SPEECH

INSURANCE AND RISK MANAGEMENT IN A LIBERALISED ECONOMY

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It gives me great pleasure to inaugurate this Conference and be with you here this morning. It is no doubt a tribute to the organisers for having attracted such a large gathering comprising of distinguished experts, to deliberate on a theme which is of critical importance to the Indian growth process. Insurance and risk management can play a critical role in ensuring the effectiveness of our program of structural reform.

I am no expert on insurance and risk management. I shall therefore content myself in raising some issues that arise in the context of our efforts to accelerate economic growth.

2. The forces currently shaping the Indian economy are also influencing the insurance industry. With the Indian economy poised for higher growth, the demand for insurance products will also increase. Market liberalisation, introduction of sophisticated technologies and processes, emergence of new and different forms of businesses and a larger play in the field of global trade and finance are making financial and trade transactions riskier. The ease, with which one could undertake banking for instance, no longer exists. This is prompting insurers and others to reassess the scope of their operations and design products and services tailored to meet rapidly changing market requirements. Government, as the owner of insurance companies in this country is also recognising these trends and exploring ways to widen the scope of the insurance sector.

3. Most of the discussion during the last two years of the reform process has underscored the benefits of liberalisation — what economists call the efficiency and productivity gains. While this premise is of utmost importance, it has also to be recognised that as the economic system transforms itself, market imperfections and speculative actions of some of the participants could generate uncertainties, increase volatility and pose substantial economic risks. While systemic risks can be prevented by putting appropriate macro-economic and structural policies in place, the risks at the micro-level would persist, requiring proper understanding, quantification and management. Institutional mechanisms thus have to be properly developed which provide competitive and consolidated insurance against risks — both financial and non-financial.

Risk and Economic Activity

4. In all forms of economic activity, a certain amount of volatility and uncertainty is inherent. Frank Knight in his celebrated book "Risk Uncertainty and Profit" drew attention to the fact that profit is a consequence of uncertainty. He made distinction between quantifiable risk and non-quantifiable risk. According to him, it is non-quantifiable risk that leads to profit. Talking of existence of risk he wrote "It is a world of change in which we live, and a world of uncertainty. We live only by knowing something about the future; while the problems of life, or of conduct at least, arise from the fact that we know so little. This is as true of business as of other spheres of activity."

5. Risk exists not only in the real world of production but also in financial world. The history of financial market is replete with examples resulting in losses and financial disturbances of a systemic nature, due to the failure of properly assessing and managing risk. Considerable amount

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of financial engineering therefore, now goes into exploring ways to measure risks as a prelude to managing and pricing it. In the area of regulatory oversight of the activities which are aimed at controlling risks, an emerging point of view is that developing a better understanding and a sharper perception of various forms of risk is necessary before reducing the burden of rules and regulations. Haphazard and indirect management of risks thus, must give way to a more scientific and well measured management of risk. Today, as the structure of individual industries changes, competitive advantage is increasingly becoming a function of who is able to better manage their risks. Risk is something which is now taken up upfront rather than be left to circumstances or fate to decide.

6. The connotations of risk in the service economy are much broader than the notion of risk familiar to the industrial enterprises. This appreciation is important since the contribution of the services sector to Indian real GDP growth has been continuously rising. The notion of vulnerability which covers the possibility of breakdown or malfunction of a given system becomes fundamental. Modern technology has also rendered the problem of vulnerability very acute, not because the technology is bad, but precisely, and this is the paradox, because it is good. The frequency of risk tends to be extremely low, but exposure reaches higher and higher levels. Airplanes crash very rarely whereas stagecoaches are likely to have breakdowns every 30 miles or so. But which of these two vehicles is the more vulnerable? In the case of a stagecoach, a broken wheel is not too serious, but when a window of a jet opens in flight the results are catastrophic. Increase in natural and manmade calamities and disasters in recent years has attracted attention of all concerned—the government, the industry and the insurers. Therefore at all levels—personal and macro-industrial—we have to pay serious attention to the discipline of risk management.

Insurance and Risk Management

7. Insurance indeed is a mechanism to reduce the element of risk and make it possible for economic agents to maximise their portfolios. In fact, insurance and reinsurance market is essential for sustainable economic growth and development. It complements economic activities, stabilises trade and commerce, and helps mitigate uncertainties affecting economic agents. In a broad sense, insurance enables active risk management. In the search for better risk management techniques derivative products are being developed, helping the financial institutions and corporates to prepare for a riskier world. The understanding, thinking and perception about risk is undergoing a fundamental change. Today, while fundamentally, risk remains the volatility of the potential outcomes, the perception differs from person to person. However with the use of sophisticated tools these outcome are being captured quantitatively and managed effectively. The theory of probability is the bedrock on which the actuarial science is built. The risk of an aggregate is not simply the sum of the individual risks. It can be more or less, depending on the cross correlations.

8. Risk management stands today in contrast to the intuitive and traditional methods of managing uncertainty. Theory of risk management does have its limitation but its value lies in the fact that by measuring what could go wrong and estimating its likelihood, firms and institutions have a better chance of making sensible decisions. Many of the financial institutions, particularly, the large global banks are today operating more as risk managers rather than as a traditional banking institution.

Insurance Industry In India

9. A common man's view of insurance in most developing countries, including our own is, that it entails regular premium payment for the policies taken as insurance against premature death, fire, accidents, natural calamities, financial/property losses during riots, or owing to theft or burglary, hospitalisation etc. Insurance premia are often taken to be a given cost to cushion against uncertainties. Insurance, however, need not be confined to such a narrow view. Not only the services could be extended to cover more non-financial sectors but also a number of volatile financial risks.

10. The coverage and spread of the Indian insurance market — particularly the life insurance segment — has been phenomenal. In fact, life insurance dominates the Indian insurance scene. The experience with general insurance in India raises hopes of good performance by the industry. Since 1972 when the Government of India took over the ownership of general insurance companies and reorganised them the industry has witnessed a phenomenal growth. The spread of offices, number of policies issued, variety of insurance cover, and the premium income earned—all indicate towards the positive growth in insurance services. As per available data, the percentage of premium relative to Gross National Product for the insurance industry as a whole has consistently moved up from 1.67 per cent in 1990 to 1.95 per cent in 1992. Incrementally, the ratio of premium to GNP is rising sharply. All these indicate the diversified spread and coverage of the insurance industry in our country. However, the industry remains much less developed in terms of sophistication of new insurance service products than those found elsewhere.

11. The stage is however set for challenges and opportunities for insurers to grow manifold. For instance, export credit guarantees, and export credit insurance schemes which are already in operation have to be, comprehensive enough to cover both commercial and political risks. Similarly, the scope of agro-based insurance cover will have to be expanded as cash crop and agro-based productive activities pick up. Again, more refined hedging mechanisms to insure against currency, interest rate and credit risks, as well as risks relating to capital market instruments need to be developed. Insurers can play yet another role. Even as they are taking specific risks, they can do much to minimise the occurrence of such risks in general. Introducing and promoting better safety measures and educating people about risk avoidance are some such measures.

Some Imperatives

12. In general, one could say that securitisation, trading in debt instruments and derivatives financial products, which have become common in the developed economies and are also entering some of the developing markets, would also be present sooner or later in our financial system. These instruments often pose problems for banks which if allowed to freely invest in them or given credits on their account, could have large risk weighted assets. Indeed, there is a need to devise some mechanisms to provide cover for banks engaged in permissible off-balance sheet activities, as well as in other balance sheet assets. This will go a long way in reducing systemic risks even as deposit insurance continues to provide a boost to the confidence in the banking system.

13. To offer products which are able to meet the client needs more closely, the insurers themselves however need to be in financially strong and competitive position. Capacity should be enhanced to offer a wide range of solid products, backed by secure investments and professional management. Apart from improving viability, product range, pricing practices, the insurers must also strengthen their distribution or selling networks and devise ways to market in a more customer-friendly manner, taking into account the consumer psychology. Face to face contact with entrepreneurs and clients, particularly, the small clients is essential. An important element for institutions which are helping others to manage risk is to know what their own risks are. Risk managing institution must have a proper system of internal control and standards of limits so that the institution does not, while managing others risks, run a high degree of risk itself. Internal reporting and control lines therefore must be transparent and sensitive.

14. The financial system as a whole must gear itself towards offering a solid and wide range of banking *and* insurance services — 'bancassurance,' as someone has termed it — so as to support the efforts in the trade, industrial and agricultural sectors in order to boost the overall rate of real growth. Provision of comprehensive and modern financial services, constitutes a key condition for the sustainable adjustment, recovery and growth of a developing economy.

Regulatory Issues

15. While great advances have been made in the area of risk management it does not constitute a substitute for proper and prudent management on the part of the insured. The fact that there is growing sophistication both in terms of management and hedging of risk does not imply that institutions cannot go wrong. Provision of insurance sometimes, especially under imperfect information system leads to the moral hazard problem such as in the case of Deposit Insurance System, which necessitates constant monitoring. Since the deposit insurance agencies usually insure all depositors up to a limit, depository institutions have been found to undertake deliberate and reckless risk-taking. A case in point was the widespread bank and thrift failure in the United States leading to a massive insolvency of the agency which insured the deposits.

16. There are several regulatory issues connected with the insurance companies, which are engaging the attention of regulatory and policy makers, worldwide. The regulation of insurance companies either emphasises the fixing of premiums at levels which are adequate to pay future claims and avoid insolvency, or the approach is based on solvency monitoring. A major concern also relates to companies offering deceptive packages in terms of the calculation of premium, including the discount rates etc.. The other issue is dealing with the extent to which innovative insurance policies can be introduced. Perhaps there is an argument for allowing insurance companies to offer covers which can be devised by enjoying considerable freedom in terms of both product innovation and premium setting. Such issues will require some careful thought as the Indian insurance industry assumes a more competitive character with a larger set of players.

17. Legislative and regulatory changes are also necessary in order to bring about new arrangements so as to improve the competitiveness and structure of the insurance industry. The structure of the insurance industry, the creation of new insurance products and services as well as the regulation and supervision of insurance are some of the areas which are being inquired into by the Committee chaired by Shri R. N. Malhotra, formerly Governor of the Reserve Bank of India which is looking into the reforms of the insurance sector. While it will take some time for the Committee to submit its report, the fact is that in the present ambience, insurance covers and hedging mechanism are bound to develop and grow, especially in the financial services sector.

Conclusion

18. To conclude, there is therefore an urgent need for undertaking considerable research in areas such as insurance pricing, identification of risk exposure, loss—behaviour patterns and characteristics of different investor groups. There is a general perception that premia charged are high in India essentially because there is no effective competition in the industry. There is also a widespread feeling that procedures for claims are cumbersome and claim payments are effected with considerable delay. Efficient funds management, and computer networking for instance could, to a large extent, take care of procedural and operational problems, as well as the issue of pricing of products. There is a need for flexibility in the operations of the insurance companies, especially in regard to their investment decisions. Introduction of new players may not necessarily lead to efficiency and reduced premia. What is important is to have a re-look at the existing legal framework relating to insurance, the constraints presently in place on the use of funds by the insurance industry, and the supervisory mechanisms. Institutional changes in these areas are important for efficient functioning of insurance industry, and will go a long way to promote better risk management by all institutional and individual investors.

I wish your deliberation all success.