



Motor Third-Party Liability Insurance

Serap Gönülal

PRIMER SERIES ON INSURANCE
ISSUE 16, SEPTEMBER 2010

NON-BANK FINANCIAL
INSTITUTIONS GROUP

GLOBAL CAPITAL MARKETS
DEVELOPMENT DEPARTMENT

FINANCIAL AND PRIVATE SECTOR
DEVELOPMENT VICE PRESIDENCY



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THIS ISSUE

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The Primer Series on Insurance provides a summary overview of how the insurance industry works, the main challenges of supervision, and key product areas. The series is intended for policymakers, governmental officials, and financial sector generalists who are involved with the insurance sector. The monthly primer series, launched in February 2009 by the World Bank's Insurance Program, is written in a straightforward, non-technical style to share concepts and lessons about insurance with a broad community of non-specialists.

The Non-Bank Financial Institutions Group in the Global Capital Markets Development Department aims to promote the healthy development of insurance, housing finance, and pension markets, and to expand access to a broad spectrum of financial services among the poor. These markets provide opportunities for household investment and long-term savings, and can buffer the poor against the risks of sickness, loss of breadwinner, catastrophic events, and other misfortunes.

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Introduction

Serap Gönülal

Motor Third Party Liability Insurance (MTPL) ensures that damage to third party health and property caused by an accident for which driver and/or owner of the car were responsible is covered. A policy may be taken out by the owner of a vehicle or by a lawful possessor authorized by the owner on behalf of the owner.

Compulsory MTPL Insurance is a financial protection system built to prevent any grievance that third parties could face, due to lack of solvency of first party who caused bodily injury or property damage following any event related to a Car Accident.

Motor insurance is generally measured non-life insurers' strongest class of business in terms of premium volume. In most markets, it is characterized by high competition and cyclical fluctuations in results. Non-life insurers' motor result is thus likely to have a particularly strong impact on the overall result. In most countries, MTPL insurance is compulsory in order to protect the public. World Bank studies in Africa, Central Asia, and Europe have shown that motor insurance premiums represent at least 30 percent of all non-life premium income (Annex 1). This phenomenon may be explained by the rapid rise of motor fleets. MTPL insurance has been introduced in the formerly centrally planned economies only in the past decade, but it is poorly understood. Motorists are inclined to view it as a form of tax that they are at liberty to evade, rather than as a protection against their personal liability—a concept that is not familiar to the general public.

According to the first major report on road injury prevention jointly issued by the World Health Organization (WHO) and the World Bank, road traffic injuries are a huge public health and develop-

ment problem, killing almost 1.2 million people a year and injuring or disabling between 20 million and 50 million more. Both WHO and World Bank data show that, without appropriate action, these injuries will rise dramatically by 2020, particularly in rapidly motorizing countries. Over 90 percent of the world's fatalities on the roads occur in low-income and middle-income countries, which have only 48 percent of the world's registered vehicles.¹ Although data on the costs of traffic accidents are sparse, particularly for low- and middle-income countries, these injuries clearly have an enormous economic impact on individuals, families, communities, and nations, costing countries between 1 and 2 percent of their gross national product. In addition, there is the heavy and tragic burden on those directly affected, physically and psychologically, as well as on their families, friends, and communities. According to the WHO's 2004 *World Report on Road Traffic Injury Prevention*, health facilities and their often meager budgets are greatly overstretched in dealing with survivors of traffic accidents.

In some countries, the insurance industry shares responsibility for preventing road injuries, and organizations funded by the insurance industry make a valuable contribution to road safety. For example, *Folksam* in Sweden and the Insurance Institute for Highway Safety in the United States provide objective information about the crash performance of new cars and other safety issues. Data is collected by such groups as the *Finnish Insurers' Fund* and by *TRAMER*, the Turkish data collection system, both of which investigates every fatal crash occurring nationally, carries out safety studies, and provides information to the public.

Motor insurance has the potential to be a powerful tool in the promotion of personal responsibility. If communicated effectively, the link between the consequences of causing an accident and the economics of paying for those consequences will of itself gradually lead to improved driving. Many more developed economies work extensively with bonus-malus premium pricing, which has a dramatic effect on making the driver feel responsible for his or her own driving. In developing economies, this is rarely a practical option at the individual level, but price variations by type of vehicle (and perhaps by location) can play a valuable part in bringing home the principle of the "user pays." Similarly, compensation that reflects the behavior of the individual can be harnessed to improve behavior—if the system pays benefits on a no-fault basis, there is no incentive to wear a seatbelt.

While it is not within the power of insurers to change the state of roads and bridges, standardization of methods, both in establishing histories and in assessing claims, has a certain beneficial impact

1 Global status report on road safety 2009

on both the insurer and insured. Databases permit more accurate tracking in cases of fraud, while simplifying the assessment of imminent compensation claims by insurance companies. In the absence of an insurer of last resort, i.e. when insurance companies are obliged to underwrite, this factor is especially important, as it also might stabilize the development of premiums and rates. A more predictable development, in turn, would be to the insured's advantage.

The main components of MTPL

The protection of policyholders against insolvency of insurance companies is one of the primary objectives of insurance regulation. In order to achieve this goal, a range of regulatory and supervisory measures are normally established to ensure financial and managerial soundness of insurance companies, and supervisory authorities are expected to do their best to avoid the failure of supervised companies. It is sometimes inevitable, however, that some insurance companies will encounter serious financial difficulties. In spite of all possible supervisory measures, insurance companies can become insolvent. In MTPL, typically, guarantee funds are created to compensate persons who suffer bodily injury caused by hit-and-run drivers and to pay claims for property damage caused by uninsured motorists. Such funds have been recommended by the Organization for Economic Co-operation and Development (OECD) and the European Union (EU). The main arguments in favor of and against insurance guarantee schemes typically revolve around their "moral hazard" and costs. Normally the guarantee schemes are financed by contributions, which are related to the premium income of the insurance companies. Roughly half of the countries with a guarantee scheme have mechanisms in place to permit the guarantee scheme to borrow or receive income from other sources. Generally, the government does not finance or underwrite guarantee schemes, but in practice there is an implicit commitment to finding a solution that ensures that claims will be met.

In light of the influence of MTPL in developing insurance markets, it is of utmost importance to gain the trust of the motoring public by developing a system that is seen to be transparent, efficient, and equitably run. Such a system would be free of unfair market practices and promote the timely settlement of claims. Also important are efforts to reduce the proportion of motorists who are uninsured, because their accidents are costly for the guarantee fund. No less important is the efficient collection of data. Reliable data can assist with processing claims, tracking uninsured motorists, pricing products fairly, and preventing fraud.

The main elements of MTPL can be summarized as follows:

- A. **Legal structure:** This includes systemic factors such as the role of the courts and torts; minimum cover; thresholds and limits (if any); whether the insurance goes with the car or its owner; the overall role of liability law; the workings of any tariff system; links to new registrations; and the role of the traffic police.
- B. **Actuarial methodology:** This includes the foundations for establishing premium rates and for posting reserves to meet pending and future claims.
- C. **Contingency reserving:** including the state guarantee fund
- D. **Claims management and information service:** This includes data collection, information-sharing mechanisms, and claims services.
- E. **Reinsurance:** This includes the proper approaches to maximize the benefits of reinsurance, which should be tailored to the solvency requirements and financial standing of the particular insurer.

A.) Legal structure: Liberalization, regulation or deregulation

A fundamental principle of any type of insurance is that if the insurers are to sell coverage willingly, they must receive a premium that is sufficient to fund their expected claims costs and administrative expenses and earn sufficient profit to compensate for the cost of obtaining the capital necessary to fund the solvency margin. In fact, an insurer will only survive if it charges adequate rates consistently over time for the risks it accepts. This is particularly relevant in general insurance and in motor business, where risks can be very volatile and the cost of meeting claims is constantly under pressure from inflation and other upward trends. Also, the fact that policies are normally issued on a one-year renewable basis means that an insurer can lose good business or gain bad business very quickly if its rates become out of line with the rest of the market and if the tariffs do not reflect the real cost of claims that the risks will entail. It is, therefore, of vital importance that the insurers keep premium rates under constant review and be prepared to amend them as necessary.

In the majority of developing countries, MTPL premiums are subject to government oversight typically through the setting of maximum prices. The rationale behind statutory prices is, generally, a combination of arguments:

MTPL in the European Union (EU) has been deregulated fairly recently (mainly over the period 1968–94). Yet different countries

have pursued liberalization at different times and in different ways. In France, for instance, a very limited regime of control was in place for the approval of MTPL tariffs after the end of World War II. A pure regime of liberalized tariffs has been applied since 1986 (that is, many years before the official date for liberalization imposed by the European directive). Many of the differences in international motor insurances are simply a reflection of the length of time the market has been deregulated. Hence, the UK (deregulated in the 60s) has one of the most sophisticated rating structures, while those more recently deregulated (e.g. Hungary, Poland and Turkey) still have relatively simple structures.

However, in many respects these are the most interesting markets as the picture is changing rapidly. Only a few years ago, just the car and the cover had an influence on the rate, but already we are seeing additional factors such as “Bonus/Malus” and “Age of driver” becoming common place. This trend towards a more complicated structure looks set to continue. The MTPL is more strictly regulated by national legislation than other lines; this is an area where knowledge of the distinctive features is especially important. The primary public policy concern underlying this regulation relates to concerns over the willingness and ability of consumers to observe and monitor the financial health of their insurer, especially when insurance is made compulsory. In the past, this led to a variety of policy interventions designed to restrict competition. Deregulation has involved a lifting of these restrictions on competition, a refocusing of regulation on prudential controls and consumer protection issues, and a focusing of regulation on consumer product lines.

Public policy in the MTPL insurance primarily seeks to overcome consumers’ difficulties in observing and monitoring the financial health of their insurer, both before and during the lifetime of the insurance contract. Even if consumers were willing to do so, there is a concern that a competitive market does not make the information available in a form which consumers could understand. Furthermore, where insurance is compulsory, to the extent that the requirement forces consumers to purchase insurance that they otherwise would not have purchased, consumers face little incentive to observe and monitor the financial health of their insurer. As a result, there is a concern that competition between insurers would lead to deterioration in the financial health of insurers, bankruptcies and a lack of coverage for consumers.

Regulatory concern relates to concerns over the ability of consumers to understand and compare the various terms and conditions in insurance contracts. Competition between insurers will therefore be ineffective and will lead to adverse surprises for consumers. These concerns are not as strong for those lines of (voluntary) insurance which are

purchased primarily by large businesses (such as reinsurance and insurance covering industrial risks).

As a result of these concerns, regulation has traditionally taken the form of limiting the extent of competition between insurers, through controls on entry, on prices (particularly price floors), on the methods for calculating premiums, on terms and conditions and, in some cases, through the explicit promotion of cartels. These regulations may not be effective at preserving the financial health of insurers, however, if they merely divert competition away from, say, prices and into other dimensions of service quality. If the regulations are effective at restricting competition, they may have the usual undesirable effects of limiting incentives for efficiency and innovation.

Deregulation has therefore involved: First, the targeting of insurance regulation to those markets in which the primary consumers are individual citizens and away from markets in which the primary consumers are large businesses; second, a trend away from controls which limit competition between insurers (such as statutory monopolies, controls on premium prices and policy terms and conditions, the fostering of cartels), to controls on the financial position of insurers; third a trend away from requirements for prior approval of terms and conditions of insurance contracts, to reliance on general prohibitions against certain terms, industry agreements and general consumer protection laws; and finally, moves to enhance the quantity and quality of information that insurers must disclose relating to their financial position and attempts to increase the responsibility of directors and managers regarding to prudential health of their company. In a few cases MTPL price controls have acted as a ceiling (rather than a floor) on insurance premiums (particularly in response to consumer concerns over premium growth in health and motor vehicle insurance). This results in a withdrawal of coverage for certain risks, which typically leads to pressure for further intervention in the form of an insurer-of-last-resort.

B.) Actuarial Methodology

Calculation of Premiums and Reserving

Usual Steps to be taken during a tariff study

1. Collecting Data
2. Creating an analyzable Actuarial Data-Set

3. Monitoring the results, understanding the characteristics of claims, then calculating the Key Performance Indicators (Claim Freq / Average Claim Severity, Loss Ratio)
4. Understanding and describing significant variables specific to that data set based on the existing information and creating meaningful risk groups.
5. Calculating the effect of each detected variable to claim costs.
6. Finalizing tariff model
7. Simulating potential results

Three well-known characteristics of insurance have an impact on the management of MTPL, particularly on its pricing and its reserving:

Inverse sequence. In insurance, the producer (the insurer) prices its service (insurance coverage) before its cost is known (the actual cost of the claim, if and when a claim occurs). When the insurer sets its prices, it faces two uncertainties: one regarding the number of claims that will occur and one regarding the total cost of all these claims. These uncertainties also affect the supervisory authority when it sets the statutory price of compulsory insurance such as MTPL.

Long time lag. Although the insurance activity has to be accounted within a yearly framework, the entire process (period between payment of the premium and settlement of the claim) usually takes more than a year. Therefore, at the end of each year, the insurer has to set aside an amount on the balance sheet to meet liabilities arising out of insurance contracts underwritten during the accounting year, including claims provision (whether reported or not) and other technical provisions. And the longer the settlement process (as in emerging countries), the more difficult the reserving issue.

Market cyclicity. In almost all free markets, the profitability of insurance rises and falls in economic cycles. Any understanding of the management of an MTPL portfolio needs to take into account the reality that the forces of competition create times when pricing can and will either rise above or fall below the pure risk rate. The cyclicity of insurance pricing can affect pressures on MTPL even when that class is price-controlled.

These three features of insurance (inverse sequence, long time lag, and market cyclicity) affect both the pricing and the reserving of insurance, especially in the MTPL branch in developing countries. In addition, the process of reserving for claims and other liabilities already incurred as a result of writing the MTPL business does not affect the ultimate profit or loss stemming from that business; it only controls the rate at which that profit or loss will emerge in the accounts. Neverthe-

less, ultimately, an insurer will only survive if it charges adequate rates consistently over time for the risks that it accepts.

Actuarial Approach of MTPL Premiums

In most developing countries, compulsory MTPL premiums are statutory, and the government, either directly or through some more complex governance process, is in charge of setting statutory minimum and maximum or only maximum prices.

In most of the more mature markets, prices are free and only subject to tough competition. In general, insurance risks can be very volatile, and the cost of meeting claims is constantly under pressure from inflation and other upward trends. Also, the fact that policies are normally issued on a one-year renewable basis means that, in a competitive environment, an insurer can lose good business or gain bad business very quickly if its rates become out of line with the rest of the market. In this case, it is of vital importance for an insurer to keep rates under constant review and to amend them as necessary.

It is highly desirable that the insurance supervisory and/or regulatory authority, when setting the price of compulsory insurance (if that is part of its mandate) and supervising market practices, (a) should have powers to intervene if an insurer's activities threaten its solvency margins and (b) should have a regular flow of information that promptly indicates when intervention may be required. It also should be able to take action to manage any dumping attempt that may push market prices below the breakeven level. In both cases, a trivial rule of insurance is that the premium charged to the insured before tax must represent the risk introduced to the insurance company (including every component of the costs) and an acceptable level of profit margin. The actuarial equation to define a fair-cost premium is, therefore, as follows:

$$\text{Fair-cost premium} = \text{base premiums (cost of claims)} + \text{acquisition cost} \\ + \text{administration cost} + \text{profit margin} - \text{financial income.}$$

A different equation expresses the relation between costing and pricing:

$$\text{Market premium} = \text{fair-cost premium} \pm \text{market price adjustment.}$$

Costing the product is included in the base premiums. Pricing the product (that is, deciding on the actual premiums to be charged in practice) relates to the loading factors of the equation and the market forces that may cause the company to adjust the theoretical rates during the pricing process.

- The major component of the premium (cost of claims) is unknown at the time the price is set. Although the exact future amount is by definition unknown, it is likely that some information can be collected from the past in order to estimate its value. In practice, there are many ways of calculating MTPL insurance. The rating process normally starts with a calculation of the pure risk premium (that is, the premium required simply to meet the expected cost of claims arising from the policies written under the new rates); to this should be added loadings for expenses, profit, and other contingencies.

When setting up the price of an MTPL insurance contract, premiums are quoted in relation to the unit of exposure. At its simplest, the risk premium for any group could be calculated by analyzing the values of the following:

$$\text{Risk premium (RP)} = \text{expected cost of claims} / \text{number of contracts.}$$

This approach is always easy to undertake, since both the “expected cost of claims” and the “number of contracts” are usually available information.

In essence, a strong statistical basis is essential for the successful management of any MTPL framework. This is due to the following:

- Insurance is subject to the principles of inverse sequence, long time lag, and market cyclicity.
- Viable and sustainable MTPL insurance needs to be founded on intelligent and risk-related pricing foundations. Hence pricing it requires careful research and analysis.
- The expected cost of claims is a complex function of the underlying risk segments, inflation, and a large number of more detailed variables.
- Risk segmentation is desirable to promote consumer awareness of risk, but only a limited degree of segmentation can be achieved by government-sponsored insurers.
- Data collection is essential to a well-managed scheme.
- Inflation is a deeply complex subject founded in many variables and needs careful analysis if its impact on MTPL claims is to be properly understood.
- Commissions and costs need careful analysis.
- External reinsurance, capital issues, and financial revenues all need to be integrated in the complete actuarial model.

- Likewise, all forms of premium reserves and loss reserves need to be properly established and actuarially monitored.

With all of these in place, there is a sound foundation for a sophisticated actuarial analysis that will enable the pricing of MTPL to be conducted on a sustainable basis. This, in turn, will enable the MTPL insurance to fulfill its proper role in helping developing countries to manage their motor risks and gradually to improve their response to the challenge presented by motoring.

C.) Contingency Reserving (Guarantee Fund)

At the heart of every property and casualty insurance contract lies a promise that, if misfortune strikes, insurance will step in to soften the blow by covering the losses suffered by the insured. MTPL insurance is intended to cover third-party claims when vehicles driven on public roads cause significant harm to human life or property. However, although the legal beneficiaries of the insurance may have the right to receive compensation, they, or a third-party victim, may not receive compensation as a result of unforeseen circumstances. Although insurance companies are expected to compensate victims, the state may have to intervene when the relevant insurer is insolvent or otherwise unable to pay or when the guilty driver (or vehicle) is uninsured or not identifiable. This intervention is normally done through a contingency fund (also called a guarantee fund) in the case of an insolvent insurer and either through a guarantee fund (sometimes the same as the insolvency fund) or a nominal defendant (which may be an individual or independent government entity) in the case of an uninsured and unidentified liable party. Guarantee funds and nominal defendants thus constitute a necessary safety net that operates as part of a coherent system of compulsory national MTPL insurance.

Insurance guarantee funds protect victims of accidents involving uninsured or hit-and-run drivers. According to the Motor Insurance Bureau (MIB) of the United Kingdom, which is in charge of compensating the victims of negligent uninsured or untraced motorists, three people every hour are injured by uninsured or untraced drivers in that country. The MIB claims-handling experts manage more than 30,000 claims every year for accidents involving uninsured vehicles and seek to settle the claims fairly and promptly. The company also manages the motor insurance database, which is the central record of more than 34 million insured vehicles in the United Kingdom. The database is used

principally by the police but also by the state and insurance companies as a key tool in combating fraud.

The guarantee fund may also deal with various issues, including the insolvency of insurance companies and the negative effects of uninsured driving, untraced drivers, and stolen vehicles. In countries such as Canada and the United States, guarantee funds may protect consumers of a wider range of insurance products, including life and health insurance in addition to MTPL coverage. However, because of the moral hazard created (that is, drivers and vehicle owners have less incentive to use better managed insurers), guarantee arrangements are seen as a poor policy choice in countries that do not also have strong regulatory and supervisory regimes.

The terms and conditions, scope of coverage, or type of policies included in the scheme will be defined by the regulations of the country concerned. The details of the financial structure of the fund will typically be the subject of detailed regulation.

In addition to national regulations, European Union motor insurance directives, specifically the second directive (Directive no. 84/5/EEC, December 30, 1983) and subsequent amendments, call for each member state to set up a guarantee fund to provide cover for accidents caused by uninsured or unidentified vehicles. The fourth directive refers to a guarantee fund as the body, established in each European Economic Area member state in accordance with the second directive, set up to compensate the victims of accidents caused by uninsured or unidentified vehicles.

Guarantee funds are usually set up as nonprofit organizations under the control of the insurance supervisory authority or the relevant industry association. They are legal entities established by law for the purpose of paying certain policy claims of at-fault parties (in some countries where no-fault systems apply, the guarantee fund also pays not-at-fault claims), who either do not have proper insurance coverage or do not satisfy the legal requirements for coverage, and the claims of hit-and-run drivers, whose liabilities the insurance companies technically are not obliged to pay. In many ways, guarantee funds resemble the claims department of an insurance company.

The main legal framework is spelled out in a government regulation specific to the guarantee fund. The regulation should include details on the managerial bodies and their job descriptions, clarify the revenue and expenditures of the fund, describe the terms of use, and detail the process of evaluating and paying claims. Covered and uncovered claims and exclusions should be defined clearly in the regulation to avoid any possible disputes between the fund and claimants. An appendix to this chapter presents a sample, taken from Turkey, of a

regulation creating and governing the operation of a guarantee fund for compulsory insurance.

D.) Claim management and information service

Insurance claim management is a core issue for the protection of insurance policyholders and hence a priority concern for the insurance regulator and supervisors. From the insurance company viewpoint, claim management is a key element in the competition between insurance providers and for the improvement of industry's public image. The claim should be dealt with quickly and efficiently. The ideal claims management should focus the followings topics as recommended by OECD.

- Claims reporting
- Receipt of claims by company
- Claims files and procedures
- Fraud detection and prevention
- Claims assessment
- Claim processing
- Timely claims processing
- Complaints and dispute settlements
- Supervision of claims related services
- Market Practices

The environment in motor insurance today is dominated by fierce competition for market share in some developing countries. The lower prices not only increased clients' price sensitivity but have also raised their expectations of service, and we are now witnessing an unprecedented tendency on the part of clients to switch insurers on the basis of such criteria. However, one aspect is affecting everyone concerned: claims expenditure is rising all the time.

Effective claims management is dependent on two fundamental prerequisites: it must effect a sustained reduction in claims expenditure, which currently constitutes the greatest single cost item in insurance, and at the same time produce greater acceptance and satisfaction on the part of clients and claimants in order to strengthen customer ties. After all, a claim and its handling are the ultimate test of an insurer's performance and services. In order to meet these two central requirements, it is essential that the organizational and in perfect working order. This in turn requires modern information technology and communications media, highly qualified staff who are easy to reach at all times, and prompt, client-friendly claims handling.

Insurance information centers and MTPL insurance database centers are frequently established to implement an industry wide database of information on motor insurance. They provide a central source of information for the police and others, assist in the fight against uninsured driving, and provide other benefits as well.

Running a system of compulsory MTPL insurance requires a series of properly orchestrated participants, including insurance companies, policyholders, loss adjusters, insurance agents (if relevant), and the police. A central database that stores and provides access to the insurance information of policyholders, including claims, is critical to this coordinated effort.

Storing the historical insurance information of the individual policyholders and making it usable for diverse participants in the system are beneficial for the sake of both the process and supervision. Such a system is useful for the following:

- Identifying uninsured drivers
- Unifying MTPL insurance practices
- Preventing fraud.

Such a system is a public service that protects the rights of citizens. If it is seen as such, its presence will support the creation of a well-run, compulsory insurance sector.

Storing all insurance information in one database and providing appropriate levels of access to the related parties create benefits across the community. The key users of the system are the police, who need to know as quickly as possible who the relevant insurers are and whether the vehicles are insured. This information puts the police immediately on the track of criminal activities and can be used constructively in more general police matters. In the United Kingdom, for example, the police have powers to confiscate a vehicle that is on a public highway and found to be without insurance; if, after a period of time, no evidence of insurance is produced, the vehicle concerned can be sold or crushed. Individuals will benefit from a system that protects them from the risk of purchasing a fraudulent policy, allows them to query policies, ensures that they receive a suitable no-claim or other discount, if eligible, and enables them to receive payments quickly. In some countries, it may be difficult to protect the data from fraudulent use. It is essential for the system to respect privacy and only grant access to suitably authorized persons. Insurance companies and agencies will benefit from the system as well. They will increase the volume of premiums as a result of the correct application of tariffs, gain additional income from premiums and commissions due to the prevention of fraud, and

be protected from the issuance of policies outside the system. Both insurance companies and agencies (if relevant) will benefit from having access to the statistics created by the system. Finally, the state will minimize tax losses due to unregistered transactions, be able to protect the consumer, and receive more tax revenue as insurance companies earn more income.

E.) Reinsurance

Risk transfer is a mechanism that allows an insurer to protect its capital and stabilize its results from underwriting risk. From a motor insurance perspective, this capital is exposed to the risk of an adverse frequency or severity of claims in any one period. The compulsory nature of MTPL insurance provides for a minimum statutory limit, which should, in most countries, be sufficient to indemnify the insured against loss.

In purchasing reinsurance, insurers seek to improve their financial performance, security and stability over time. Basically there are five primary functions of reinsurance from the insurer's point of view:

- *Capacity*: Reinsurance provides flexibility for insurers in the size and types of risk and the volume of business they can safely underwrite.
- *Expertise*: Reinsurers supply assistance to insurers in specialised areas where the insurer may have little or no expertise.
- *Stability*: Reinsurance programs properly structured will assist insurers by limiting wide fluctuations in underwriting results.
- *Financial*: In the financing of insurance operations, being used as an alternative to increasing an insurer's capitalization. In this regard, the insurer may have access to the asset backing of many large reinsurers.
- *Protection*: Associated with stability, reinsurance provides protection against the potential large, accumulations that can result from catastrophic events e.g. earthquakes, bushfires and cyclones.

In practice a company normally finds that its reinsurance requirements are best met by a total program involving different reinsurance arrangements for particular classes of insurance, which it underwrites and combining in most cases, several of the treaty forms mentioned earlier, supplemented perhaps by facultative reinsurance where an occasional unusually large risk is accepted.

Theoretically, MTPL insurers should have a statistically significant data set of common policy limits. As a result, they should be able to ascertain relatively easily the extent to which they need, if any, to protect against an adverse frequency or severity of loss in respect of their domestic exposures arising out of MTPL insurance.

The following issues are critical in determining the appropriate reinsurance structure for an insurer's MTPL portfolio:

- The relationship of premium volumes accepted to the insurer's own retained capital and surplus
- The policy limits in force for the MTPL portfolio. The first of these points, ultimately aimed at the insurer's solvency ratio, is almost always addressed with quota share reinsurance.

The issue of policy limits is complex. The insurer will obviously have to provide coverage for the minimum legal limits required in the insurer's own country. Less obviously, the insurer almost always will have to provide cover up to the standard minimum legal requirement in many nearby countries. Cross-border driving is an escalating issue for both private cars and commercial vehicles. Commercial haulage routes can spread the length and breadth of a continent. Customers increasingly need an insurer to provide cover for every country in which driving may be needed. In some countries, cross-border coverage is not a prerequisite, but in many it is. Reinsurance can be bought for individual risks (facultative) or for a portfolio of risks (treaty). Given the compulsory nature of MTPL insurance and the adequacy of the minimum statutory limits, facultative reinsurance is rarely used unless the original insurer chooses or is required to offer limits significantly in excess of the original minimum statutory limits. Given that this scenario rarely arises, this section details the main types of treaty reinsurance.

The Role of Competition in MTPL Insurance

Across the world, motor third-party liability (MTPL) insurance is conducted in a variety of frameworks. These range from a monopoly insurer that sets standard prices to a relatively unconstrained and competitive free market. Between these extremes lies a range of interventionist and semi-interventionist arrangements. Regardless of the level of competition, MTPL pricing is heavily influenced by political economy issues, as this insurance is usually a material expense for the driver and vehicle owner:

- i. It suffers from inflationary pressures that are generally greater than normal inflation, so its cost in all countries tends to rise in real terms.
- ii. For commercial vehicles, the high and rising cost of insurance is a key factor in the profitability (or otherwise) of the owner's business.
- iii. In most developing countries, there is relatively little awareness of the causal link between bad driving standards and higher MTPL premiums.
- iv. There is also an emotional issue here is also an emotional issue:
- v. Many drivers are reluctant to accept that their driving might be less than perfect, so a high TPL premium may meet with objections.

A.) The Centrally Priced Option

Many countries have found MTPL an unpopular class with insurers. If the central pressures to hold pricing down gain the upper hand, the inevitable consequence is that there will be losses for insurers. It is always hard for regulators to raise commercial vehicle insurance pricing to economically viable levels, this was the case in India, Brazil and Turkey. This experience is common. Wherever MTPL pricing is fixed centrally, the pressures to keep pricing below economically viable levels tend to gain the upper hand. This usually leads to an economically undesirable outcome.

- In a plural-insurer context, insurers with efficient systems and good management will avoid participating in a class where central pricing controls restrict the scope for profit. The tendency, therefore, is for insurers with weaker management to participate, and this in turn leads to solvency problems, pyramidal cash flow arrangements, and eventually some form of centrally financed bailout.
- In a monopoly-insurer context, the tendency is to drive prices down to a level where the insurer is starved of funds. Only when the insurance fund is reduced to impractical levels does some kind of adjustment become necessary, but by then the gap between current pricing and required pricing is so large that adjustment for the consumer is often painful.

South Africa has found a successful solution: a centrally fixed insurance price that is not subject to massive political pressures. In

South Africa, the principal MTPL insurance fund levy is collected at the petrol pump. A portion of the tax levy that is collected by the government from all road users is channeled to the government's road accident injury compensation fund. This approach gives rise to a surprisingly attractive outcome:

- The more petrol you buy, the more you pay toward the nation's MTPL insurance costs; this has a common-sense user-pays fairness
- The more petrol inefficient your vehicle is, the more you contribute to the insurance fund; thus the levy has an element of being a "green tax."
- The cost of the insurance is a very small portion of the cost of petrol at the pump; for this reason, changes in the insurance levy become a much diminished political issue.
- The cost of collecting the levy is very low indeed, one of the cheapest premium collection arrangements in the world.
- The uninsured driver does not exist; every driver needs petrol and therefore pays a premium.
- The foreign vehicles visiting South Africa find that they too contribute to the levy.

B.) The Free-Market-Priced Option

The free-market-priced option has many good qualities, but it is not a panacea. It is best to contrast some leading advantages with some key disadvantages.

Where the Free Market Succeeds

The free market has a number of undeniable theoretical advantages:

- *Homogeneous risk underwriting.* MTPL is a class where very large numbers of risks are broadly homogeneous in character. Given current actuarial technology and adequate databases, the free market should be efficient at pricing risk and marketing accordingly.
- *Administrative efficiencies.* The existence of a large-volume pool of risk with substantial segments of high-quality risk provides incentive to insurers to develop all types of administrative efficiencies. The development first of the use of the telephone as a sales tool

- and then of the Internet has created a quantum leap in efficiencies for society in keeping down the cost of MTPL insurance.
- *Claims efficiencies* The profit motive has given free-market insurers very strong incentives to improve claims management. Many state-sponsored systems have suffered from weak claims management. The South African system is a good example, where in the 1970s and 1980s the private insurers (which had been tasked with administering the claims for the central system) gradually found that the most profitable way of handling a claim was to pay it quickly regardless of the cost. This gave rise to explosive claims inflation that, in practice, wrecked the system. In response, the authorities were forced to redesign the whole system of compensation.
 - *Regulatory efficiencies* The stronger the leading insurers in a free MTPL market become, the more their behavior fits a standardized pattern. In general terms, they become easier to regulate. The biggest auto insurers in many markets are often the best-run insurers. There are exceptions (mainly in less well-developed countries), but the trend in most countries over time leads toward motor insurance becoming a less important class for regulators.
 - *Consumer responsibility* This last point is often omitted from discussions, but in fact it is of very deep importance, particularly for developing countries. Where there is a state provider, the common consumer response is to imagine that responsibility has been assumed by the state and that no further effort is required on their part. This type of attitude causes many deep problems and much waste. Where the free market imports open (or semi-open) pricing features to MTPL, the impact on consumers' sense of responsibility is of vital importance in upgrading consumer behavior. From the day that the consumer appreciates that his or her own motor premium is a function of his or her own driving behavior, a dynamic link is established between the cost of motor premiums and improved road behavior.

If the regulator permits the full force of free-market pricing to determine insurance costs, the smarter insurers will focus on the better-quality risks. This generates effective competition, and market forces will ensure cheaper premiums for the better risks. Conversely, there is usually a scarcity of capacity for the high-risk types of vehicles. This leads to heavy price escalation for the "severity risks" and can be accompanied by unpleasant political economy externalities, including forced cross-subsidies. Undesirable market practices can also emerge.

For example, if taxi drivers find it almost impossible to find an insurer, they often end up using an agent. The agent with control of a rare capacity supply is in a position to levy excessive commissions; market inefficiencies ensue. Taxi cooperatives also sometimes form small mutual insurers that are not always run by people with sufficient insurance experience.

Where Competition Fails to Encourage Improvements Directly

Competition is not the solution to every problem. In some areas, the introduction of competition does not lead naturally to market-driven benefits. The most obvious of these are situations in which the collective community stands to benefit from an investment in which the effects go beyond an individual insurer.

- Road design safety is a prime example. In some countries, the police collect statistics regarding accidents that keep occurring at particular road junctions. It is not realistic to expect one insurer in a competitive market to invest in paying for improvements at that junction; the insurer might save on its claims costs, but it will not want to spend that money because of the fear that such action will benefit a competitor.
- Child education is a second key example. Teaching road safety, the use of seatbelts, and the dangers of drunk driving at schools undeniably brings community benefits. But again it is almost impossible to convince a competitive insurer to finance work like this; the insurer will keenly support initiatives that give competitive advantage just to its own position, but the nature of competition discourages it from supporting this type of general community investment.
- Administration of justice reform is a third example. In many countries, this is a major problem. It runs through both developed and developing countries. Again, insurers individually are not likely to spend time or money pursuing reform, however badly it is needed.¹⁸⁸ motor third-party liability insurance in developing countries

Insurers will always look hard at options that improve their own position. For example, where one insurer finds a more efficient way to rehabilitate an injured claimant, it will encourage that process as a means of gaining a competitive advantage.

The more general community situations are best encouraged through a central body. Road design safety is best promoted through the country's highway authority, child education obviously should go through the usual education authorities, and law reform should be addressed at the highest political levels.

Nevertheless, the insurers should contribute their intelligent opinions to these processes. Often it will cost a good insurer almost nothing to give its opinion and encouragement to the relevant authority. There is ample evidence of the benefits of incorporating road safety issues into the general education curriculum. Some police forces will visit schools to contribute to this effort. There is also massive evidence to show the value of investments in improving road design safety, both on existing roads and when building new roads. Insurers often understand these issues very clearly. Without doubt, there is scope for them to make a real contribution to the community, without spending their own money, by helping with cost-benefit analyses regarding death and injury risks and by lobbying for improvements that the central highway authority will want to implement. They can do this individually or through market associations.

There is no simple solution to any of these matters. Every country is unique, and each needs to find its own optimal answer. Nothing can be centrally prescribed. However, the examples given in this chapter suggest that, as time passes, competition of one kind or another has brought about reforms for the wider benefit of the community. Some state-run systems have operated with striking levels of success, but, on the whole, they are in the minority.

Annex I—Written Premiums in
Select Countries

Market Ranking 2009 by Written Premiums

Legend: [Y] Prior Year [P] Preliminary [F] Forecast [A] Audited

Currency: USD millions unless otherwise noted

Market Sector: Motor and Total Non-life

Status	Country	Motor Premiums	Total Non-Life Premiums	Ratio of motor to non-life premiums
[A]	Afghanistan	14.93	134.38	11
[A]	Albania	50.28	70.74	71
[A]	Algeria	482.95	976.72	49
2008 [Y]	Bahrain	145.41	302.83	48
[A]	Bulgaria	741.37	1010.8	73
2008 [Y]	China	24527.34	42097.28	58
[A]	Croatia	743.16	1148.11	65
[A]	Egypt, Arab Rep. of	282.54	781.73	36
2008 [Y]	Iran, Islamic Rep. of	2478.36	3384.46	73
2008 [Y]	Iraq	9.81	19.61	50
[P]	Israel	2074.76	3278.21	63
[A]	Jordan	211.31	349.51	60
[A]	Kazakhstan	140.91	619.44	23
[A]	Kenya	179.04	416.4	43
2008 [Y]	Kuwait	199.03	501.12	40
2008 [Y]	Lebanon	164.5	719.94	23
[A]	Libya	67.78	261.33	26
[A]	Montenegro	52.42	66.82	78
[P]	Morocco	817.63	1432.48	57
[A]	Oman	262.75	513.54	51
2008 [Y]	Qatar	137.43	668.54	21
[P]	Romania	1835.32	2289.91	80
[A]	Russia	7430.01	14127.8	53
[A]	Saudi Arabia	814.67	1684	48
[A]	Serbia	382.02	598.41	64
2007 [Y]	Sudan	136.15	225.89	60
2008 [Y]	Syria	169.2	250.71	67
[P]	Tunisia	349.25	546.17	64
[P]	Turkey	3099.38	5412.02	57
2008 [Y]	Yemen, Rep. of	21.87	65.37	33

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