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THE ROLE
OF REINSURANCE IN THE
CARIBBEAN REGION

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The Role of Reinsurance in the Caribbean Region

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The Role of Reinsurance in the Caribbean Region

This report is based largely upon discussions and interviews with several insurance and banking executives in Jamaica and the Dominican Republic during the period October 28 through November 4. Discussions were also held with several individuals from USAID in both countries. The only useful written material that was available was the report prepared by RHUDO/CAR and USAID Missions entitled "Caribbean Disaster Mitigation Project", May 1992. Detailed financial and economic data relating to the exact way in which the insurance and reinsurance markets operate in these countries were unavailable. This report must therefore discuss the pertinent issues involving hurricane hazards and insurance markets in relatively general terms.

The remainder of the report proceeds as follows. The next section discusses some of the basics of risk and insurance. This material provides a conceptual framework within which to understand the way in which insurance and reinsurance markets operate. Then the role insurance and reinsurance firms play in the Caribbean region and the effect of recent changes in the relationship between the two types of firms are discussed. Lastly, the role of efforts to mitigate losses from natural disasters on the affordability and availability of insurance is discussed with suggested initial steps that could be taken to begin implementing a mitigation program.

Basics of Risk and Insurance

Insurance arises quite naturally in response to risk. It is essentially a risk-spreading device. The resources of numerous individuals that are located in a single geographical area or in many areas that are exposed to risk are pooled to cover the losses incurred by a few individuals. The resources that are used to cover the losses may be set aside in advance (through premiums that are levied on those insured) or they may be assessed once the losses have been incurred (through a reciprocal agreement among those insured). Insurance is therefore a system that enables individuals to protect themselves against having to incur the full extent of any losses that might occur.

Risk, as discussed here, relates to the possibility of a loss in life or a loss in economic value. Hurricanes, for instance, can result directly in a loss of life and property damage. They can also result indirectly in loses by disrupting business and financial operations. This in turn produces lost wages and profits

and retards economic growth. Insurers respond to these types of situations by covering "insurable" risks. These are risks for which there are:
(1) numerous loss exposures; (2) losses that are unintended and unexpected by the insured; (3) losses that are definite and measurable; and (4) losses that are unrelated, so that the possibility of all insured losses occurring simultaneously is extremely unlikely.

Reinsurers enter the market to cover losses that individual insurers might consider "uninsurable". They essentially become insurers to the primary insurers. This is done by operating over a wider pool of insured individuals to better assure that the losses are unrelated. A local insurer might not be able to offer hurricane coverage solely in Jamaica, for example, because every insured individual in the entire country could be exposed to losses at the same time. However, a reinsurer could offer such coverage to the local insurers by expanding the number of countries covered based on the assumption that the likelihood of a hurricane or a series of hurricanes striking all the insured individuals in every country at the same time is quite small.

To remain viable, insurers must understand and manage risk. More specifically, there are four methods used by insurers to manage risk: (1) risk avoidance; (2) risk retention; (3) loss control; and (4) risk transfer. Insurers and reinsurers rely on multiple and interdependent strategies to implement these methods, including ratemaking, underwriting, and loss adjustment. Table 1 presents a summary of the different ways in which all insurers manage risk. As may be seen, the insurance business is an extremely information-intensive activity if done prudently. For this very reason, the unavailability of information regarding the nature and probability of a natural hazard occurring may give rise to serious market failures. In any event, each of the three different strategies to manage risk will now be discussed.

Ratemaking

Ratemaking, or pricing, involves estimating the losses and the expenses associated with providing insurance coverage and then allocating them among the insured. A rate is the price charged for each unit of coverage. The premium is simply the product of the rate and the number of units insured. To assure viability, insurers need to set rates so that the premiums cover the expected losses plus their operating expenses. This means that even though rates should be relatively stable they must also be responsive to changing

Table 1
Insurance Practices for Managing Risk

General Methods of Managing Risk	Insurance Practices
Risk Avoidance	• Underwrite: deny coverage; limit coverage; and make coverage conditional on certain behavior.
Risk Retention	• Establish adequate reserves to cover abnormal and catastrophic losses.
	• Establish the ability to raise additional equity or to borrow funds should catastrophic losses occur.
Loss Control	• Closely track actual loss experience.
	• Classify risks and set risk-based rates.
	• Monitor legal and economic developments.
	• Build cross-subsidies between different lines of insurance.
	• Cover only fortuitous or unexpected losses with warrants being usually used to deny coverage if insured acts inappropriately.
	• Ensure that catastrophic loss is extremely unlikely - losses should be unrelated and payments should be fairly predictable and modest.
Risk Transfer	• Coinsurance - provides that the insured bears a percentage of the loss.
	• Deductible - to cover normal losses and to reduce moral hazard and adverse selection.
	• Reinsurance - transfer some of the risk to another insurer.

conditions. They must also be set to differentiate among nonhomogeneous risks so as to provide the proper incentives for the insured to engage in loss-mitigating activities. In this regard, the deductible is a crucial element in the pricing decision. For most lines of insurance, the insured are divided into risk classes so that each expected loss encompasses a sufficiently large, yet homogeneous, number of insured. This permits a common rate to then be applied to all the insured belonging to each class. The finer the delineation of the risk classes, the easier it becomes to set appropriate risk-based prices. At the same time, however, the greater the expense that must be incurred to obtain the information necessary to accomplish this task.

To remain in business over time, insurers depend heavily upon the evaluation of the expected losses being covered. Estimates of the losses are usually based upon what has happened in the past. Insurers, however, do not blindly use historical data in setting rates. Such data are adjusted to reflect the insurer's confidence that past losses are accurate predictors of future losses. All the recent natural and man-made disasters, for example, have led property and causality insurers and reinsurers to implement changes in their business practices, including raising rates, reducing coverage, increasing deductibles, and instituting coinsurance.

Underwriting

"Adverse selection" is a serious problem for insurers because it refers to the tendency for those with a greater-than-average probability of loss to seek insurance. To minimize this problem, insurers conduct extensive underwriting -- the process by which insurers decide which risks to avoid, which to insure, and the exact terms upon which insurance is offered to the selected risks. The underwriter's goal is to ensure that the risks that are insured and the associated potential losses are similar to the historical data relied upon to generate the rates. It is extremely important that the underwriter be careful to avoid against the concentration of risks that might lead to a catastrophic loss that would overwhelm the resources of the insurer.

The underwriter selects and classifies risks, always monitoring the adequacy of the rates. This requires a considerable amount of information about each and every insured. Some of this information is provided by those insured. Other information comes form objective sources, including information bureaus or on-site inspections. Clearly, without adequate information risks cannot be either appropriately understood or well-managed.

It is not uncommon for the underwriter to evaluate the insured even after insurance is provided -- a process known as postselection. When postselection indicates excessive losses or increased exposure to loss, the underwriter may insist on an increased deductible, raise rates, or cancel the insurance policy outright. This is indeed the major concern that currently exists among those interviewed for this report.

Reinsurance is closely related to the underwriting process. It involves the transfer of risk form one insurer to another, with the intent of spreading the risk of large losses among a larger pool of insured. Reinsurance requires a lack of concentration and independence among those insured if the risk is to be truly dissipated in an economically meaningful sense. This explains the reason that retaining all or even a large portion of the risk of a natural disaster in a small country is tantamount to self-insurance.

Loss Adjustment

An insurer will cover claims, provided that it can establish that a loss did occur and that the insured was covered for the loss. Losses will not be covered if it is established that an insured party violated a condition that suspended or voided the insurance contract. After the occurrence of natural disasters it is particularly important that losses be covered as quickly as possible to speed the recovery process. It is reported that this indeed was the case with respect to the insured losses from Hurricanes Gilbert and Hugo in Jamaica.

Insurance Markets in the Caribbean Region

The insurance markets in Jamaica and the Dominican Republic, which tend to typify insurance activities in the other countries in the region, consist mainly of insurance brokerage firms. That is to say, most of the insurance firms in these countries retain relatively little of the risk that is covered by insurance. Instead, a relatively high percentage is transferred to reinsurers. This is true not only of the coverage for losses resulting from catastrophes, like hurricanes and earthquakes, but also for the coverage of the losses from more normal property damage.

Many of the insurance firms in these countries are also affiliated with banks or other financial service firms. This results in the provision of joint products and services. A loan by a bank, for example, is made conditional on the property that is being acquired be insured by the affiliated insurer. Most of the insured risk is then transferred to a reinsurer. These types of arrangements and the existence of a fairly large number of insurers generates considerable competition. However, the insurers appear to be only loosely regulated and supervised. There is, moreover, no formal classification system whereby the insurance firms are rated or classified according to overall financial soundness. This means that purchasers of insurance are without a readily available source of information by which to compare the financial condition of the different insurers. As result, although there is competition among the insurers, it may not be healthy competition. There appears to be too much emphasis on short-term profits through pricing for market share and too little emphasis on longer-term viability.

The structure of the insurance markets in these countries has several important implications. First, the fact that most of the risk is transferred to reinsurers means that so too are the premiums. Since the reinsurers are almost entirely located outside the Caribbean region, this results in the need to obtain foreign exchange with which to make the insurance payments. Second, since so little risk is retained, the primary insurance firms generate their profits from selling insurance products and services with relatively little incentive to engage in risk avoidance and loss control. The more insurance that is written the more commissions that are earned. This system works fine so long as all the insurers are well-managed and well-capitalized. Absent these two characteristics, which seems to be the case for several insurance firms in the Caribbean region, rates or prices will not be set to reflect fully the expected losses and underwriting standards will be lowered as insurers compete for additional business. Such imprudent practices tend to weaken the overall insurance industries in the region. Third, the heavy emphasis on brokering activities means that the technical expertise in the areas of risk avoidance and loss control is not developed to any significant degree. The insurance practices described in Table 1, in other words, are relatively unimportant in terms of producing profits. Almost all the emphasis is on selling insurance coverage to generate commissions, with the vast majority of the risk being simply transferred to a reinsurer. Fourth, even though relatively little risk is retained, there nonetheless remains the issue regarding the adequacy of reserves to cover losses. With lax regulation and supervision and inadequate pricing and underwriting, the stage is set for a shakeout among the insurance firms should a catastrophe occur. The result would be failures among the insurance firms and, more importantly, less insurance coverage than anticipated which would impede both the speed and strength of the recovery from a disaster. Fifth, as currently structured, the insurance system in the region does not appear to promote cost-effective mitigation which, in turn, makes catastrophic insurance less affordable than otherwise. The differential risks of losses from hurricanes throughout the region or throughout a particular country, for example, do not appear to be fully taken into account in setting prices and deductibles by the insurers. This is reflected in the fact that even though there appear to be well-conceived building codes they are frequently ignored in the construction of homes and buildings. Yet rates for insurance coverage are reportedly relatively uniform across fairly broad classes of the nonhomogeneous risks that result from such construction practices. The net effect is an insufficient level of investment in mitigation which, in turn, means potentially unnecessary losses in both lives and property when a natural disaster occurs. Sixth, the governments in the region, like elsewhere, self-insure public property. The location and construction of such property, however, do no adequately appear to reflect the risks of a catastrophe. The general situation is quite similar to the one facing private insurers. Without implementing cost-effective mitigation measures, the government and the private sector remain more heavily exposed to a major loss in the event of a natural disaster than necessary. Disaster relief consequently becomes more important that would otherwise be the case. The same is true of insurance, of course.

Recent Changes in the Reinsurance Markets

Reinsurers around the globe are in turmoil after years of suffering huge losses and the recent tolls taken by Hurricanes Andrew and Iniki. Not surprisingly, the result has been rising prices and reduced coverage for those insurance firms that purchase insurance form the reinsurers. This has also led to an increase in retention by the primary insurers, which is the risk they must cover themselves. This means that these insurers must increase their capital to cover the additional risks, which in turn limits the amount of insurance that can be written. This troubling situation has led to the introduction of legislation in the U.S. Congress that would establish federal earthquake insurance and reinsurance programs. More specifically, under this legislation, a federal program for providing residential earthquake insurance to all home owners would be created. An earthquake loss-mitigation program would also be created. This would entail identifying all states having an exposure to earthquake perils and zones within those states that are subject to major seismic risk. Such information would then be made publicly available. Earthquake loss-reduction criteria would also be required to be developed, with earthquake-prone states being required to adopt or enforce earthquake loss-mitigation programs that would meet or exceed the criteria. Federal agencies regulating financial institutions would generally be required to prohibit those institutions from providing mortgages to residents of non-compliance states. Lastly, an earthquake excess-loss reinsurance program for private insurers would be created. This program would provide private insurers with federal assistance in the event an earthquake caused losses and loss adjustment expenses that exceeded a specified percentage of the industry's countrywide premiums.

The proposed legislation in the United States demonstrates the concern about the costs to individuals, business firms, and society that might arise if a major earthquake were to occur. A related concern was expressed in the interviews about similar potential disruptions resulting from the recent and the expected future changes in the reinsurance markets in the Caribbean region. All of these changes are having or will have adverse affects on the primary insurers and their customers. These changes will also produce more general adverse affects on overall economic activity. Among the most significant changes are higher prices, increased deductibles, reduced coverage, and greater reliance on coinsurance. Even the commissions received by the local insurers in their roles as brokers appear to be shrinking. The overall effect of these changes being imposed by the reinsurers is to increase the risk borne by the primary insurers and the insured individuals while reducing the risk borne by the reinsurers. Some reinsurers have even gone so far as to withdraw completely form the Caribbean region, which indicates a belief that the risk is simply too great. These adverse effects are compounded by the higher prices for the reinsurance that is still provided. At the same time, however, the losses that can be expected to occur form a natural disaster, like a hurricane, have not diminished. This means that more of the losses that would be incurred in the event of a hurricane, for example, would have to covered with domestic funds. Furthermore, these types of changes can signal a potential disruption of the insurance mechanism, which increases uncertainty and therefore discourages business ventures and opportunities, both domestic and foreign, in the region.

To retain the presence of reinsurers, actions must be taken to enable them to cover the expected losses from hurricanes and to cover their normal business expenses, including an acceptable return on equity capital or net worth. Higher prices, increased deductibles, and coinsurance help cover expected losses either through greater premiums or through lower expected losses borne by the reinsurers. But these actions make insurance less affordable. It is therefore also appropriate to consider reducing expected losses through mitigation efforts. This requires, of course, expertise in identifying and evaluating the risks from hurricanes that are hazardous to people and property. Base upon such expertise one can develop hazard maps, which would delineate geographical areas according to risk. Although a whole country (or region) may be exposed to the risk of a hurricane, for instance, the risk may differ substantially across the country (or countries). Hazard mapping can be used to improve overall development planning, including the siting and construction of infrastructure and other physical development, as well as enable one to better determine the risks to be borne by the insurer and by the uninsured individuals or entities. This type of information is absolutely essential to implement an insurance pricing scheme that not only accurately and fairly reflects risk but also provides an incentive to the insured to engage in those activities that would mitigate any losses. Such information is also essential to developing and implementing meaningful building codes. For mitigation to be successful, however, one must also be willing and able to enforce the building codes in a cost-effective manner. In the United States in order for a community to be eligible for flood insurance it must agree to adopt and enforce specific regulations, such as restricting land use and imposing building codes.

The major problem that arises by not pursuing mitigation efforts in the Caribbean region is that the risk of loss retained within the region may grow to an unacceptable level given available domestic resources. Furthermore, the reinsurance that is so essential for natural disasters may become increasingly unaffordable to more entities, especially to smaller business that account for large numbers of jobs. The result is a growing amount of underinsurance. (This is currently a problem with automobile insurance in Jamaica as premiums rise due to increasing repair costs and insurance coverage becomes more unaffordable for a growing number of individuals.) Worse yet, the reinsurers could conceivable simply withdraw from the entire area or specific countries. Limiting the expected losses from natural disasters through cost-effective mitigation efforts is a way to ameliorate these types of adverse developments. To continue proceeding in a "business as usual" manner is unacceptable insofar as the hurricane risk will always be present and individual countries within the region are not large enough to spread the risk without relying on some form of reinsurance. This situation undoubtedly explains the reason the Insurance Commissioner's Office in Puerto Rico has recently ordered a study of the island's historical hurricane experience and the resistance of structures to wind, taking into account the geographical location of buildings and businesses. Such a study will produce an estimate of the probable maximum loss from a hurricane. No similar studies appear to be underway or to even be contemplated for other countries in the Caribbean region.

Indirect Economic Effects

It is clear that the recent changes in the reinsurance markets in the Caribbean region produce adverse effects. These effects, however, extend beyond the more immediate and direct effects of price increases, increased deductibles, reduced coverage, and greater reliance on coinsurance. There are longer term and more indirect effects as well. These include affects on lending by banks and other financial service firms, foreign exchange markets, saving and investment, and overall economic development and growth. In short, without properly functioning insurance markets it is virtually impossible for an underdeveloped country to become a developed country.

It is well understood that financial intermediation facilitates economic growth through the bringing together of savers and investors. However, financial lenders typically lend funds by evaluating a borrower's ability to repay and by evaluating the value of any collateral. They are not in the business of assessing the likelihood that the collateral will be damaged or destroyed by a natural disaster. It is therefore common for lenders to require that the collateral for any loan be covered by insurance, at least sufficient insurance to cover the amount of the loan. Interviews with four bankers in Jamaica and the Dominican Republic, for example, indicated that they consider themselves to be in the lending business not the insurance business. This means they view insurance as being absolutely essential to their lending activities. Any disruptions in the reinsurance market, in other words, would also disrupt the supply of credit. The extent of any adverse affects from the recent and prospective changes in the reinsurance market cannot be quantified without detailed financial and economic data. In some cases, moreover, loans may be made that rely more on guarantees made by entities outside the Caribbean region than on the existence of insurance on the collateral for the loans. Data are also required to assess the importance of these types of arrangements.

To the extent that disruptions in the reinsurance market translate into adverse effects on the supply of credit, saving and investment would also be adversely affected. The ability to attract investment funds from abroad, moreover, would be hampered in view of the less favorable economic outlook resulting from such developments. The cumulative effects would lead to a retardation in overall economic development and growth. Unfortunately, insufficient data are available to attempt to quantify these types of affects so as to assess their magnitude.

One must, of course, be careful not to over-state the likelihood that recent developments in the reinsurance markets in the Caribbean region portend disaster. As one individual with a major insurance firm indicated, prices and other terms of the insurance contracts will simply adjust to reflect market forces. This may be viewed as being both necessary and desirable, with reinsurers remaining in the region so long as the new contracts are accepted. Indeed, if prices and other terms adjust enough new entrants may enter the reinsurance market. This has actually happened because Marsh & McLennan Companies and J.P. Morgan & Company recently announced the opening of a major reinsurance company in Bermuda.

Strategies for Responding to Changing Insurance Markets

It is quite clear that there are two ways to respond to the recent charges in the reinsurance markets. One is to simply let market forces follow their course in setting new prices and other terms for reinsurance. The other is to influence these adjustments by formulating and implementing cost-effective mitigation programs, which would entail pursuing a similar strategy as Puerto Rico. Regardless of which path or combination of paths is taken, detailed financial and economic data are needed to assess the overall condition of the current insurance industry and to assess the relationship between changes in this industry and the overall performance of the economy. Even before such an assessment is made, however, one knows that without appropriate information that is publicly available markets do not operate efficiently, because the resulting prices provide improper signals and incentives when it comes to allocating resources. To the extent that markets fail because of such informational problems, it is incumbent to obtain the appropriate information and then make it publicly available. This is the overriding virtue of the Caribbean Disaster Mitigation Project proposed by RHUD/CAR and USAID Missions -- it proposes to help fill what appears to be an informational and educational void. The degree to which such efforts aimed at mitigating losses are successful can be determined by examining the prices and other terms of reinsurance contracts both before and after the completion of the project. The differences detected then can be related to any changes in land use and building structures that would lessen the vulnerability to hurricanes.

APPENDIX A

Individuals Interviewed in Jamaica

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APPENDIX B

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