in insurance</li> </ul>
<b>Non-life insurance</b>	
<ul style="list-style-type: none"> <li>■ Compulsory insurance</li> <li>■ Natural catastrophe exposure</li> <li>■ Public role in health and workers' compensation insurance</li> <li>■ Claims awards</li> </ul>	<b>Life insurance</b> <ul style="list-style-type: none"> <li>■ Economic stability (inflation, currency)</li> <li>■ Savings rate</li> <li>■ Demography</li> <li>■ Tax benefits</li> <li>■ Pension system</li> </ul>

Source: Swiss Re Economic Research & Consulting

**Non-life insurance dominated by motor and property insurance**

Motor insurance is the dominant non-life business line in most emerging markets. Due to the fact that motor third party liability insurance is compulsory in most countries, insurers get into contact with clients and can thus sell them motor own damage insurance as well. In addition, leasing contracts for cars often require the purchase of motor own damage insurance. Property and accident and health insurance are in most cases the next biggest in terms of premium volume. The importance of accident and health insurance depends heavily on the government's role in this line of business. Where workers' compensation is covered by the private insurance industry – as is the case in several Latin American and Asian markets – or where public health insurance is insufficient, these lines are more important. Transport insurance is insignificant in Eastern Europe, but accounts for 6–10% of non-life premiums in the other regions. Liability is still of minor importance in most markets. In Eastern Europe, however, its importance has increased strongly in recent years. Changes in liability regulations as these countries approached the EU have stimulated growth in liability insurance business. In Asia, liability business has also increased, albeit from a low base, due to demand for product liability covers for exports to the US as well as more widespread liability regulations.



Source: Swiss Re Economic Research & Consulting

**Privatisation**

State involvement in the form of state-owned insurers has decidedly lost importance over the last ten years in Latin America as well as in Eastern Europe.

The government still plays a major role in parts of Africa, the Middle East and Asia. In South Africa, state involvement is minimal, but in Morocco and Egypt, for example, the state still plays a key role. In Morocco this is manifested through the state-owned reinsurer SCR, and in Egypt through the public sector

reinsurer Egypt Re as well as state ownership in direct insurers which control 75% of non-life and 69% of life insurance premiums. While the privatisation of public sector insurers has been on the table in Egypt, the process is currently on hold.

### Liberalisation

Entry barriers to most emerging insurance markets have been reduced over the last decade, leading to more international insurers entering into these markets.

In turn, merger and acquisition activities have accelerated and competition intensified.

	Market share of (≥50%) foreign-owned insurers			Market share of (≥50%) foreign-owned insurers	
	Life	Non-life		Life	Non-life
<b>Asia</b>			<b>Eastern Europe</b>		
South Korea	10%	1%	Russia	na	na
China*	2%	1%	Poland	52%	41%
Taiwan	33%	12%	Czech Republic	81%	89%
India	0%	0%	Hungary	85%	89%
Hong Kong	87%	74%	Slovenia*	17%	2%
Singapore*	58%	53%	Slovakia	97%	96%
Malaysia*	81%	25%	<b>Africa</b>		
Thailand*	41%	7%	South Africa*	0%	14%
Indonesia*	48%	25%	Morocco	52%	28%
Philippines*	61%	29%	Egypt	11%	10%
Vietnam	56%	6%	<b>Middle East</b>		
<b>Latin America</b>			Turkey	12%	27%
Brazil	32%	43%	Iran	0%	0%
Mexico	75%	58%	United Arab Emirates	na	na
Chile	62%	63%	Saudi Arabia	na	na
Argentina	53%	35%	Lebanon*	≥64%	≥35%
Venezuela	39%	50%	Kuwait*	14%	14%
Colombia	38%	46%			

Notes: The foreign market share is calculated from the total premium volume of companies with a foreign majority stake. Latest available figures are used, which typically refer to 2003 (+2002 data; \*2001 data); in India and Iran, foreign insurers are not allowed to hold majority stakes.

Source: Swiss Re Economic Research & Consulting

### Deregulation

In big parts of Eastern Europe and Latin America, Africa and the Middle East, tariffs have disappeared over the last decade. Exceptions are mainly for tariffs on compulsory motor third party liability (MTPL) covers. In Asia, South Korea, Singapore and Indonesia have successfully moved away from tariffs but in some other non-life insurance markets, detarification is still a major subject. Taiwan is in the process of giving up price control. Other markets, including India, have voiced their intention to follow suit, but some 75% of India's non-life premiums are still generated under tariffs. China took a big step when it abolished motor tariffs on 1 January 2003. Detarification is expected to result in more volatile underwriting results while post-deregulation price developments will depend on the rate adequacy of prior tariffs. Motor own damage tariffs, for example, are below a sustainable market level in India. Price deregulation will thus likely lead to higher rates going forward.

### *Solvency regulation changes all over the world*

A clear trend to align standards of insurance supervision to international best practice can be observed across the world. Regulators in the emerging markets are increasingly gravitating towards insurance supervision as promoted by the International Association of Insurance Supervisors (IAIS) and other supranational bodies. Product and pricing controls are being lifted and solvency control reinforced. An example is the adoption of risk-based capital (RBC) frameworks.

The enforcement of a more stringent solvency standard will help to underpin the need for sound technical underwriting, foster confidence in insurance and possibly accelerate market consolidation. In many markets there are still numerous undercapitalized insurance companies – some of them will need to search for partners, merge, or cease business.

### Growth in emerging markets outpaced that of industrialized countries

Over the past five years, growth in emerging markets' insurance premiums has clearly outpaced that of industrialized nations.

	Total premium volume 2003, in USD million	Real premium growth 1998–2003				
		Total	Life	Non-life	Motor	Property
South Korea	59 758	0.5%	-1.2%	5.3%	5.9%	1.7%
PR China*	46 911	23.1%	31.6%	11.5%	14.2%	3.0%
Taiwan	32 402	14.3%	15.2%	12.1%	3.5%	9.5%
South Africa	25 398	4.2%	4.1%	4.8%	5.6%	16.8%
India	17 302	15.3%	17.5%	8.9%	na	6.2%
Brazil	14 565	6.5%	16.6%	1.4%	-1.4%	2.4%
Russia	14 145	23.3%	27.3%	21.5%	na	32.2%
Hong Kong	12 494	17.1%	20.0%	8.3%	6.5%	1.4%
Mexico	10 920	6.5%	3.2%	8.9%	7.7%	11.1%
Singapore	8 898	14.0%	14.1%	13.7%	8.3%	6.8%
Poland	6 258	4.4%	9.3%	2.1%	-1.0%	3.7%
Asia	194 473	10.5%	11.3%	8.8%	8.2%	4.6%
Latin America	41 784	5.4%	7.6%	4.3%	1.0%	8.1%
Eastern Europe	34 460	13.0%	17.4%	11.4%	2.5%	18.3%
Africa	30 919	4.3%	4.2%	5.0%	5.6%	16.8%
Middle East	5 870	8.3%	8.0%	8.6%	7.2%	8.2%

\* For motor and property insurance 1998–2002

Note: Growth rates are shown in local currency terms adjusted for inflation. Growth by region is derived by weighting individual market growth by premiums from the preceding year in USD.

Source: Swiss Re Economic Research & Consulting

### Strong economic growth will continue to underpin insurance demand

Emerging insurance markets will continue to grow at a fast pace. Healthy economic growth and increased stability will favor insurance market development.

While the economies of industrialized countries are projected to increase by an annual average of less than 3% over the next ten years, the economic growth of emerging markets will average nearly 5% pa in real local currency terms. Asia is expected to show above average growth of 6%, whereas growth in the other regions will reach about 4% per annum.

In addition to the healthy economic growth and higher stability, insurance will benefit from increasing household wealth and the globalization of emerging markets. Experience suggests that in countries with per-capita income between USD 2 000 and USD 10 000, insurance premiums increase on average by one to two times faster than the overall economy. For the 2004–2014 period it can be expected that premiums in emerging markets will increase by 7.5% in real terms per year.

Growth rates will, however, vary across regions and countries. Growth will not only depend on economic development, but also on insurance rate developments and changes in the other insurance-specific factors: new products offered, the use of new distribution channels, the availability of tax benefits, the introduction and enforcement of compulsory lines, as well as privatization of social security business (workers' compensation, pension insurance). Asia will likely outperform, particularly when looking at absolute growth.

### Challenges ahead – what does it take to realise growth potential?

In order to realise the growth potential of emerging markets, certain prerequisites have to be met.

*Government and supervisory authority's role in releasing the growth potential* In order to grow, insurance business needs a predictable environment: this includes economic stability, legal certainty, stability of institutions and the enforcement of property rights. Clients need confidence in obtaining real value benefits in the event of a claim; insurers need a legal framework they can trust in as a basis for their business plan.

Insurance supervision needs to be effective to enhance insurers' reputations. Only if the market environment is attractive will there be competition which entails the provision of a large variety of products and high service levels. Privatisation, liberalisation and deregulation of the insurance markets, if implemented appropriately, are important steps in that direction. In addition, a further relaxation of investment rules may help insurers to respond to market developments and thus make insurance more attractive.

Besides these general market conditions, insurance-specific efforts by the authorities could help to realise this potential, including the admittance of private pension, health or workers' compensation insurance, as well as the introduction and enforcement of compulsory lines of business. The demand for compulsory insurance is being fuelled by government's and society's increased willingness to protect consumers or

other potential victims. Third-party liability insurance, for example, guarantees that necessary funds are available to compensate accident victims; compulsory earthquake insurance helps to avoid adverse selection. Further government initiatives may comprise the provision of information with regard to insurance (eg standardised forms, sent annually to insured clients, stating social security benefits and possible protection gaps) as well as tax incentives to employers for promoting group risk coverage or to individuals to promote private retirement arrangements.

*The insurance industry's role in enforcing growth*

The biggest effort, however, has to come from the insurance industry. If insurance business is to grow strongly, new clients have to be reached and/or new insurance products sold. Insurers have to listen to their clients' needs, to design products accordingly and explain them to their clients. Innovative distribution channels, like bancassurance, distribution through department stores, or the sale of insurance in combination with the purchase of a car, help to reach a wide sector of the population. Cost efficiency will be crucial, especially with regard to low price products. For life insurance, in contrast, product transparency is a major challenge: insurers will need to design simple products and increase their information efforts. Insurers also need to act in a professional manner in order to increase the industry's reputation. Potential clients have to trust in the insurer's risk management capabilities and be convinced that a warrantable claim will be paid out in a reasonable time frame.

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## **Insurance Markets Re-View Willis**

### **Overview**

The impact on rates for the 1st January Renewal has been much more influenced by local and regional loss events than has sometimes been the case. The most significant catastrophe events to have occurred during 2004 have been the US/Caribbean hurricanes, the Japanese typhoons and the recent tragic events occurring as a result of the tsunamis in the Indian Ocean.

Overall, these events have not had a significant impact on global pricing, but have clearly changed the pricing in respect of those regions specifically affected; for example, in the US, the number of national/international US ceding companies whose catastrophe programmes have incurred losses from the hurricane activity is small. However, the affect on regional carriers and specifically those with a Florida bias has been significant.

Clearly, it is too early to comment with any accuracy on the impact the Indian Ocean tsunamis will have on pricing, but yet again, it is likely to be regional in nature. At this stage, it seems likely that, in addition to limited property losses, the Personal Accident market could be affected by losses to the travel policies of the many tourists who were staying in the region.

Unlike the aftermath of either Hurricane Andrew or the World Trade Centre events, loss free catastrophe pricing has not been affected on an overall basis.

Whilst the frequency of events in both the US and Japan is unusual, the severity of these events was such that ceding companies retained a significant proportion of these losses and did not transfer them to the reinsurance market. The trend noted during the last year of a softening market has not been arrested. Many regions have seen a reduction in pricing of up to 15-20% with the majority of regions showing reductions of between 0-10%. However, loss hit programs have suffered rate increases.

### **Aerospace**

We have seen rate reductions during the final quarter of 2004 in the region of 10-15% (in cases where there is evident reduction in exposure or where the previous year's program was more expensive than the normal market level, we have seen reductions of up to 20%+). This has been due to a combination of factors; first and foremost the continued low loss activity within the aviation sector, together with overcapacity in the reinsurance market and the desire to maintain market share.

In addition, the majority of the world's airlines renew in the final quarter, and the November renewals have shown reductions in rate of between 10% and 15%, although the decrease in actual premium is less due to increased fleet values and higher passenger levels.

Reinsurance reductions have, to an extent, also been driven by this factor. The reduction in rates in the airline market, together with the trend of the reinsurance renewals in the final quarter, have led to reinsurance rates falling at 1/1/05 by around 15%.

With regard to proportional reinsurance, due to the absence of major losses over the last three years, clients are continuing to maintain higher shares and therefore the need for proportional reinsurance is reduced. It is also evident that, when opportunities do arise, clients continue to be strict with regard to the security they will accept.

In the absence of any significant change in the market landscape, such as losses or capacity reductions, we can foresee a similar pattern to 2004, with, in all probability, further reductions in the final quarter.

There may be a time whether it be in 2005 or 2006, when the reinsurance market may stabilize at the insistence of capacity providers in particular, but currently market forces are the prevalent factor.

### **Casualty**

Our perception is that rates on general casualty business are generally renewing with rate reductions of between 5 - 10%. This might seem counterintuitive given that most motor accounts are showing increases of around 10% - 15% plus (subject to the regional variations mentioned in the Motor section), but it is probably explained in reinsurers' minds by the fact that original rates for casualty are holding more steady than they are for motor, combined with the reality that social inflation continues to be lower in General Third Party and Employers Liability than it is in Motor.

## **Professional Lines**

Reinsurance markets are substantially content to renew at unchanged treaty terms, reflecting a willingness to follow original market movements. In the absence of a major new presence within the reinsurance market, pressures are broadly steady, although reinsurers have expressed concern at the slipping of primary levels.

Buyers, as in other casualty lines, are re-emphasising their concerns as to the counterparty security risk. Unlike in Motor, where pricing pressures have combined with security concerns to lead some insurers to raise their retentions, there have been limited signs as yet within Professional Lines that the security concern is translating into increased retentions.

D&O underwriters are continuing to focus on the US exposure within any risk. If anything, the same questions as before are being asked with increased frequency, which is encouraging. On the other hand, we are seeing underwriters drift away from earlier efforts to introduce co-insurance features in relation to securities entity cover, which, whilst being pragmatic and realistic, is nonetheless a step away from earlier more disciplined efforts.

We anticipate a relatively steady and uneventful year. The modest rate of pricing slippage does not suggest major problems ahead. Reinsurers appear to be comfortable at current conditions. Barring unforeseen and dramatic problems, we would expect 2005 to be a year of consolidation for most parties.

This field remains technically complex at all levels, from risk analysis and policy wording design all the way through to claims reserving, handling and settlement. Cases such as the Disney/Eisner/Ovitz suit are constantly demonstrating the fast-evolving nature of the D&O risk. The quality of market debate, whether in Europe, Australia or the U.K., has been consistently rising. We are optimistic that the stronger market fluctuations in this field will gradually soften into a more stable environment.

## **Engineering**

Both cedants and reinsurers have undertaken a period of consolidating their accounts and reinsurers appear now to be looking to further develop their business, with profitability being the key to their acceptance criteria.

The Engineering market has remained disciplined throughout the renewal season with regards the scope of original / reinsurance cover, deductible / attachment levels. However, Machinery Breakdown business is under extreme pressure from the Property market, who are prepared to absorb it for little or no additional cost.

Pressure has been put on reinsurance rates for excess of loss business supported by the fact that there have been no major engineering losses in the past 12 months. Whereas the pressure in the proportional treaty market has been driven by reinsurers who are working to tighter profitability margins.

There is a continued move to build on and improve the already good cedant / reinsurer transparency.

Underwriters are increasingly having to involve the use of actuaries, with less autonomy remaining with the underwriters (in certain companies).

The state of the reinsurance market will undoubtedly make it attractive for new players and 2005 will see an increase in activity from reinsurers outside of the traditional engineering market, such as Bermuda.

This will conflict with the existing markets who will be required to develop, but not at the expense of profitability not least of all proportional to offset the legacy of past results.

## **Marine**

Reinsurers have been seriously impacted by Hurricane Ivan. The energy loss, including business interruption losses, appears to be in the region of \$2.5 billion. Of this sum, \$1.5 billion is likely to be settled by the traditional marine reinsurance market, with the remaining \$1 billion falling under insurers' own retention, oil companies' self-insured retentions and OIL. This claim has evolved from a hurricane path, which was not subject to the Lloyd's RDS analysis, and escalated into the largest ever marine/energy reinsurance claim.

The marine reinsurance market was already adjusting to a downturn. The loss combined with some other substantial claims in the marine sector during 2004 has caused this move downwards to falter. Loss-making layers are paying up (in line with loss cost analyses) and catastrophe layers with a loss are paying a little more. All other marine reinsurances are under pressure and the restructuring of program layering and

consolidation of reinsurance purchasing has enabled savings for many reassureds.

The weakening reinsurance market is a reflection of a Marine and Energy insurance market which is under heavy pressure on rates. Energy is falling from recent knee-jerk price increases; Hull is flat, but seeing rating pressure from some markets; Cargo is also seeing reductions; the Marine Liability sectors (including P&I) are stable.

### **Property**

2004 has seen the reinsurance market continue to support the use of pro rata structures to accept per risk exposures. The reinsurance market seems to have been keen to maintain its premium income and therefore, where a pro rata treaty has yielded a sufficient margin, reinsurers have been prepared to maintain their shares. Where the margin has been eroded, they have reduced their shares or declined to participate at all. The following issues have remained important in the consideration of pro rata contracts during 2004:

- Contingent Business Interruption
- Nuclear Risks
- Limitation on Natural Perils Exposures

The use of non proportional structures to manage per risk exposures continued to grow in 2004 with a strong preference for this type of structure being shown by reinsurers. It is anticipated that there will be continued improvements in terms for 2005 for loss free programmes.

Regarding catastrophe excess of loss, at Monte Carlo and Baden Baden the general consensus was for a flat or neutral renewal season. The effects of numerous hurricanes and typhoons were only expected to have a pricing impact locally on loss affected programmes and not on the global market.

Indian Ocean tsunamis footnote... Whilst the recent Indian Ocean tsunamis have been tragic in terms of loss of life they are not expected, from early estimates, to generate significant financial loss to the international reinsurance property markets.

As the rates for loss free excess of loss business show signs of continuing to soften, the reinsurance market will continue to offer support for pro rata capacity in

2005. We have already seen signs of a loosening of terms with the introduction of improved commission levels or the introduction of profit commissions for treaties that offer a suitable balance. There have also been some reductions in the size of event limits that have been introduced in recent years.

Based on the comments above, one assumes that there are still good margins in the property reinsurance product and an acceptance by the sellers of capacity that, in order to meet their shareholders' ever growing demand for earnings, they must first of all participate in the market's products.

### **Retrocession**

The 2004 hurricane season has made insurance and reinsurance companies address the frequency issue of multiple storms hitting their retentions. Aggregate Industry Loss Warranties have been one of the ways to address the retention issues for our retrocession clients with contracts attaching after two to four events.

The 2004 hurricane season also produced the most active and heavily traded live catastrophe market in recent years. Traditional reinsurers and hedge funds were buying and selling capacity for all four hurricanes with capacity being bought and sold in the USA and the Caribbean.

Due to the scrutiny regarding finite reinsurance contracts, some clients are unwinding contracts and either buying traditional retrocession or, if that is too expensive, looking to structure a retrocession program using Industry Loss Warranties at various industry trigger points.

### **Security**

The autumn's major hurricanes and typhoons had little discernable impact on reinsurer security, despite the anticipated high total cost - some estimates are upwards of \$40 billion. Those reinsurers specializing in catastrophe protections suffered big number losses, but their business philosophies remain intact.... they operate how they're designed to operate, and their ratings have remained untouched.

Whilst ratings for the majority of reinsurers are fairly stable, attention appears to have focused again on price. But this brings with it the concern about the pressure on companies to generate volume to satisfy their thirst for growth, whether internally or externally promoted.

From a financial strength rating perspective, the reinsurance sector is largely enjoying a period of relative stability. This is giving many clients the opportunity to focus inwardly and ensure that their own house is in order, revising and improving internal structures, processes, and documentation.

Finally, we also expect to see continuing efforts by the rating agencies to improve and develop their models and assessment practices, as they seek to increase their relevance and support to the market.

## **Export credit insurance Munich Re**

### **The functions of export credit insurance**

#### **Functions for the individual exporter**

– Credit insurance's main function is to protect against the risk of non-payment.

The exporter is protected against losses or prolonged lack of liquidity caused by protracted failure to pay on the part of the buyer or buyer's country, which of course gives the exporter an instrument to protect his own financial position.

– Obtaining sufficient working capital is a crucial factor for exporters to take full advantage of the opportunities in the international market. Lack of information and lack of collateral cause lenders to refuse financing to the exporter, or alternatively charge higher interest rates, thus increasing export prices, and hampering exporters' competitiveness.

If the exporter's assets are protected by credit insurance, the insurance policy is of great assistance in facilitating

the mobilization of working capital to finance transactions.

– In order to expand, or even to maintain, existing business, companies can be forced to grant export credit. Capital is scarce and many companies are only willing to buy when offered finance. Exporters can safely offer credit lines and thus increase sales volumes only

by securing the credit risks involved. This may also create a competitive advantage towards other suppliers of the exporter's products or services, as the insured exporter may, because of his credit insurance cover, be in a position to grant supplier credit, while other exporters may not have this possibility.

– Many firms lose more money from delayed payments than from bad debts. Credit insurers offer collection services and can use the economies of scale in this respect to their advantage. The accumulation of claims with an insurer, through the insurer's international standing and contacts, places it in a stronger position to collect overdue debts than any of the individual creditors separately.

– Credit insurance companies will also play an important role with respect to developments in the exporter's buyer portfolio. Potential clients can at any time be checked by the credit insurer with regard to their creditworthiness, as a consequence of which the exporter will be in a position to be more proactive towards new clients and/or potential business partners. Furthermore, because the credit insurance company constantly monitors the risks in its portfolio, the exporter will be informed immediately if the financial situation of one of his buyers deteriorates.

#### **Functions for the exporting country**

The additional uncertainties in international trade bring additional risks and greater transaction costs than found in domestic trade. If exports to markets with excessive credit risks can be prevented, the country benefits. Exports for which no payment is received as a consequence have a negative impact on a country's assets. On the other hand, the opposite is also true. If better information makes exports possible to buyers in countries with a sound credit risk, the country gains in terms of production capacity, employment and foreign-exchange earnings.

Credit insurance ensures the continuity of industry against hazards from external factors: for example, non-payment from one country will not cause failure and bankruptcy throughout the home industry.

Although no hard and fast rules can be given regarding the effect export credit insurance will have on export volumes,

it is clear that export credit insurance provides exporters with an instrument to facilitate their international business.

### **Basics of credit insurance**

#### **Distinctions in credit insurance**

**The following distinctions in credit insurance can be made:**

##### **1 Short-term/Medium- and long-term credit**

Short-term credits are considered to be credits up to one year. Usually the products offered by credit insurers for medium- and long-term credits, like capital goods and construction works, are quite different from those available for short-term credit. As medium- and long-term credits are usually not

considered to be marketable in the private reinsurance market, we will concentrate in this paper on short-term credit insurance.

## **2 Turnover insurance/insurance of specific transactions**

It is one of the most important principles of credit insurance that as a rule short-term credit insurance should be offered on a whole turnover basis. Experience has shown that credit insurance companies should insist on this item towards their (potential) policyholders. Even though the credit insurer will underwrite and evaluate each individual risk and may even require an additional premium for selected risks, every effort should be made to avoid anti-selection as much as possible.

## **3 Commercial risks/political risks**

Commercial risks are the risks relating to the buyer, to its ability to pay. Political risks relate to events or situations that may arise in the buyer's country preventing the buyer from paying or preventing the transfer of payment to the exporter's country. Political risks are always outside the sphere of influence of both the buyer and the exporter.

## **4 Pre-shipment risks/post-shipment risks**

Once the exporter has sent the goods, usually all it can do is wait and see whether payment of its invoices is received. The goods are already out of its control. These risks are called post-shipment or credit risks. However, in several lines of business, the exporter may also have a financial risk in respect of the buyer or on the buyer's country before the goods have actually been sent. These risks, pre-shipment or fabrication risks, arise when goods are specifically produced for a certain buyer.

In those cases the exporter may suffer a loss when it cannot deliver the goods (finished or still in production) to its client, as it may be impossible to find an alternative buyer willing to pay a similar price. In the insurance of pre-shipment risks, the focus is on "costs" incurred by the exporter.

## **Some principles of credit insurance**

Credit insurance covers the inability, not the unwillingness, to pay.

Usually, short-term turnover policies have a standard duration of 12 months from the date of inception, insuring a maximum of 80–85% of the invoice value of the delivery (whereby for the sake of simplicity it is assumed here that the value-added tax is not covered). A claims waiting period of six months is common. The policy can be endorsed, amended and varied to provide both pre- and postshipment cover as well as post-shipment cover only. The endorsement can be used as a collateral to banks for pre- or post-shipment financing.

Furthermore, the turnover character of the policy is compulsory, obliging the exporter to insure its whole turnover or objectively specified parts of its turnover in order to obtain a reasonable spread of risk and to protect the insurer against anti-selection.

## **Types of risk**

Export credit insurers concentrate on the cover of the following risks:

### **The commercial (or buyer's) risk**

The risk that a foreign buyer will fail to meet its payment obligations to its supplier due to default or insolvency (insolvency risk), including the risk of protracted default, i.e. the risk that without the occurrence of a commercial or political cause still no payment from the foreign buyer is received within a certain period (waiting period).

### **The political (or country) risk**

- The transfer and convertibility risk that a buyer with adequate local funds available to meet its obligations is unable to obtain the foreign exchange required to meet those obligations;
- The risk of political events which prevent or delay payments due to:
  - a general moratorium on external debt decreed by the government of the buyer's country or of a third country through which payment must be made;
  - any other action by the government of the buyer's country which prevents performance of the contract;

- war or similar events preventing performance of the export contract, including strikes, riots and civil commotion;
- cancellation or non-renewal of an export licence;
- contract repudiation or cancellation;
- insolvency or protracted default of a public buyer;
- confiscation, expropriation, nationalisation and deprivation.

### **Premium systems**

In fixing the premium a distinction should be made between the insolvency risk and the political risk. This premium is usually calculated as a pre-set percentage of the invoice value of deliveries. The following basic criteria could be used for the calculation of the insolvency premium:

- Trade sector of the insured
- Average terms of payment used by the insured
- Size of turnover and number of accounts
- Percentage of cover
- Loss experience from bad debts in the past

### **Underwriting**

#### **Buyer underwriting (commercial risks)**

Essential questions in this respect are:

- Why is buyer underwriting necessary?
- What are important elements to look at?
- Which procedures, skills and IT aspects are required?
- How does constant review take place and how are changes implemented?

The basic principle for the assessment of credit insurance risks (as for any other type of insurance risk) is that the risk to be covered should be a sound one at the moment it is underwritten.

In this respect it should also be mentioned that there may be a certain accumulation of risks on one and the same buyer.

If several policyholders do business with the same buyer, and thus apply for a credit limit on this buyer.

Credit insurers keep files which contain information on buyers obtained through various sources such as banks, information agencies, chambers of commerce, other credit insurance companies, embassies as well as information from press cuttings and other publications.

#### **Country underwriting (political risk)**

Essentially, the same basic questions apply to country underwriting as do to buyer underwriting.

Underwriting country risks requires a continuous inflow of information regarding the political and economic situation and development of buyers' countries, in order to assess whether restrictive measures are necessary or earlier measures can be waived. There are different alternatives that can be used when underwriting country risks, of course next to the possibilities of providing cover without restrictions or being off cover. Among others:

- A longer waiting period
- A lower maximum percentage of cover
- Maximising the total exposure on a country at the present level
- unconditionally or
- with a possibility for policyholders to get credit limits on new buyers in exchange for the withdrawal of (some of) their already existing credit limits on buyers in that country (up to the same amount)
- Requiring a letter of credit issued by a bank (in that country) that is acceptable to the credit insurer
- Requiring other types of guarantees (bank, government, etc.)

## **Reinsurance**

### **The function of reinsurance**

- The provision of “soft” capital, in order to
- enable the insurance company to do more business, in order to
- increase the spread of business in the insurance company’s portfolio, and
- to produce economies of scale, in order to
- produce better results for the insurance company.

### **Reinsurance of commercial risks**

It may be useful to work with a small group of private reinsurers in order not to become too dependent on one company. Nevertheless, having some larger leading reinsurers, which can back the whole programme and who can control larger commitments on individual debtors is also of great importance.

In addition to some evident elements (like capacity and reinsurance strategy), the question whether or not (large) reinsurers are willing to support the programme, depends on a number of factors, like:

- the types of risks covered;
- the wording of the policies;
- the legal environment;
- procedures and experience of people/institutions handling the underwriting of buyer risks;
  
- countries that are being exported to;  
and
- loss experience of the region involved.

### **Reinsurance of political risks**

Historically, political risk underwriting was considered to be a government responsibility because of the difficulty of spreading the risk due to the limited number of existing countries and the concentration of risks in a small number of countries. Nowadays we can also offer facilities for the reinsurance of political risks, and for most countries the capacity available is quite sufficient. Technically a credit insurance company’s reinsurance scheme for political risks can be arranged in a similar manner to that regarding its commercial risks, and in fact in most cases the two types of risks will be combined in one treaty. Nevertheless, it should be borne in mind that often reinsurers require the political risks to be offered to them together with the commercial risks, as most reinsurers are not prepared to reinsure only the political risks.

### **Business Plan**

It is common practice, when starting a new activity of business or when introducing a new product type in one’s company, to prepare a business plan. Preparing such plan is useful for organising one’s thoughts, but primarily forces one another to consider all aspects of the new activity and to look at how these influence each other.

We would strongly recommend to also do this regarding the introduction or set-up of an export credit insurance activity.

One of the most difficult topics in deciding on whether or not to introduce an export credit insurance company or unit is to ascertain whether the new activity would have the potential to become profitable within a reasonable period of time. As one has to consider that – as in many types of business – the set-up of the unit will cause relatively high costs and still little income, we suggest to take at least a period of three or five years into account in this respect. A relatively simple example of how this feasibility can be ascertained is given in the following chapter.

Of course, in a business plan, not only attention should be given to the financial elements like forecasts and capital structure, but also to topics like:

### **Marketing**

- How will the product be sold?
- Which part of the market can be handled by the own sales force?
- What role can insurance brokers play?
- What kind of remuneration should they get?
- Can banks help in selling the product?

### **Buyer underwriting**

- Where do we get our information from?
- What contracts should we negotiate with information sources?

### **Claims**

- How do we manage claims and recoveries?
- Functioning of the insolvency laws in our major exporting countries.

### **IT**

- What hardware/software do we have to acquire/develop?
- Where can we obtain/how do we develop a buyer database?

### **Personnel**

- How can we find qualified personnel?
- What training do they need and who can give such training?

### **Legal**

- Various details of the company, including capital requirements.
- Clearly these are only some of the areas of attention. We would be more than pleased to assist you in preparing such business plan or to provide you with a more complete list of items.

An important element involves the development of a flow chart regarding the timing and consecutive follow-up of the various activities. Such chart will help you in keeping control of the project, especially when the accepted time schedule is strictly adhered to.