The Essential Role of Insurance Services for Trade Growth and Development

A Primer from The Geneva Association's Programme on Regulation and Supervision (PROGRES)

December 2011

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(The International Association for the Study of Insurance Economics)

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by Julian Arkell, Special Advisor, The Geneva Association

The Geneva Association
53 Route de Malagnou,
CH-1208 Geneva,
Switzerland
E-mail: *secretariat@genevaassociation.org*
Tel: +41 22 707 66 00
Fax: +41 22 736 75 36
www.genevaassociation.org

PROGRES Research Programme

The PROGRES name stands for Research PROGramme on REgulation, Supervision and legal issues in insurance. It focuses on questions related to regulation, supervision and international co-operation of insurance and financial services as well as other legal issues of importance. The research programme manages The Geneva Association's co-operation with the supervisory authorities around the world and in particular with the International Association of Insurance Supervisors (IAIS).

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Foreword

Every industry has its own characteristics and specificities. Two of the elements that set insurance apart from many other activities are its facilitating nature and its wide scope. Consequently, the economic importance of the insurance industry is only partly reflected by the number of people it employs in a given country, its assets under management, or its contribution to the economy. It actually plays a more fundamental role in the mechanisms of a modern society and enables some activities, for which its absence would render the financial risks too great for the relative benefit, to exist at all. As such, insurance is a key component of economic development and an important driver for growth. Modern economies need functioning markets for transferring risks and as an extension for insurance. Therefore the rules that govern the conduct and trade of insurance are hugely influential, not just on the business but on the wider economy also. This is why all countries around the world keep a close eye on the industry and scrutinise and regulate insurance companies carefully—rightly so.

But this importance in economies and societies should not only mean a focus of attention solely on the regulation and supervision of insurance companies themselves, but also on the legislative, economic and legal environment in which they operate. Regulatory interference and special constraints have to be carefully balanced with the efficiency of the market mechanisms and the necessary preconditions for any insurer to engage in entrepreneurial activities. The right environment can foster the growth of insurance of course, but for the insurer as risk manager and custodian of a pool of risks, there needs to be a stable and reliable background against which to conduct the business. Inefficiencies and unpredictability can present a fundamental problem. This is especially true if the economic and legal setup is not conducive to proper risk management and to risk transfer mechanisms that allow the shift of risk to new carriers and the spreading among more of them. Unfortunately too often, when policy-makers discuss legal changes and when trade experts gather to draft their agreements, whether those are directly or indirectly linked to insurance activities, the particular effects on the insurance system are not fully reflected upon by the actors.

This is not only problematic from an economic (growth) perspective but also from a societal one as insurers are also key transmitters of preferences in a society. Very often, particular insurance schemes are encouraged to compensate for specific behavioural structures that a society believes it should influence. Tax breaks for taking out life insurance, mandatory third-party liability insurance or long-term care insurance are examples. In some cases, the insurance coverage is a precondition for other businesses to operate. And sometimes that precondition is not cheap: if one considers operating aircraft, for example,

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insurance rates are significant, especially if they cover large commercial aircraft flying over crowded cities. Insuring oil exploration activities or super-tanker transportation of fuels are other examples. This provides a lever for introducing social policies and societal preference into the economy using insurance mechanisms.

Insurance is therefore an accelerator of economic growth, an economic shock absorber and is intertwined with development and protection of societal assets and aspirations. The availability of insurance has important positive effects and externalities that go far beyond the purely financial. We live in a world that is increasingly globalised and interdependent, where international trade and cross-border activity have become the norm. In this world the sustainability of many activities, especially those that are of an international nature or linked to an international production chain, has become impossible without the protection of insurance. Hence, careful consideration must be given to the industry, not only on the crafting of an international regulatory architecture, but also in the treatment of insurance in current international trade and development discussions.

The Geneva Association has therefore produced this primer as an overview of the role of insurance in society with a view to the current state of international discussions on trade growth and development.

Patrick M. Liedtke
Secretary General and Managing Director
The Geneva Association

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1. International Trade in Insurance Supports Development and Growth

Statements from the G-20 group of world leaders have long urged all nations to refrain from protectionist moves that would reduce international trade, of which insurance services form a significant part. The rationale for the G-20 stance is that trade can benefit both exporters and importers due to the comparative advantages of each that arise from their specialisations, risk management and from economies of scale and scope. This was reinforced by the G-8 leaders at their meeting at the end of May 2011 in Deauville, stating that the World Trade Organization (WTO) plays a critical role in preventing protectionism and constitutes a fundamental part of the global multilateral system, and they reaffirmed their longstanding commitment to free and open markets. Improved access to insurance services, given their importance to global growth and development, would be a tangible way to underpin the recovery of the global economy.

“The new limitations affect both national insurers and affiliates in which investment from abroad has been made. They might even reduce the market access accorded to foreign insurers under the legally binding commitments made in the context of the General Agreement on Trade in Services of the World Trade Organization.”

Recent moves by certain developing countries to promote their state and private sector reinsurance providers, ostensibly to bolster regional trade, involve restricting the opportunities for business to be ceded to reinsurers based abroad. This will affect the potential benefits that arise from taking advantage of the greater world underwriting capacity and is likely to reduce the ability in those countries to cover large risks solely out of local insurance premiums. The new limitations affect both national insurers and affiliates in which investment from abroad has been made. They might even reduce the market access accorded to foreign insurers under the legally binding commitments made in the context of the General Agreement on Trade in Services (GATS) of the WTO.

The World Bank asserts that gains from properly managed liberalisation of services trade are substantial and an analysis from their studies has shown this to be the case even in poor countries. The GDP of countries that liberalised their infrastructure and financial services markets has grown faster than that in countries that did not.[1] Recent research using data from 77 countries in the period 1994-2005 shows statistically robust evidence that both life insurance and non-life insurance play a much more important role in the economic growth of developing countries than they do in developed countries.[2] In fact, insurance premium growth acts as a leading indicator for economic growth overall. The benefits to be reaped by allowing investment in insurance services is evident from how insurance grows generally faster than GDP and helps to stabilise the economy. Insurance can increase the savings rate, create deeper financial markets and available working capital is greater as a result. Where capital markets are not well developed they might benefit from the long-term investments made by the insurance sector that are held to meet future claims and will not be sold off in the short term.

“Recent research using data from 77 countries in the period 1994-2005 shows statistically robust evidence that both life insurance and non-life insurance play a much more important role in the economic growth of developing countries than they do in developed countries.”

1 B. Gootiiz and A. Mattoo (2009) *Services in Doha: what’s on the table?*, Policy Research Working Paper 4903 (April), Washington D.C.: World Bank.

2 L. Han, D. Li, F. Moshirian and Y. Tian (2010) “Insurance Development and Economic Growth”, *The Geneva Papers on Risk and Insurance—Issues and Practice*, 35(2): 183-199.

Insurers entering the large emerging markets can deliver a wide range of products, better quality and competitive pricing for consumer choice. The larger insurer groups also in effect play a role in technical capacity-building that is of assistance where local suppliers lack expertise. Without such international competition national suppliers hold back from investing in innovation and this applies particularly to government agencies: indeed there are still some that exercise a monopoly over certain types of insurance and reinsurance products.

When insurance is provided at the individual level, it gives independence to people and increases their capacity of self-reliance. The ability to cope with adverse effects, which are often unexpected and might occur at the least opportune moment, is strengthened. This creates a very strong impact on future development because it enables people to become and stay active, as they do not have to worry about all possible adverse effects that a certain activity might entail. While there is a direct economic effect through the financial protection of assets, there is also an additional consequence: peace of mind. People tend to behave differently—and we suppose more positively—when they know that certain risks are taken care of. This is a psychological rather than a financial effect accompanying the purchase of insurance.

The growth of offshore back office process outsourcing, including by the insurance sector, has proved to be a contributor to service sector growth and the first step in moving up the value added chain for the local businesses and professional services firms involved. It can improve gender parity by providing more opportunities in services sectors for female employment.[3] For some years insurers have been outsourcing various routine back-office activities either to their own affiliates abroad or to independent firms, in addition to setting up call centres in countries with foreign language capabilities and lower wages. Some insurers conduct financial literacy programmes which aim to improve the understanding of consumers of their long-term financial needs and build up their confidence in financial services, which enhances their ability to take appropriate decisions on a range of issues, from debt to the management of savings.

"Construction firms assessing whether to undertake major projects will hesitate to be commissioned if extensive insurance and reinsurance facilities are not available locally."

Many emerging and developing countries have set up investment promotion agencies to attract inward investment and benefit from the job creation and the stimulus this gives to economic growth and development. Such foreign investment can crucially provide funds for the construction of infrastructure projects such as roads, railways and seaports and the supply of water, electricity and telecommunications. Construction firms assessing whether to undertake major projects will hesitate to be commissioned if extensive insurance and reinsurance facilities are not available locally.

Insurers investing from abroad must routinely consider the interests of a wide range of stakeholders, including: consumers, business associates and suppliers, employees, shareholders and the investor community, academia, the media, non-governmental organisations, consumer associations, as well as governments and the regulatory authorities. Good corporate governance and responsibility is an aim of insurers entering developing markets, defining and increasing sound values around trust, ethics and environmental responsibility. This helps to ensure full compliance with regulatory requirements and the best risk management procedures.

3 L. Puri (2004) "Trade in services, gender and development: A tale of two modes", in UNCTAD, *Trade and Gender: Opportunities and Challenges for Developing Countries,* Chapter 7, Geneva: UNCTAD.

Next follows a discussion of the place of insurance in the economy and its legal underpinnings, and the state regulatory framework is briefly considered. Then the role of the International Association of Insurance Supervisors (IAIS) in strengthening the state regulation and supervision of private sector insurers is summarised. Finally the roles of two multilateral institutions, namely the General Agreement on Trade in Services (GATS) and the United Nations Conference on Trade and Development (UNCTAD), are noted as they affect insurance.

2. The Role and Function of Insurance in the Economy

2.1 The role of insurance in sustainable development

Insurance plays a major role for the efficient and sustainable development of modern economies, deploying expertise that is unavailable elsewhere. Insuring risks in a modern domestic economy is a multi-dimensional undertaking. It is a complex business that interacts with many aspects of people's lives. The importance of the insurance industry for an economy can only in part be measured by the number of its employees, the assets under management, or its contribution to the national GDP. It actually plays a more fundamental role in underpinning the workings of a modern society, being a necessary precondition for many activities that would not take place in the absence of insurance. It facilitates new ventures and is intertwined with the most basic human needs and aspirations. The availability of insurance has important positive effects and externalities that go far beyond the purely financial.[4]

The insurance sector can be a major employer within domestic economies, providing high-skilled and quality jobs, with good working conditions, and it generates significant indirect work for agents, brokers, and other intermediaries and service companies such as in information technology (IT), transport, accounting and consultancy sectors. Insurance also has a crucially important role for businesses to cover their wide range of risks from fire insurance to business continuity. Some of the huge financial assets are held over the long term, even across generations, which acts as a buffer when sudden surges in financial needs arise from natural disasters.[5]

In summary the main roles performed by the insurance sector for the economy are the following:

- to promote financial stability and security at both the national and personal levels;
- to mobilise savings and provides a channel for the efficient use of capital through acting as a significant institutional investor;
- to facilitate credit by providing security for bank lenders in the event of borrower default;
- to encourage productive investments and innovation by mitigating the consequences of financial misfortune;
- to facilitate international merchandise trade;
- to enable the efficient management of risk, by diversifying both personal and asset risk;
- to encourage technical methods of reducing risk;
- to enable personal responsibility for certain insurance provision, thus relieving the state welfare programmes of this burden: examples include life insurance, workers' compensation or medical health cover;
- to create additional incentives for controlling losses; and,

"The importance of the insurance industry for an economy can only in part be measured by the number of its employees, the assets under management, or its contribution to the national GDP."

4 For further discussion see P.M. Liedtke (2007) "What's Insurance to a Modern Economy?", *The Geneva Papers on Risk and Insurance—Issues and Practice*, 32(2): 211-221.

5 The extensive research of The Geneva Association on the insurance sector is available at *www.genevaassociation.org* (see the section on Publications).

- to serve household consumers, by providing cover for cars, houses and their contents, life and pension products.

2.2 Coverage of risk sizes—and reinsurance

Insurers exclude cover for the smallest risks which would be relatively too expensive to administer, and the largest which could put them out of business. These pools of different categories of risk can cover those that arise in part or the whole of a jurisdiction, or a number of countries and even globally in the case where a few major reinsurers insure the primary insurer.

Insurers often lay off some of their risks to reinsurers, who assume risks from many countries, diversifying risks globally and lowering their impact in each area covered. In turn these reinsurance companies may lay off through retrocession policies some of their risks to other reinsurers that operate on a global basis.

> ***"The 'buffer' function of insurance in the modern economy smoothes out sudden surges in financial needs linked to a disaster for all insured players that might otherwise fall into bankruptcy."***

2.3 The reversed commercial sequence of insurance

One way to understand how insurance functions is to see that insurers sell the promise to make a payment upon the happening of a future event beyond the control of both the insurer and the insured, for example death, property destruction by fire, accidents and disabilities. The cost of the promise is unknown initially and insurers have to make estimates based on experience with assumptions about future events—especially important in the case of life insurance and annuity policies, as the risk could increase over long future periods.

The primary logic of insurance is the spread of financial loss through the pooling of risks. Insurance policies are bought to protect against the occurrence of specific events, and insurance underwriters make provisions against the eventuality of such claims. In this way the normal sequence of commerce is reversed, because the price—in the form of an insurance premium paid—is set before the service is rendered, whatever the final extent of its cost. Indeed, the total cost is possibly not known until long after the insured event that gave rise to a claim had occurred.

The premiums received are managed actively and because insurance operations are not subject to potential immediate cash withdrawals, insurers can match assets and liability periods closely. The risks that insurers accept are for the most part independent of the economic cycle, even if the volume of risks covered may reflect the level of economic activity. The "buffer" function of insurance in the modern economy smoothes out sudden surges in financial needs linked to a disaster for all insured players that might otherwise fall into bankruptcy. The existence of insurance allows forward planning with more certainty, avoiding or mitigating specific risks that might threaten commercial viability.

2.4 Insurance pricing signals and risk management

The pricing of insurance plays an important informational role in an economy, revealing the existence, frequency and extent of risks. Such risk-based insurance premiums have to take account of reliable and cost-effective indicators of various risks. Usually the scoring is based, for example, on relevant factors such as age, gender, location, vehicle type and driving record, marital status, income, race and nationality. When insurers give advice on how to improve safety and quality, they rely on their databases as sources of valuable information from hard won experience.

Insurance is in essence a risk management service, whether supplied to individuals, businesses or governments. It is an arrangement providing individual protection against the risk of losses resulting from various perils. Insurance is both socially and economically valuable. The need for insurance arises in societies and across economies with widely differing organisational features.

2.5 Societal preferences influencing insurance

The insurance mechanism can also be a key transmitter of preferences in a society. Very often, particular insurance schemes are encouraged to compensate for specific behavioural structures that a society believes it should influence. Tax breaks for taking out life insurance, mandatory third-party liability insurance or long-term care insurance are examples. In some cases the insurance coverage is a precondition for other businesses to operate. And sometimes that precondition is not cheap: if one considers the operations of airlines, for example, insurance rates are very costly, especially if they cover large commercial aircraft flying over crowded cities. Insuring oil exploration activities or super-tanker transportation of fuels are other examples.

2.6 The largest risks covered, including climate change

The major high risk but less frequent occurrences, such as natural catastrophes and terrorism, are usually covered by a combination of commercial insurance and public funds. Although non-financial risks have a low degree of correlation because different individuals are affected at different times and to different degrees, this is not the case when such large scale disasters and epidemics occur.

> ***"Insurance is in essence a risk management service, whether supplied to individuals, businesses or governments. It is an arrangement providing individual protection against the risk of losses resulting from various perils. Insurance is both socially and economically valuable."***

In relation to climate change, insurance is not only a tool for addressing the immediate risk assessment and risk management challenges before us; it can be a powerful mechanism to discover and give incentives for the right behaviour. Insurance is a key component of economic development and as such is intimately linked with climate-relevant aspects. If any industry understands the need to tackle climate issues and the risks involved, it is insurance—the risk industry.[6]

2.7 Limits to private sector market cover and the interface with public insurance

A national private insurance market has only a finite capacity and nation states themselves have to cater for the consequences of the largest man-made and natural catastrophic disasters, such as major earthquakes, tsunamis, hurricanes and the effects of climate change and damage to biodiversity to the extent they cannot access the substantial global capacity of commercial reinsurers to underwrite such catastrophe risks.

The fundamental reasons which may limit or even prevent private insurability are: insufficient scope for risk pooling (risks correlated in aggregate), absence of information or its ambiguity, and (excessive degrees of) moral hazard or adverse selection.

6 C. Bosse and P.M. Liedtke (2009) "The relevance of insurance to climate-sensitive economic development", in *The insurance industry and climate change—Contribution to the global debate*, The Geneva Reports No 2, pp. 9-22 Geneva: The Geneva Association.

Public or "social" insurance has played a major role in most societies for a long time. In some of these cases, it is not necessarily a fundamental inability of private markets to provide workable solutions, but rather the desire of society to combine insurance with considerations of equity and redistribution, which leads to government involvement.

Finding the appropriate balance between private and public insurance remains one of the central open issues in insurance market regulation. Guiding principles could be that private insurers should only be expected to deal with those risks which sufficiently meet the conditions for insurability. Mandatory requirements to go beyond this can only lead to disillusion and, eventually, to market withdrawal. On the other hand, governments should abstain from interfering in those markets where private insurance is feasible and functional. The combination of insurance with income redistribution is best resisted, but if politically sought, it should be pursued through other mechanisms.

> ***"A national private insurance market has only a finite capacity and nation states themselves have to cater for the consequences of the largest man-made and natural catastrophic disasters, such as major earthquakes, tsunamis, hurricanes and the effects of climate change and damage to biodiversity to the extent they cannot access the substantial global capacity of commercial reinsurers to underwrite such catastrophe risks."***

There are some significant risks that are difficult either for firms or the state to cover entirely by means of insurance, and require other solutions, where this is possible. These include the loss of key personnel, goodwill and the confidence of consumers or clients as a consequence of disasters.

The insurance sector, unlike other financial services, is not likely to trigger major financial crises. The insurance business model—encompassing both insurers and reinsurers—has specific features that make it a source of stability in the financial system. Insurance is funded by up-front premiums, giving insurers strong operating cash-flow without requiring wholesale funding. Insurance policies are generally long-term, with controlled outflows, enabling insurers to act as stabilisers to the financial system. During the recent financial crisis, insurers maintained relatively steady capacity, business volumes and prices.[7]

Thus a crisis in the insurance sector would develop differently from one in banking because there is less liquidity risk and usually more time to react. Most insurance risks—and that includes most climate risks—cannot be triggered by the policyholder. Or, such as in the case of life, accident or health policies, they will usually not be triggered as they involve grave personal harm. Even in the case of savings products, insurance companies often build in withdrawal costs that stabilise the system in adverse times, as it makes the cancellation of policies more costly to the insured.

2.8 State provision of insurance

The state steps in to insurance's quarters to carry risk for specific reasons: for example to finance the provision of health care, though usually within certain limits increasingly constrained by its fiscal capacity and special intentions of social engineering.

7 The Geneva Association (2010) *Systemic Risk in Insurance—an analysis of insurance and financial stability* (March). See also *Key Financial Stability Issues in Insurance* (July).

It may also mandate compulsory cover for third party motor vehicle liability and employment cover, and provide tax incentives for private pensions because national budgets cannot usually offer enough under state pension schemes.

Ultimately, the state acts as the risk manager in cases of extreme events following major catastrophes.

2.9 Public-private insurance provision

The state can act as a complementary risk taker and possible partner to insurance carriers where this involves cover for risks such as terrorism, nuclear disasters, mega events, earthquakes, volcanic eruptions and tsunamis. This is a benefit from state action and can underpin more extensive boundaries of commercial insurability.

Socially-inspired insurance such as old-age security and health are different but also important here. The areas where the state may seek joint insurance provision are likely to be cover for health and medical costs, invalidity and old age pension income.

The state may pick up the highest levels of risk arising from terrorist attacks and catastrophic man-made and natural disasters once commercial cover is exhausted.

This provides a lever for introducing social policies and societal preference into the economy using insurance mechanisms. However, care is needed because the nature of the insurance business is that of a private market activity. Regulatory interference and special constraints have to be carefully balanced with the efficiency of the market mechanisms and the necessary preconditions for any insurer to engage in entrepreneurial activities.

2.10 The legal principles of insurance

The legal doctrine governing insurance contracts is that of "utmost good faith" (*uberrima fides*). Both the buyer and the seller of an insurance product must make a full declaration of all material facts at the outset, unlike the typical market situation where the rule is "let the buyer beware" (*caveat emptor*). The principle of *uberrima fides* does not change the arms-length nature of the agreement and cannot be used to import a general fiduciary relationship.

The insurer-insured relationship is contractual—they are parties to an arms-length agreement—and insurance policies are "conditional contracts" in that they oblige the insurer to pay only in the event of the occurrence of certain conditions. They are also "contracts of indemnity" because the insurer counteracts the loss the insured has suffered. Here the principle is that the insured shall not profit from the occurrence of an event covered by the contract. Indeed under many types of policy, the insured must share some part of the loss (for example where there is a "deductible" or "excess" to be met by the insured under motor insurance policies).

"Regulatory interference and special constraints have to be carefully balanced with the efficiency of the market mechanisms and the necessary preconditions for any insurer to engage in entrepreneurial activities."

The insurance policy forms the legal contract and it sets out the terms and conditions, specifying the extent of coverage (amount of compensation) in the event of a loss from the perils covered for the term (period) of the indemnification. When the insured experiences a loss for any peril covered, a "claim"

can be made against the insurer in the amount specified in the policy contract. Once a policy has entered into force, upon payment of the premium the insurer is legally bound by contractual obligations for future performance. Thus the insurer, unlike the insured, can be charged with breach of contract and compelled to perform (hence the term "unilateral contract"). Where any ambiguities in the cover have to be resolved legally, they generally are resolved in favour of the insured, because the insured party had no or little bargaining power, having had to take the insurer's offer (hence the term "contracts of adhesion" for certain covers).

A risk insured is exogenous and may have to be mitigated by taking certain actions (such as installing security equipment or fire sprinklers), but there is no prospect of gain. Appraising and controlling risk is important so that those insured do not increase their risk exposure through their own behaviour (described as "moral hazard").

3. Measuring the Scale and Scope of the Insurance Industry Worldwide

The global insurance funds in 2010 are estimated at US$24.6 trillion, which corresponds to a share of around 31 per cent of global managed fund assets.[8] In the Eurpean Union (EU), the *Comité européen des assurances* (CEA) estimated insurance investments at €7,300 billion in 2010.[9] The significant scale and scope of the insurance industry as custodian of these assets and manager of the portfolios to the performance of these economies is evident, as is its share of direct and indirect employment created by insurance companies. For the EU, the CEA estimated direct employment of almost 950,000 in 2010. The Information Insurance Institute (III) estimated that in August 2011 there were some 1.3 million employees in the U.S. and a further 937,000 in brokers, agencies and similar service providers.[10] The insurance industry is a major economic sector with a large percentage of high-quality and well-paid jobs.

As reported each year by SwissRe, global insurance premiums in 2010 were US$4,339 billion, as is shown in Table 1. Life cover accounted for US$2,520 billion (58 per cent) and non-life (or property and casualty) the other 42 per cent.

Table I: Premium volume by region and organisation in 2010

	Premium volume (in millions of USD)		Change (in %) inflation-adjusted		Share of world market (in %)	Premiums[1] in % of GDP	Premiums[1] per capita (in USD)
Total business	**2010**	**2009**	**2010**	**2009**	**2010**	**2010**	**2010**
America	**1,409,530**	**1,357,559**	**0.7**	**-5.5**	**32.49**	**6.71**	**1,519.2**
North America	1,281,664	1,249,254	0.0	-6.3	29.54	7.90	3,724.4
Latin America and Caribbean	127,867	108,305	8.2	4.6	2.95	2.68	219.1
Europe	**1,620,437**	**1,614,385**	**1.8**	**1.8**	**37.35**	**7.47**	**1,850.2**
Western Europe	1,532,631	1,529,489	1.9	2.6	35.32	8.44	2,890.3
Central and Eastern Europe	87,806	84,896	-0.4	-10.1	2.02	2.62	272.5
Asia	**1,161,118**	**1,014,419**	**7.2**	**4.7**	**26.76**	**6.16**	**281.5**
Japan and newly industrialised Asian economies	791,349	721,910	2.8	2.1	18.24	10.64	3,733.3
South and East Asia[2]	336,448	262,699	18.8	12.3	7.75	3.66	93.9
Middle East and Central Asia	33,321	29,810	10.1	5.0	0.77	1.51	105.0
Africa	**66,719**	**57,453**	**-1.1**	**2.3**	**1.54**	**3.86**	**64.7**
Oceania	**81,160**	**65,819**	**2.3**	**-11.5**	**1.87**	**5.82**	**2,283.1**
World (3)	**4,338,964**	**4,109,635**	**2.7**	**-0.3**	**100.00**	**6.89**	**627.3**
Industrialised countries[4]	3,688,758	3,568,693	1.4	-1.0	85.01	8.65	3,526.7
Emerging markets[5]	650,206	540,943	11.0	4.6	14.99	2.99	110.1
OECD[6]	3,629,636	3,521,726	1.2	-1.3	83.65	8.14	2,847.8
G7[7]	2,843,371	2,776,919	0.7	-1.4	65.53	8.76	3,775.2
Euroland	1,069,855	1,076,059	3.1	6.8	24.66	8.15	3,005.2
EU, 27 countries	1,482,347	1,484,642	1.9	2.1	34.16	8.43	2,736.3
NAFTA[8]	1,300,859	1,266,611	0.0	-6.1	29.98	7.54	2,859.7
ASEAN[9]	57,169	46,658	9.3	4.9	1.32	2.97	103.6

1. Excluding cross-border business; 2. Excludes industrialised countries in South and East Asia (Hong Kong, Singapore, South Korea and Taiwan); 3. Insurance penetration (premiums as percentage of GDP) and density (premiums per capita) include cross-border business; 4. North America, Western Europe (excluding Turkey), Japan, Hong Kong, Singapore, South Korea, Taiwan, Oceania, Israel; 5. Latin America, Central and Eastern Europe, South and East Asia, the Middle East (excluding Israel) and Central Asia, Turkey, Africa; 6. 34 member countries; 7. The U.S., Canada, the U.K., Germany, France, Italy, Japan; 8. The U.S., Canada, Mexico; 9. Singapore, Malaysia, Thailand, Indonesia, the Philippines, Vietnam. The four remaining member countries—Brunei, Cambodia, Laos and Myanmar—are not included.

Source: World Insurance in 2010, *Sigma* No 2/2011 (page 31), Swiss Re: the life and non-life data are also given on page 31. The countries included in each category are given on page 30.

8 TheCityUK (2011) *Fund Management* (October). Note: the U.S. insurance assets amount to US$6.4 trillion, or 26 per cent of the total.

9 CEA (2011) *European Insurance—Key Facts* (September).

10 III (2011) *Insurance Industry Employment Trends: 1990-2011* (October). The III is a U.S.-based industry organisation which exists "to improve public understanding of insurance and what it does and how it works."

As can be seen in Table 1 the significant regional difference in the extent of the scope of insurance cover is notable. The industrialised countries, where insurance solutions are more readily available and uptake by the general population is more widespread, account for the majority of the worldwide premiums, with a share of 85 per cent. In the G-7 countries the insurance premiums to GDP ratio (the insurance penetration) is 8.76 per cent and the premiums per person (the insurance density) were US$3,775. In emerging countries the insurance uptake is not as extensive. Total insurance premiums in emerging countries stood at US$650 billion in 2010, which equals a penetration of only 2.99 per cent and the insurance density was comparatively very low at US$110 per capita.

The emerging markets have the highest growth potential for insurance services which recent figures confirm. This can be seen in recent real growth rates adjusted for inflation:

Table II: Real growth rates adjusted for inflation

	2006	2007	2008	2009	2010
Industrialised countries	3.1	2.5	-5.3	- 1.0	1.4
Emerging markets	14.6	11.8	11.0	4.6	11.0

Sources: *Sigma*, Swiss Re, No 3/2008 and No 2/2011 (in per cent).

This follows a steady increase in premium volumes in the preceding years.

4. Regulatory Principles and Restrictions

4.1 The role of the state in creating a regulatory framework

Economies are becoming increasingly dependent on insurance and accordingly the importance of regulation grows—both through specific rules for the sector and through general competition policy. Consumers must be protected and fair market competition assured, including by foreign companies. Stringent regulation is applied to protect individual consumers and in practice this encompasses all the key dimensions of the insurance business.

The state aims through prudential and market regulation to prevent insurance firms from failing financially, as consumers cannot directly impose financial probity on their insurers. There are rules to prevent insider trading, and other conflicts of interest. There are also rules for the competence and integrity of directors and managers (so-called "fit and proper" requirements), on actuarial calculations and accounting standards and reporting, and for disclosure of information. Insurance firms are required to register with the authorities, who grant them a licence to operate if they are sufficiently well capitalised for the types of risks being written and free of other impediments.

The regulatory framework separates the insurance sector from banking and the securities exchanges, and has specific regulations for the different classes of insurance, and also for the granting of licences to insurance agents and independent insurance brokers and to financial advisors.

4.2 Government restrictions on factors used by insurers to evaluate risk

There is a role for government consumer protection that particularly applies for individuals who lack the ability to assess the insurance products on offer, even where adequate information is made available by the insurers. Laws may prohibit insurers penalising customers with no credit history, insurance policies that exclude certain debts (such as hospital expenses) or have imposed disclosure rules, such as on the use of credit scores. Applicants must be informed, because these scores are likely to be adverse for those on low incomes, due to a lack of credit history. Credit scoring uses the credit history information to develop models to predict how often a customer is likely to file a claim and how expensive the claims will be, due to the high correlation found.

"The regulatory framework separates the insurance sector from banking and the securities exchanges, and has specific regulations for the different classes of insurance, and also for the granting of licences to insurance agents and independent insurance brokers and to financial advisors."

Insurers can be affected by adverse selection due to their inability to distinguish and separate different risk groups among customers, forcing them to offer pools based on average risk of entire populations, but this can draw in bad risks and be unattractive to persons with good risks.

Governments may ban genetic information from being used to deny cover. They may also, for certain types of insurance, impose a reversal of burden of proof, under statute or judgemental law, concerning evidential proof of causal links between events and the damage incurred.

Theoreticians point out that qualitative regulations on entry by firms to the insurance market are necessary to guarantee high-quality services and avoid adverse selection. But others say that there is a risk that qualitative regulations may be disproportionate as a result of excessive entry requirements and may lead to certain regulations that can be clearly anticompetitive. They may harm consumers by preventing providers from developing new services or cost-efficient business models.

5. The Role of the International Association of Insurance Supervisors

> *"The international trading of risks enables advantage to be taken of differences in endowments and preferences, and of the potential for a risk pooling over a large number of events and through reinsurance."*

There is no multilateral institution to set an overarching regulatory framework at the global level to condition national laws. However, the International Association of Insurance Supervisors (IAIS) acts to coordinate the regulations enforced by national insurance supervisors. The IAIS was established in 1994 and its members are the insurance regulators and supervisors of some 190 jurisdictions in nearly 140 countries, constituting 97 per cent of the world's insurance premiums. It also currently has more than 120 observers involved in its meetings and working groups. Its objectives are to:

- promote effective and globally consistent supervision of the insurance industry in order to develop and maintain fair, safe and stable insurance markets for the benefit and protection of policyholders; and to
- contribute to global financial stability.

The main IAIS goals are to ensure improved supervision of the insurance sector through cooperation among its members, by developing practical standards for insurance supervision, assist in the implementation of such standards through training seminars and to encourage and reinforce information exchange among different jurisdictions around the world.

It gives advice on rule-making and offers guidelines on general policy and principles which can assist in the context of legal liability when there are challenges in the courts for judicial review.

Typically its members aim to support market confidence in the financial system and its stability and secure consumer protection, while assisting also in reducing financial crime. They seek to protect the public interest, promote competitive markets and facilitate the fair and equitable treatment of insurance consumers, by promoting the reliability, solvency and financial solidity of insurance institutions.[11]

These standards are published by the IAIS as consensually approved Insurance Core Principles, covering the main issues, such as group-wide supervision, acceptable persons, risk management and capital adequacy.[12]

The IAIS Multilateral Memorandum of Understanding has been developed for the recognition of supervisory activities and enforcement through close cooperation and information exchange amongst insurance supervisors. This is considered extremely important to strengthen insurance supervisory regimes and promote financial stability.

Trade protectionism of various sorts would, through restrictions on market access, undermine the laudable aims of the IAIS supervisors and reduce insurance capacity in such markets, potentially adversely affecting financial stability.

11 See, for example, www.fsa.gov.uk and www.naic.org

12 The latest set of Insurance Core Principles, Standards, Guidance and Assessment Methodology was published by the IAIS on 1 October 2011 and can be found on www.iaisweb.org

6. The WTO Doha Development Agenda Round of Trade Negotiations

The WTO entered into force on 1 January 1995 and has 153 Members (as at May 2011) which account for almost 90 per cent of world trade.[13]

6.1 The General Agreement on Trade in Services (GATS) coverage of trade in insurance services

International trade in insurance services has been included in the WTO regime under the GATS. The international trading of risks enables advantage to be taken of differences in endowments and preferences, and of the potential for a risk pooling over a large number of events and through reinsurance.

While the current WTO "Doha Development Agenda" Round of trade negotiations continues, governments are discussing how to regulate certain insurance activities and products. The issues that need to be addressed at the global level include digital trading across borders and data hubs that raise issues of data protection and encryption and oversight by national supervisors; life products that include both cross-border aspects and fund management activities (given a grey area in the GATS Annex on Financial Services which defines the services covered under the headings of: *Insurance and insurance-related services*; and *Banking and other financial services (excluding insurance)*; and the capacity of reinsurers in emerging and developing countries.

The World Bank asserts that an ambitious package in services may provide new dynamism to multilateral trade cooperation. Doing so may also allow the Doha Development Agenda to live up to its name and improve access and benefits for developing countries in the insurance field. However, many observers would say that the most that can be expected for specific commitments in the insurance sector would be to bind current autonomous liberalisation levels. Any further liberalisation will have to be undertaken in Regional Trade Agreements, few of which so far have begun to address the key challenges where emerging and developing countries are involved.

"As the supply of services is becoming increasingly globalised, while regulation remains primarily national, the WTO Doha Development Agenda Round of market access negotiations needs to be supported by greater regulatory cooperation."

Proposals by the private sector for a Model Schedule for specific commitments on insurance services have not been picked up by the services negotiators. Some observers suggest that negotiators should consider specific disciplines for domestic regulations related to insurance services, presumably in the next "successive" round of services negotiations mandated under GATS Article XIX *Negotiation of Specific Commitments* in Part IV *Progressive Liberalisation*. Others have suggested that UNCTAD should develop practical means and advice for developing countries on how local insurers can successfully stand up to foreign competition, rather than seek protection for its own sake.

As the supply of services is becoming increasingly globalised, while regulation remains primarily national, the WTO Doha Development Agenda Round of market access negotiations needs to be supported by greater regulatory cooperation, including:

- for prudential regulation (e.g. on finance and data flows) and pro-competitive regulation;

13 WTO (2011) *World Trade Report 2011*.

- through coherent assistance to developing countries ("aid for services trade") to build regulatory institutions and institute access-widening policies; and,
- between host and source countries on the temporary presence of individual services suppliers in a host country (GATS Mode 4)[14].

6.2 Policy space for financial services regulators

The WTO agreement on financial services concluded in December 1997 entered into force in 1999. The key to obtaining treasury and finance ministry agreement to the inclusion of financial services was that the regulators retained full discretion over regulations to protect their economies from systemic financial sector risks, called the "prudential carve-out" which includes the following provision in the GATS Annex on Financial Services:

> "§ 2 (a) Notwithstanding any other provisions of the Agreement, a Member shall not be prevented from taking measures for prudential reasons, including for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial system. Where such measures do not conform with the provisions of the Agreement, they shall not be used as a means of avoiding the Member's commitments or obligations under the Agreement."

These ministries had also insisted in the Uruguay Round of trade negotiations (1986-1994) on their own definitions of financial services, placed in the GATS Annex, which was not constrained by the 1991 United Nations Provisional Central Product Classification-based listing applied to other sectors.

Such was the importance attached to financial services that the Council for Trade in Services of the GATS immediately set up its Committee on Trade in Financial Services, as provided for in the Marrakech agreements of April 1994. It "is mandated to provide a forum for technical discussions, to conduct studies on measures of Members and to conduct examinations of any technical matters affecting trade in services in the financial sector". It has discussed a range of technical issues, for example the distinction between Modes 1 and 2 for financial services,[15] cross-border solicitation and marketing, classifications, scheduling clarification, consistency of schedules with the Most-Favoured-Nations (MFN) Exemptions, and phasing in staged liberalisation of financial services commitments.[16] The WTO Secretariat offers technical assistance on scheduling techniques for developing country members.

14 The GATS definition of a Mode 4 supply of a service is: "by a service supplier of one Member, through presence of natural persons of a Member in the territory of any other Member". Such individuals can only be present on a temporary basis as defined by the host country and are usually limited to certain specific categories including contractual services suppliers, intra-corporate transferees and business visitors.

15 The GATS definition of a Mode 1 supply of a service is: "from the territory of one Member into the territory of any other Member", and Mode 2: "in the territory of one Member to the service consumers of any other Member."

16 WTO (1996) *Technical issues concerning financial services schedules*, S/FIN/W/9, (July) (§ 1). Under the GATS each WTO Member has to legally bind a schedule of specific commitments setting out which services sectors or sub-sectors are open to foreign market access and the conditions and limitations that apply to the supply by foreigners of these services in their jurisdiction.

6.3 Recently Acceded Members

It is notable that the 40 or so WTO Members that have acceded since 1995 have mostly made GATS commitments that match in general, or even exceed, those of developed countries, including for financial services. Most are small economies, but among these new Members are China and Chinese Taipei, Saudi Arabia, Ukraine and Vietnam. It should be noted that Iran, Iraq, Libya and the Russian Federation are among the 29 countries seeking WTO Membership.

7. UNCTAD and Insurance

The United Nations Commission on Trade and Development (UNCTAD) is committed to supporting the aims of the WTO Doha Development Agenda Round of trade liberalisation negotiations including in particular for the insurance sector. This is done by offering capacity-building support to the governments and insurance regulators and supervisors in developing countries. Without this aid from the United Nations, the governments of developing countries would be less able to participate in these multilateral trade negotiations which would tend to delay the attainment of a successful conclusion.

Insurance has been on the work programme of UNCTAD since its inception in 1964.

> "Over the years and in direct response to the needs of developing countries, activities related to the insurance sector have become an institutionalised part of UNCTAD and one of its mainstays. The objective of the Insurance Programme is to help, in particular developing countries, establishing competitive and well regulated insurance markets. It conducts its work through producing analytical work and conducting technical cooperation."[17]

"The objective of the Insurance Programme is to help, in particular developing countries, establishing competitive and well regulated insurance markets. It conducts its work through producing analytical work and conducting technical cooperation."

Furthermore, the objective of UNCTAD

> "is to improve access for a large part of the population to insurance services and to mobilise investment resources from this sector. Assistance is provided to insurance supervisory authorities in the establishment of legal and supervisory insurance frameworks; training is organised and information provided on insurance markets to government officials, regional associations and managers of insurance concerns. Software to assist in insurance company management has been developed."

An UNCTAD study, based on the documentation of the relative importance of the largest insurance companies in the world and changes that may have occurred in recent years, together with the identification of some of the factors that may explain the increased internationalisation and location of insurance groups, concluded as follows:

> "First, the results indicate that location-specific advantages such as size, education and cultural distance, do provide an explanation of the internationalisation of insurance firms. Second, they show that good governance, as hypothesised, has a strong impact on the choice of countries by insurance firms."[18]

The International Monetary Fund holds a similar view, as one of its officials said:

> "Provided that liberalisation is promoted against the backdrop of a solid set of prudent supervision—the recent shift towards solvency-based supervision in the main emerging markets is in this line of approach—consumer protection, competition, as well as proper disclosure of information, the opening up of the insurance markets should bring long-term benefits to the countries. The privatisation of the social security system and excellent growth perspectives will open new opportunities for foreign insurers."[19]

17 UNCTAD, Insurance Programme: *http://www.unctad.org/Templates/StartPage.asp?intItemID=4126&lang=1*
18 J.-F. Outreville (2007) *Players and driving forces in world insurance services: location and governance*, Geneva: UNCTAD.
19 U.S. Das (2007) *Insurance services: development and liberalisation—some observations*, Monetary and Financial Systems Department, Washington D.C.: IMF.

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This document considers the essential role of insurance services in trade growth and development around the world and the main factors that influence it. In the context of the role and function of insurance in the economy and the principles and restrictions that underlie the regulation of insurance, it examines the implications of the World Trade Organization (WTO) and the Doha Development Agenda Round of trade negotiations and the work of the United Nations Commission on Trade and Development (UNCTAD) as they relate to insurance. Written by Julian Arkell, Special Advisor to The Geneva Association on Global Services and Trade and Investment issues, it is intended as a reference document and primer on these issues that affect the globalisation of the insurance industry.

International Association for the Study of Insurance Economics—"The Geneva Association"
Route de Malagnou 53, CH-1208 Geneva | Tel: +41 22 707 66 00 | Fax: +41 22 736 75 36