# Assessment of the Reinsurance Business in Developing Countries: Case of Ethiopia

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## Declaration

I, Mezgebe Mihretu Woldegebriel, declare that this research report is my own work, except those acknowledged. All the sources, references and texts have been acknowledged. I submitted to the Graduate School of Business Leadership in partial fulfillment of the requirements for the degree of Master in Business Leadership, University of South Africa. It has not been submitted before, in whole or part, for any degree or examination at any University.

Mezgebe Mihretu Woldegebriel

Signed on ---------------- day of --------------------- 2010

**Abstract**

There are contrasting views about the impact of cross border reinsurance business in developing countries. In the literature, some argue that cross border reinsurance plays a critical role in strengthening risk absorbance, solvency, know-how, and in availing foreign capital for the insurance industry of developing countries. Some of the literature underpin cross border reinsurance as indispensable in availing foreign capital for the insurance industry in the aforesaid countries. Others claim that excessive dependency on cross border reinsurance not only negatively affects foreign currency holdings of a given country, but, also has an adverse effect on the contribution of the industry to the economy of a nation. The Ethiopian insurance industry is entirely dependent on cross border reinsurance business. Despite the importance of sound reinsurance business regulation for the stability and growth of the local insurance industry, no such regulations in Ethiopia have been issued. This paper reports the findings on the influence of the cross-border reinsurance business, on the insurance industry and the economy and perceptions of the management of the industry regarding reinsurance business regulations in the Ethiopian context. The study used ten years data including financial transactions of the insurance companies, GDP and sample primary data of the perceptions of the management of the insurance industry regarding reinsurance business regulations. Quantitative and qualitative analytical research approach is used. The results show that cross-border reinsurance business affects negatively the insurance industry from the financial performance perspective. The insurance industry is contributing little to the economy of the country. Awareness gap regarding the reinsurance regulation persists in both management levels. Lack of awareness induced the industry to engage in the international business without the appropriate regulations. Both the government and the industry should work in unison towards putting in place a regulatory framework and appropriate strategies that can enhance competitiveness of the industry, both at national and global spectrum.

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## ACCRONYMS

| | |
|---|---|
| ADLI | Agricultural Development Led Industrialization |
| CICA Re | Common Insurance Creation Reinsurance |
| CIMA | The Central Insurance Monitoring Agency |
| CIRA Re | West and Central Africa Sub Region Reinsurance |
| COMESA | Common Market East and Southern Africa |
| CP | Ceded premium |
| CSA | Central Statistics Agency |
| EDRI | Ethiopian Development Research Institute |
| EIC | Ethiopian Insurance Corporation |
| ETB | Ethiopian Birr (currency) |
| FD | Financial Development |
| FDRE | Federal Democratic Republic of Ethiopia |
| GDP | Gross Domestic Product |
| GP | Gross premium(underwriting premium) |
| GTAP | Global Trade Analysis Project |
| ILO | International Labor Organization |
| M2 | Broad Money, Economics |
| MoFED | Ministry of Finance and Economic Development |
| MoTI | Ministry of Trade and Industry |
| NBE | National Bank of Ethiopia(Central Bank) |
| NCC | Net Ceded Claim |
| NCI | Net Claims Incurred |
| NCP | Net Ceded Premium |
| NP | Net Premium (Retention) |
| PTA Re | Preferential Trade Area Reinsurance |
| PMAC | The Provisional Military Administration Council (PMAC) |
| TGE | Transitional Government of Ethiopia |
| UNCTAD | United Nation Conference on Trade and Development |
| USAID | United States Agency for International Development |
| WB | World Bank (The International Bank for Reconstruction and Development |
| WTO | World Trade Organization |

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# CHAPTER ONE
# ORIENTATION

## 1.1 The Ethiopian Context

The Federal Democratic Republic of Ethiopia (FDRE) is situated in the Horn of Africa. Ethiopia is bounded by Eritrea in the north, Djibouti in the north-east, Somalia in the south-east, Kenya in the south-west and Sudan in the west. With an area of 1,235,000 square km, Ethiopia is as large as France and Spain combined. About 65% of the land mass is arable while only 15% is cultivated. The population is estimated at 79.5 million; of which over 50% are under the age 20 and about 85% reside in rural localities. In terms of population density, the number of inhabitants per square km is about 50. The capital Addis Ababa, has about 2 .8 million inhabitants (CSA, 2010).

Ethiopia is a multi-culture and multi-ethnic country with more than 83 languages. The official language, Amharic is spoken by 60% of the population but two other languages (Oromigna and Tigrigna) are also commonly spoken: English is widely spoken particularly in the big urban centers.

Geographically, Ethiopia has a rugged topography with an elevated central plateau varying in height between 2,000 and 3,000 meters. In the north and centre of the country, there are some 25 mountains whose peaks rise over 4,000 meters (peak of Ras Dashen is at 4,620 meters). Dallol, world's lowest place, being 48m below sea level, with live volcano (located at Erta Ale) and colorful hot brine springs is found in the North East part of the country. To the north, Lake Tana is the source of the famous Blue Nile River, which runs a distance of 850 miles and joins the White Nile at Khartoum, Sudan. The Nile River is the longest river in the world that stretches north for approximately 4,160 miles from East Africa to Mediterranean Sea. Similarly, Omo River rises in western part of the Ethiopian plateau and feeds into Lake Turkana on the Kenyan border.

Ethiopia has two seasons: dry and wet. The dry season prevails from October to May and the wet season from June to September. Due to huge variation in altitude, the country is not characterized by tropical climate across the national space. Under 1,830 meters, average temperature is 27°C. Between 1,830 and 2,440 meters, the temperature is about 22°C. Above 2,440 meters, the temperature is cooler (around 16°C) and precipitation is abundant (from 1,270 meters to 1,780 meters per year).

Over 85 percent of the Ethiopian population is currently living in rural areas. The vast and dispersed settlements in the rural areas have large populations with minimal access to services and limited economic resource base. Most urban areas are also fragmented with great spatial separations and disparities between towns and townships, resulting in inefficient and costly urban sprawl.

Since the last decade and half, Ethiopia is rigorously working to transform itself from the backward self-subsistence agriculture economy to commercialized agriculture thereby to enjoy agro industry and industrialization ultimately. Following the overthrow of the dictatorial military government, various policies targeting at promoting economic growth, market transformation social well being and equality under the auspices of market economy are put in place. Private investments have also been flourishing including in the financial sector. Structural adjustments such as liberalization of foreign trade, privatization of public enterprises and investment motivational schemes were undertaken to promote economic growth (Ahmed, Diaz-Bonilla, Robinson, & Lofgren, 2006). Hence, the economy is ever integrating into the global economic system.

Over the last six years (2004-2009), the Ethiopian economy has markedly grown, subsequently placing Ethiopia among the top performing economies in Sub-Saharan Africa. Overall economic performance measured by growth in real Gross Domestic Product (GDP) has registered 11.5 percent on average. The average growth rates in value added of agriculture, industry and service sectors were 10.8%, 10.1% and 13.0%, respectively in the reported period. The country's real GDP has grown tremendously from Birr 66 billion in the year 2000 to Birr 135 billion in the year 2009. This growth is registered at all levels and sectors of the economy (Agriculture, industry, construction, services, and infrastructure). The service sector constituted 36% and 46% of the GDP in 2004 and 2009, respectively. Of the service sector, the financial sector's contribution to GDP has grown from 1.8% in the year 2000 to 2.8% in the year 2009 (MoFED, 2010).

These economic performance indicators show that the economy is not only growing but also becoming wide and diversified in terms of mix and complexity and degree of monetization. This in turn, implies the ultimate need to have a strong financial sector in general and an insurance industry in particular (Ahmed, Diaz-Bonilla, Robinson & Lofgren, 2006). However, despite all efforts for foreign oriented business and export oriented development strategies, the Ethiopian insurance industry has still been operating exclusively with cross border reinsurers for a number of years. Attempts have so far never been witnessed to changing national and international circumstances in this regard.

## 1.2 Background of the Study

According to UNCTAD (2007), there is a positive and strong correlation between the economic development level and insurance coverage of a country. The same study has emphasized the strong alignment between the insurance development and the macroeconomic, social, governance, and cultural factors such as inflation, currency, exchange rate, national income, regulations, supervision strategies, and national objectives of a country. According to (UNCTAD, 2007), insurance plays a crucial role in fostering commercial and infrastructural businesses. From the latter perspective, it promotes financial and social stability; mobilizes and channels savings; supports trade, commerce and entrepreneurial activity and improves the quality of the lives of individuals and the overall wellbeing in a country.

However, the economies of developing countries in general and that of Ethiopia in particular are dependent on subsistence agriculture, as well as micro and small industries, which are highly vulnerable to natural disasters and risk (Todaro and Smith 2009). To alleviate poverty, backwardness, and risks of natural disasters like drought, developing countries, including Ethiopia, need to capitalize on long term investments like dams, electric power, industries, and IT technology. This inherently entails a structural change in the economy and the availability of capital or financial market. For the sustainability of such an economic structure and stable economic growth, a strong and efficient financial sector in general and the insurance industry in particular is a pre-requisite (Ahmed, *et al*., 2006).

The study by UNCTAD (2007), states that insurance industry in developing countries depends extensively financially and technically on cross border reinsurance. Likewise, the Ethiopian insurance industry is entirely dependent on a cross border reinsurance business. Besides, according to UNCTAD (2007), the Ethiopian insurance industry is among the lowest in the world and African countries in terms of the three parameters: Insurance premium market share, market penetration rate and insurance density (per capita insurance premium) and hampering industry competitiveness.

In the literature, there are two contrasting views in general with respect to the dependency on cross border reinsurance. Outeville (2002) argues that cross border reinsurance provides insurers with professional management expertise, financial leverage and foreign exchange. However, other studies claim that full cross border reinsurance has two basic consequences: First, like any import business, it requires foreign currency that may increase costs of insurance service products due to exchange rate depreciation (ultimately harm the underwriting premium), and contributes to balance-of-payments the deterioration in a given country. Second, it has a negative impact on the domestic insurance industry due to excessive recourse. Thus, both are challenges to the economy of developing countries (UNCTAD, 1980, Irukwu, 1987).

Some authors suggest that there is a strong positive correlation between economic growth and insurance coverage (UNCTAD, 2007). Another literature on the other hand, underlines that if countries are excessively dependent on foreign reinsurers, it may limit the contribution of the insurance industries to the national development agenda (UNCTAD, 2007).

Besides, according to UNCTAD, (2007), insurance industry in developing countries lacks adequate insurance legislation. Similarly, Wang (2003) emphasizes that the reason for establishment of regulations in particular by developing countries is rooted in the economic motive, which is the country’s balance of payments. In this regard, some literature on the Ethiopian insurance, indicate different views with regard to the reinsurance business regulations. Some argue for the non existence and others claim for it.

In line with these various views, therefore, it becomes imperative to assess the influence of cross border reinsurance business on the insurance industry and the economy; the correlation between the insurance industry and the economy and the perception of industry management concerning reinsurance business regulations.

## 1.3 Problem Delineation

Varied literature underlines the significant contribution of cross border reinsurance business to the sustainability and growth of the domestic insurance industry and the economy. In this respect, Wang (2003) and Outeville (2002) underscore that Cross-border reinsurance provides domestic insurers not only overseas professional management expertise, knowledge transfer, financial leverage and capacity but, also avails foreign exchange, in times of claims.

On the other hand, literature emphasizes the disadvantage of cross border reinsurance on the developing countries insurance industry and economic growth. For example, UNCTAD (1980 and 1987) underline that developing countries are concerned about cost in foreign currency and excessive recourse to reinsurance negative impact on the growth and development of domestic insurance industry due to foreign reinsurance. Similarly, Irukwu (1987) and Wang (2003) claim that full cross border reinsurance like any import business requires foreign currency. This may increase costs of insurance service products. This ultimately harms the underwriting premium and contributes to the deterioration in foreign currency holdings and the balance of trade, which is the challenge to developing countries. Thus, literature brings to light contrasting views with regard to developing countries dependency on cross border reinsurance. These contrasting views indicate that the influence of the cross border reinsurance business on the Ethiopian insurance industry and on the Ethiopian economy is inconclusive.

Many of the economic literature suggest a strong positive correlation between financial development, economic growth and insurance coverage. For example, UNCTAD (2007) underscores that insurance markets grow faster than national income; and for emerging market economies insurance has been growing a multiple of three or four times than the economy as a whole. The importance of insurance to developing countries was emphasized by UNCTAD in its first session in 1964 where, it formally acknowledged that "a sound national insurance market is an essential characteristic of economic growth" (UNCTAD, 1964:55). However, UNCTAD (2007) underline that developing countries' dependency on foreign re-insurance is extensively high, which has implications for the contribution of the insurance industry to national development. The Ethiopian economy is growing fast, while the insurance industry is exclusively dependent on foreign reinsurers. Thus, the situation of the insurance industry in relation to the economic growth is unclear.

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By the same token, other literature shows the importance of reinsurance regulations for the sustainability of insurance industries, regardless of the level of development of the countries. UNCTAD (2007) claims that insurance industry of developing countries lack adequate insurance legislation regardless of its critical role in strengthening and enhancing the competitiveness of the insurance industry in the global market arena. On the other hand, according to Wang (2003) the development of appropriate regulatory framework regarding reinsurance business is becoming crucial for the stability of the insurance industry. Wang (2003) also stress that the reinsurance arrangements should be appropriately regulated to protect the solvency of the primary insurers. In the context of the Ethiopian insurance industry, the Licensing and Supervision of Insurance Proclamation No. 86/1994 has postponed the manner in which reinsurance business may be transacted. However, no such directives or a detailed guideline related to "the manner in which reinsurance business may be transacted in Ethiopia" has been issued. Others, in the industry, argue that the industry is actively transacting in the reinsurance business without a problem. These arguments imply that the Ethiopian insurance industry has long been in the reinsurance business without detailed regulation despite the latter's irreplaceable importance. This triggers the interest why the industry has been long without reinsurance regulations.

## 1.4 Objectives of the Study

Ethiopia pronounces export as engine of growth in various strategy and policy documents as a means to secure foreign exchange reserve sustainability. One of these documents is the industry development strategy, guided by export-oriented industrialization and import substitution strategies (MOTI, 2002). However, Ethiopia's insurance industry is still entirely dependent on cross border reinsurers. There are contrasting views regarding the influence of cross border reinsurance business over local insurance industry and an economy of a country. There are also views about the absence of reinsurance regulations in the Ethiopian insurance industry despite the crucial roles that reinsurance business regulations can play for the sound, comprehensive and stable growth of insurance industries.

The main objective of this study is, therefore, motivated by the literature to review and analyze the reinsurance business in Ethiopia, with particular emphasis on the impact of the cross border reinsurance on the insurance industry and the economy. The study also aims to assess whether the insurance industry is performing in line with the economic growth. Moreover, the study aims to review the perception of the insurance industry management regarding legal and regulatory requirement of the reinsurance business in Ethiopia. By doing so, the study may help the industry and policy makers to formulate strategies and policies that can enhance the growth of the insurance industry. In the context of these general objectives, the study comprises the following specific objectives from the Ethiopian perspective:

- Analyzing the effect of cross boarder reinsurance business on the growth of local insurance industry and the economy;
- Examining whether there is strong correlation between the growth of insurance industry and the growth of the economy;
- Examining whether there is perception gap in the insurance industry management regarding the legal and regulatory requirements of the reinsurance business; and
- Recommending measures to strengthen the reinsurance business and ultimately to the insurance industry

## 1.5 Significance of the Study

Despite the importance of the reinsurance industry for the overall growth of the Ethiopian economy, only very few studies have been conducted on the area. As far as the researcher's knowledge is concerned, the studies done so far, have not been empirically addressed the effect of the reinsurance business on Ethiopian local insurance industry and the growth of the economy in general.

Thus, this study aims to fill this gap and stimulate researchers, policy makers and students to undertake in-depth and rigorous studies on the insurance industry in general and in the reinsurance business in particular.

## 1.6 Methodology

To address the research objectives, quantitative and qualitative research approaches are applied. Primary and secondary data are used in the study. The primary data is obtained from the insurance companies and the supervising authority. The information has quantitative and qualitative nature. The secondary panel data for the insurance industry and other micro and macro are obtained from the National Bank of Ethiopia (NBE) covering time range of ten years from 2000 to 2009. The data are analyzed using both descriptive and inferential statistics. Moreover, the study employed appropriate data analyses procedures including triangulation.

## 1.7 Scope of the Study

The scope of the study is limited in terms of content, space and time. It analyzes the impact of cross border reinsurance on the Ethiopian insurance companies. The study focuses on the analyses of financial transactions as well as legal and regulatory requirements of the reinsurance business. The secondary data for the financial transactions of the industry is limited to the trends of gross premium (written premium), retention (net premium), claims incurred, cession premium, and cession claimed covering the period from 2000-2009. The questionnaire focuses on randomly selected sample groups of the targeted population and is limited to phenomenological study type of the qualitative method. The conclusion is not therefore robust on account of small sample size and the limited number of years, that should be applied with caution.

## 1.8 Structure of the Research Report

The remaining part of the research report is organized as follows. Chapter two, presents theoretical foundations and literature review pertaining to the insurance industry in general and to the reinsurance business in particular with a particular focus on reinsurance business financial transactions and legal and regulatory context. Chapter three, deals with discussion on the problem statement and the research questions along with the respective research hypotheses. Chapter four in turn, discusses the research design and research tools employed, including data gathering methods, sampling, data preparation and analyses. In chapter five, the research results are presented. Finally, chapter six comprises discussions of the results, conclusion and recommendations.

# CHAPTER TWO
# THEORETICAL FOUNDATION AND LITERATURE REVIEW

## 2.1 Introduction

In chapter one, the recent Ethiopian context, background to the study, problem delineation, objectives, significance of the study, methodological approaches and scope of the study were briefly described. In this chapter, theoretical foundations and findings of empirical studies pertinent to this study are presented. Under the theoretical foundation, discussion of concepts, the rationale, development, nature and functions of reinsurance, types and methods of the reinsurance business and retention, insurance industry and economic growth, reinsurance business environment and regulatory requirements, reinsurance market and developing countries, the insurance industry and reinsurance business in the context of Ethiopia, and literature review are provided. For both the theoretical and empirical literature, the main sources are academic and scientific research journals, books, and workshop proceedings that have a direct bearing and relevant to the study.

## 2.2 Theoretical Foundation

### 2.2.1 Reinsurance Business: Concepts, rationale and development

The desire of human beings for security against uncertainties is as old as human-kind, and evolving along with stages of human and socio-economic development. Human beings strive for security against uncertainty, as initially witnessed by helping one self, and then by establishing the family, clan, guilds, and then community and society. The notion (idea) of "one for many and many for one" is the basis for the emergence of insurance concept (Swiss Re, 1996). Insurance is a mechanism of the spread of financial loss through the pooling of risks whereby the losses of the few are borne by the many (UNCTAD, 2007).

Insurance, as a business, has emerged following the steady growth in commerce and labor specialization. It was in marine commerce that the idea of both insurance and reinsurance started to emerge. Around 1370, a specialized and well structured way of protecting oneself from risks and uncertainties started through well-framed and regulated company. In the year 1370 in Europe, an insurer covering a maritime shipment from Genoa to Slyus purchased insurance for itself to cover the most dangerous segment of the journey, from Cadiz to Slyus, which is often referred to as “insurance for insurance companies”(Leichtling and Pardes, 2005).

International trade and industries pervasively grew up, both in terms of size, type and complexity. That led to the need for protection against the potential risk of loss and the modern way of risk management system and balancing of portfolios, such as having many similar individual potential risks of losses to be pooled into different class of risks. This implies that, human beings, were introduced not only with mechanisms of securities but also with specialization and segregation of uncertainties and risks by type and cause and the way it could be managed (Outreville,2002).

The first independent professional reinsurance company was formally founded in April 1846 in Germany under the name “Cologne Re”. The benefits became evident following the loss of the Great Fire in Hamburg. Swiss Re and Munich were then founded in 1863 and 1880 respectively (Holland, 2009). According to Kopf (1929), the fire insurance business is chiefly accountable for the development of modern reinsurance business. In the present world, however, insurance and reinsurance is a business practice in any modern society. Airliners and satellites have replaced the risks associated with early sailing vessels, hurricanes, earthquakes and terrorisms, sea pirates are risks beyond the great fire of the past. Reinsurance will be of long and continuing importance not only to the insurance business itself but also to risk management worldwide (Holland, 2009).

Scholars and practitioners in the field of insurance/reinsurance define reinsurance in different ways, though difficult to differentiate one from the other. Park (1799) describes the definition of reinsurance as: “re-insurance, as understood by the law of England, may be said to be a contract, which the first insurer enters into, in order to relieve himself from those risks which he has incautiously undertaken, by throwing them upon other underwriters, who are called re-assurers”. On the other hand, Outreville (2002:59) defined reinsurance as “the transfer of liability from the primary insurer, the company that issued the insurance contract, to another insurer, the reinsurance company. The business placed with a reinsurer is called a cession of an insurance company. An insurance company's policyholders have no right of action against the reinsurer, even though the policy holder is probably the main beneficiary of reinsurance arrangements. According to the author, a reinsurance contract therefore deals only with the original insured event or loss exposure, and the reinsurer is liable only to the ceding insurance company".

Similarly, Wehrhahn (2009:1) defines reinsurance as "a financial transaction by which risk is transferred (ceded) from an insurance company (cedant) to a reinsurance company (reinsurer) in exchange of a payment (reinsurance premium)". According to Wehrhahn, reinsurers are professional entities that exclusively deal with the activity of reinsurance. According to Patrik (2001), the reinsurer reciprocally agrees to indemnify the reinsured for a specified share of specified types of insurance claims paid by the cedant for a single insurance policy or for a specified set of policies. A professional reinsurance company can be a multi-national organization operating through a subsidiary or branch offices in different countries, or licensing reinsurance brokers or on a direct basis with its ceding companies. Reinsurance in turn reduces its underwriting risk by purchasing reinsurance coverage from other reinsurers both domestic and international referred as a retrocession and the assuming reinsurer called retrocessinnaire.

In general, therefore, a reinsurance business involves two main players, namely the primary (direct) insurers that use reinsurance mainly to cede risks and the professional reinsurers that indeed possess geographically and across insurance lines of very heterogeneous portfolios (Plantin,2006). Mayers and Smith (1990) find that the decision of insurers to purchase reinsurance is similar to that of any non financial firm. According to Outreville (2002), insurance companies regardless of size, type, and location use reinsurance as mechanism to share the potential risks assume with others to spread and minimize risks and catastrophe, and to leverage the business.

According to Davies and Podpiera (2003) and UNCTAD (1980 and 2007), there are three major stakeholders in the insurance industry: the insured (which is the policy holder or consumer), the insurer (the service provider both the primary and secondary insurer), and the regulator (the government or an independent authority). Other stakeholders in the industry include brokers, actuaries, and auditors. Life insurance such as, savings and health insurance, presupposes the existence of large capital base, good distribution networks and direct selling and marketing that have high potential to benefit lower-income sections of the population. The non-life or general insurance includes motor insurance, marine, aviation, fire and property, engineering, and bonds and loan guaranteeing contracts. Reinsurance business presupposes a high level of sophistication in terms of professional, technical know-how and capital.

Both primary insurers and reinsurers may involve use of reciprocity in certain markets for their outwards and inward reinsurance portfolio. The involvement of the professional reinsurers on outward is however, rare whilst the scale and methods of the involvement varies considerably as the types of primary companies themselves may operate as professional reinsurers through subsidiary companies (The Chartered Insurance Institute, 2004).

UNCTAD (2007) pronounces that the insurance industry in general (including reinsurance) plays a crucial role as commercial and infrastructural businesses. From the latter perspective it promotes financial and social stability, mobilizes and channels savings, supports trade, commerce and entrepreneurial activity and improves the quality of the lives of individuals and wellbeing of a country.  Insurance in return is highly aligned to the macroeconomic, social, governance, and cultural factors such as inflation, currency, exchange rate, national income, regulations, supervisions strategies, and national objectives of a country (UNCTAD, 2007).

According to UNCTAD (2007), the insurance industry in Africa is a phenomenon of the twentieth century, following independence in the 1960’s. South Africa has a longer insurance history followed by Egypt. Africa presently has some 650 companies, many of them small and medium-sized enterprises. Similarly, the establishment of local reinsurance in Africa is a more recent practice and is related to the development of insurance after independence in the 1970s and 1980s. The aim for establishing local reinsurance companies was to conserve profitable reinsurance premium ceded out of their countries and indirectly control the operations of the primary reinsurers.

Generally, Africa's industry is very much underdeveloped, and should grow faster than in the developed countries. According to UNCTAD (2007), the performance and growth of the industry in general and the reinsurance companies in particular has been challenged by a number of factors. To mention but a few: lack of adequate capitalization, shortage of qualified or professional staff, outdated insurance legislation, non existence of information system and national insurance statistics, and lack of confidence in their security by the majority of insurance that they try to serve. Hence, African countries realize the importance of being part of the global insurance market and almost all African countries committed themselves to bring their respective country's insurance industry to international standard with the assistance of UNCTAD.

### 2.2.2 Nature and Functions of Reinsurance

The internationalization of the insurance service has succeeded following the globalization of production, business and commerce. The insurance business has transnational nature to a large extent not only for higher underwrite growth rate, but also for achieving profit maximization by distributing risks across multi nations (UNCTAD, 1980).

Reinsurance is a secondary market and is the main feature of the non-life insurance in the insurance business industry. Reinsurance has a global feature as manifested by economic interdependency, mobility of capital and transactions across borders, sharing regulations, international competition and management; and like any product, it is subject to cycles and fluctuations driven by internal and external factors (Plantin, 2006). Thus, the primary insurers' assets consist of reinsurer's capital as a capital structure mix, which may also be a cross border source. The professional reinsurers do indeed hold very diversified portfolios: geographically and across insurance lines. In contrast, primary insurers rather use reinsurance mainly to cede risks, and rarely trade risk with each other. Regarding the behavior between the two parties, Jean-Baptiste and Santomero (2000) expound that long- term relationship between cedant and the reinsurer allows stability between them and further for information symmetry and inclusion of new ideas in pricing of the products of the reinsurance services.

According to Hoerger, Solan, & Hassan (1990) and Garven and Lamm-Tennant (2003), reinsurance purchase is a capital structuring decision to substitute capital, so as to keep optimal level of risk to the level of the insurer's capitalization. Reinsurance promotes relationship with clients without increasing insolvency risk, though both insurer and reinsurer may share a larger unexpected loss (Weiss and Chung, 2004 and Meier and Outreville, 2006).

Reinsurance is one of a number of options or tools to reduce the financial cost to insurance companies arising from the potential occurrence of specified insurance claims, thus, further enhancing innovation, competition, and efficiency in the marketplace (Patrik, 2001). According to Patrik (2001), Outreville (2002), the Chartered Insurance Institute (2004), and Wehrhahm (2009) insurance companies use reinsurance for Capacity, Business, Asset Management, Catastrophe Protection, Spread of Risk, and Market Environment reasons, which are all needed at different times in a company's development.

- Capacity: Insurance companies can only accept risks up to a certain limit based on authorized assets (capital and solvency margin). Reinsurance business enables primary insurers to be competitive and retain liquidity for acceptance of additional and large risks. Without it, insurers may use Co-insurance which shares direct responsibility for the risk. Such a system usually is not preferable by the insurers as it shares the responsibility and the problem of management. Co- insurance is often preferred for large industrial risks.
- Business Reasons: Reinsurers help the primary insurers by way of stabilization or smoothing of losses and Portfolio or entire range of risks management.
- Asset Management: Direct insurers can be encouraged to invest in large investments and get the advantage of tax shield.
- Catastrophic Protection: All risks underwritten by the insurers may not be substantial individually, but there are incidences of disasters like storm, and terrorists act, and reinsurance can cushion and protect insurers against a catastrophe.
- Spread of Risk: Insurers can spread their loss which may be concentrated in either one type of business, one class of risk, or geographic area.
- Market environment and new product development: Reinsurance companies provide expertise and experience in pricing and developing of new insurance products that can affect the purchase of reinsurance.

- Financing new businesses: Insurance companies can finance other projects especially when reinsurance companies can advance the future profits in the form of reinsurance commission. This is particullarly appropriate in the case of life insurance.

According to Wang (2003), reinsurance is mainly designed to transfer insurer's risk to reinsurers domestically or internationally, but also provides ancillary functions such as improving insurers' capacity of obtaining business, stabilizing and strengthening insurers' profits and solvency, and obtaining technical service.

Garven and Lamm-Tennant (2003) describe reinsurance as both risk management and financial structure decision. In terms of risk management, reinsurance enables the reinsured leverage with skills of analysis and proper and modern way of management of risk portfolios including assessing of underwriting risks, and handling of claims properly and efficiently. In this regard, Swiss Re (2004) underscore the importance of reinsurance in that, the reinsurer plays pivotal role in assessing potential underwriting risks and in assisting insurers' efforts to handle claims efficiently.

According to Meir and Utreville (2003), reinsurance allows primary insurers to boost the underwriting revenue more than what would otherwise be possible. As a result, primary insurers would be more competitive in the insurance market as the price of reinsurance decreases. Then, reinsurance would be more affordable and primary insurance companies would have more capacity for more underwriting and premium retention. In the context of insurer and reinsurer relationship, Cozzolino and Jacque (2007) develops a model such that both insurance and reinsurance companies must integrate the foreign exchange variables both in terms of currency and the rate into the decision of international reinsurance underwriting risk portfolios. In other words, while underwriting cross border risk portfolios, insurance and reinsurance companies must consider not only across traditional insurance categories but also across national currencies.

According to Leichtling and Pardes (2005), reinsurance broadens the economic capacity of the insurer by both distributing the portfolio of risks (just as the original policy broadens the capacity of the insured for more businesses and projects) and by way of creating the capacity to expand the market share and investment options. On the other hand, Garven and Louberge (1996) emphasize the advantage of reinsurance business to the insured in terms of tax shield, enabling to reallocate their finance optimally.

### 2.2.3 Methods of Reinsurance Business and Retention

Reinsurance is divided into two main types (groups) namely: Facultative and Treaty reinsurance (Outreville, 2002; The Chartered Insurance Institute, 2004; and Wehrhahn, 2009). Facultative reinsurance involves individual single risks (insurance policy) the insurer wishes to insure and where the original insurer and the reinsurer reach a common agreement on the terms and conditions to enter into the contract. Facultative reinsurance relates to large risks in terms of capital and hazardous nature but risks are few and require some degree of adverse selection for the reinsurer. It is useful when the insurer is less experienced, and requires the professional reinsurers' assistance.

Treaty reinsurance, unlike the previous type, provides a solution of an obligatory contract by both parties where the insurer is bound to cede in advance a fixed amount of its business and the reinsurer to accept to the type, terms and conditions of reinsurance. Unlike facultative reinsurance, treaty reinsurance establishes a more stable contractual relationship between the two parties. Most insurers prefer treaty reinsurance because it is less expensive and easier to manage and administer, while facultative is less practical when dealing with a single business class or line, although the choice generally depends on the distribution of risks between the parties (Outreville, 2002).

Each of the types is further divided into two forms of insurance contract, namely Proportional (pro-rata) and non proportional (excess), each subdivided into sub-forms (in total six) of reinsurance as shown on Figure 2. 1

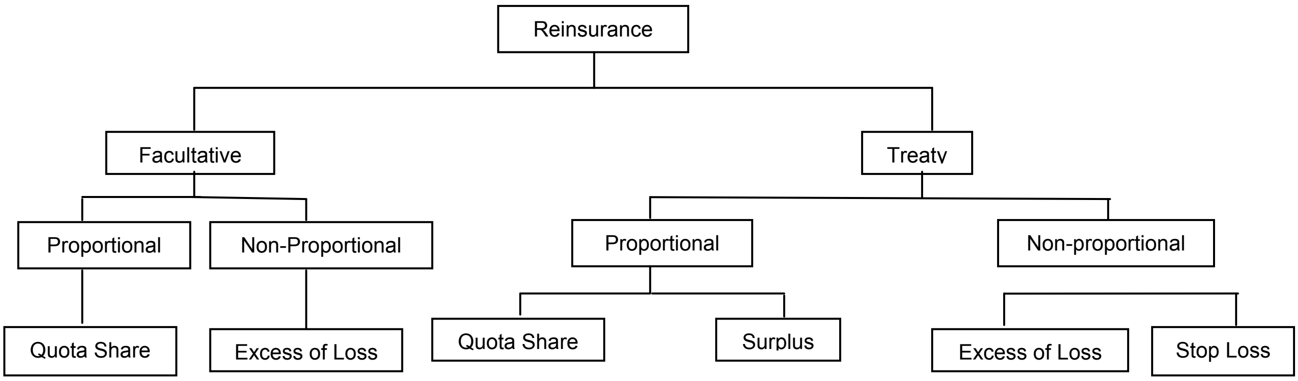


**Figure 2. 1 Methods of Reinsurance**

Source: adapted from Introduction to Reinsurance. (The Chartered Insurance Institute, 2004, 2/2)

The forms of reinsurance have been further described by Outreville (2002) and The Chartered Insurance Institute (2004) under the two major reinsurance categories as follows.

**Proportional Reinsurance:**

- In a quota share of the proportional facultative, the insurer cedes every potential exposure underwriting (liability of a risk) to one or more reinsurers, by sharing the premium (ceded less commission); and in the event of a loss recovers the same share of the claim from the reinsurers.
- In quota share of the treaty, all the risks are shared between the ceding and the reinsurer in a fixed percentage, where the insurer would get some percent from the share of the reinsurer, as benefit of ceding commission for the cost of acquiring and managing the underwriting business.
- In Surplus Treaties, the insurer would be interested to cede only those risks over a certain size, or surplus to its retention.

**Non- proportional Reinsurance:**

In non-proportional reinsurance method, the insurer or cedant undertakes payment of all losses up to pre-agreed amount which includes three ceding forms: excess of loss facultative, excess of loss treaty, and stop loss as the loss treaty:

- In Excess of Loss of Facultative method, the reinsured company selects a fixed amount on a particular risk to retain and arranges excess of loss protection contract with reinsurers; for any claim that exceeds that fixed retention or amount the reinsurer reimburses.

- In Excess of Loss Treaty, unlike the proportional reinsurance method, no insurance amount is ceded, and the reinsurer is not directly concerned about the original rates. Reinsurer has the right to share the part of original premium and no commission is paid to the reinsured company. Reinsurer pays the ceding only when the original loss exceeds some agreed limit. Excess of Loss Treaty, in turn, is divided into two: Risk Excess and Catastrophe Excess Loss.
- In Stop Loss Treaties, the reinsurer aggregates losses arising in respect of a specific class or classes of businesses rather than individual losses, and the protection applies after the benefit of all other prior reinsurance. The contract limits are expressed in percentage amounts of the ceding company gross net retained premium income (GNRPI).

Fixing the limit of the liability between the insurer and the reinsurer is one of the most crucial aspects of the development of any underwriting portfolio. The insurer's limit of retained liability is known as the retention or net premium, usually expressed as a percentage share of a monetary amount of the underwriting premium, whereas the reinsurers' liability is referred as cession (cession rate), expressed as a percentage of the underwriting premium (The Chartered Insurance Institute, 2004). Retentions are usually expressed in terms of each class of insurance products and sometimes further divisions are made such as: marine, aviation, engineering, commercial lines and non commercial lines (personal lines). Commercial lines of insurance usually have lower retention rate than personal lines (Holzheu and Lechner, 2005). According to the Chartered Insurance Institute (2004), a higher cession rate indicates that much of the gross written premiums are ceded to the reinsurer, meaning a significant portion of the risk is transferred to the reinsurer. This in return, implies that, the higher the premium ceded, the higher is the risk transferred, and the higher is the ceded to be claimed.

According to Outreville (2002), the challenge for an insurer is to obtain an optimal level which can maximize profit on the one hand and to protect the insured from severe losses that may lead to bankruptcy on the other. Hence, the initial step should be arranging the reinsurance program where they can choose the optimal point for retention and cession amount (rate). Otherwise, use of capital and retention is ineffective if retention is too low and on the other hand the insurer may run a risk of wide swings (or tenuous situation) and financial ruin in extreme cases if retention is too high. Some of the factors that influence the decision for retention include (Outreville, 2002):

- Solvency(assets structure including insurer's own resources: paid up capital and surplus),
- Heterogeneity of portfolio, in terms of risks spread(geographic location )and in terms of type and class of business,
- Premium income, cost and profitability,
- Size and frequency of losses,
- Reinsurance type(method and forms),
- Probability of ruin, compiling, analyzing, and comparing various reinsurance data,
- Local regulations and foreign exchange controls, and
- Company Corporate strategy regarding investment, and Managements of operations and human resources.

The Chartered Insurance Institute (2004) identifies the following principles and corporate strategies for reinsurance.

- The more hazardous and highly rated the risk, the lower the retention; on the other hand, the lower the risk, the lower the rate and the higher the retention.
- The larger the number of homogeneous risks of a similar value and content in a portfolio, the lower the probability of fluctuation in the expected claims experience.
- The start-up period, a new company may have to risk its entire capital, risking more than they would prefer; whereas there appears to be a tendency for smaller companies to have relatively larger retentions than the large companies.
- Large companies have greater security, and reserve problems are likely to arise from changes in the general profitability of the portfolio rather than from the size of individual losses.
- There is a declining advantage in increasing retentions as a portfolio increase beyond certain level.
- Relatively low retentions, however, suggest under- utilization of shareholders' funds while insurers must also use their funds in the most efficient and effective manner.

- Risk Excess provides protection for the reinsured if a loss occurred on an individual original policy which is greater than a monetary amount the reinsured has determined to retain. Reinsurers will be called upon to respond to their share for every loss in excess of this retention.
- Catastrophe Excess of Loss protection provides cover for occasional, infrequent but major loss events. Reinsurers define a catastrophic loss event as one caused by a specific, unexpected, shocking and external happening that can be located in time and place. It must be quantified by the reinsured in order to assess the natural possible peril exposure and the potential liability.

Each method has its own feature, merit and demerit in terms of technical operation (expertise, knowledge and experience), administration, information management, cost, type of reinsurance, reinsurance cover, accounting procedure, and location. Insurance business operates in the law of large number and its portfolio is structured in a homogeneous context that includes similar and equivalent risks. Such structuring helps insurers to set their strategy of reinsurance methods (Outreville, 2002, The Chartered Insurance Institute, 2004, and Wehrhahn, 2009).

A number of leading economists and insurance practitioners have examined on the behaviors of the different risks and reinsurance methods and as to which methods and parameters can make the two parties benefited from the contract.

- According to Holzheu & Lechner (2005), commercial lines of insurance have usually higher cession rates than motor (personal lines). In general, the non life insurance segment of the insurance industry has higher rates; whereas the Life insurance has much lower cession rates.
- Doherty and Dionne (1993) underscore that insurers can provide coverage for large number of policyholders without having larger amount of costly capital for insurance markets where risks are statistically independent, such as automobile collision insurance. The expected losses from a large pool of risks are highly predictable and loss per claim is moderate.

Golubin, Gardin and Gazov (2009) highlight that the best advantage for the insurer would be retaining all the premium of the underwriting and the application of stop-loss insurance strategy. They stressed that the optimal for risk bearing between the insurer and insured (client) on one hand and between insurer and reinsurer on the other is a combination of the stop – loss and excess of loss. In contrast Zhang, Zhou and Guo (2006) have shown that pure excess – of – loss reinsurance is an optimal combination of reinsurance strategy.

However, insurers are subject to the supervisory and regulatory authority to comply with specified solvency and reserve requirement as a minimum ratio (to retain a certain capital base) regardless of the wishes of capital providers. Such solvency requirements are attached to the premium income, that an increase to the portfolio requires an increase in the asset or reserve (Wang, 2003; and Irukwu, 1987).

### 2.2.4 The Reinsurance Market and Developing Countries

According to Davies and Podpiera (2003) and UNCTAD (1980, 2007), the insurance industry is quite heterogeneous. The insurance industry of developing countries usually includes life insurance, non-life insurance and reinsurance. The global trend of the insurance market is dynamic, evolving rapidly and varying mainly with economic development. In the year 1978, the international insurance market was monopolized by companies based in five countries, namely Germany, United Kingdom, Switzerland, United States of America and France (UNCTAD, 1980). In the year 2004, the three world largest insurance markets measured in terms of insurance densities were: United States of America, Japan, and United Kingdom.

Reinsurance market includes both domestic and cross border reinsurers, with the size and capacity ranging from monopoly of certain small to large international markets. Reinsurance market, as an international business is subject to the influence of the Global business features and economic situations (Hill, 2007 and The Chartered Insurance Institute, 2004):

- Political risks influence reinsurance business most as the business is a long-term and more vulnerable to any change.
- Economic policies influence the business negatively when they are inconsistent, less transparent and unclearly defined.
- Legal and regulatory requirements are not sound in developing countries.
- Geographic location plays a role to access potential insurance markets.
- Developing countries lack skilled manpower and the cultural gap. This poses a challenge to do businesses among companies.

- International economic and financial crises, terrorism and the global warming and emissions on the insurance industry in general and to the reinsurance business are currently the most disappointing features.
- Infrastructure like transport, communication, education and health coverage among others is low and creates a challenge for the business in developing countries.
- Multi-lingualism, culture and social structure of a country affects the costs of doing reinsurance business.

According to UNCTAD (2007), the insurance industry of Africa excluding South Africa has the lowest penetration in the world both for life and non life insurance due to:

- The late introduction of insurance to the continent,
- Monopolistic characteristics (closed markets) in many countries until the latter part of the 1990s,
- The low personal and disposable incomes of the populations,
- Lack of functional financial markets in the majority countries,
- Unhelpful legislations, tax regimes and legal and regulatory requirements do not updated in line with the pattern of economic development,
- Limited awareness of benefits of insurance by the general population, and
- Outdated products and services in a number of countries.

As to USAID (2006), developing countries are characterized by low culture of attitude towards insurance and low infrastructure and environment that frustrate the development and strengthening of awareness. Besides, the mindset of companies of the developed economies is biased towards the African industries. Hence the developed countries are reluctant to operate in the continent because of the fact that companies in the continent are still backward in terms of technology, capability and competency.

The developing countries' economies characterized by low and unstable economic growth and productivity, weak financial capacity, and less capability to attract sufficient foreign direct investment due to economic, political and security risks (WB, 2005). Likewise, the developing countries insurance industry is characterized not only by low capitalization, but also by continued eroded purchasing power due to currency devaluation (WB, 2005). Hence developing countries in general and the African countries in particular are not likely to compete and be accepted by the renowned reinsurance and retrocession markets or business of the developed economies (USAID, 2006).

UNCTAD (2007) remarks that developing countries insurance extensively depends financially and technically on cross border reinsurance, which has implications on national development. In general, WB (2005) and UNCTAD (2007) underscore that local Insurance and international reinsurance companies face challenges in facilitating the development of market in developing countries due to:

- Lack of appropriate infrastructure including institutional and traditional/ cultural,
- Lack of substantial financial strength, technological and industry know-how,
- Lack of good risk management skills and risk analysis techniques to be able to compete on the global market,
- Low supply side capacity given the capital intensive nature of the insurance sector, that involve raising public awareness, training of insurance professionals, identifying sectors of strength or niche areas where strength can be developed,
- Lack of ability setting in place efficient regulatory structures, harmonization of prudential and regulatory structure , and accessions to international standards in general,
- Weak insurance supervisory and regulatory authorities,
- Lack of discussions and agreements on issues such as classification of insurance services and transparency,
- Low income and lack of interest by the different sectors or structures of the economy, and
- Lack of clear strategies with respect to business, financial service, and insurance by the developing counties.

As a result, developing countries' markets in general and the insurance industries' market in particular depend extensively technically and financially on international or cross border services due to, among others, inadequate market structure, under-capitalization and insufficient know-how (UNCTAD, 1980 and 2007). According to Wang (2003) and UNCTAD (2007), many developing countries are entirely dependent on cross border reinsurers. Hence, the developing countries often find themselves in the position of being pure buyers of reinsurance, which accounts for low contribution to the national economy.

As described by UNCTAD (1980), developing countries' dependency on foreign reinsurance and low levels of retention varies from one country to the other depending on structure of the insurance market, degree of development and the type and size of risks covered:

**Structure of the insurance market:**

- Insurance market of developing countries is classified into three categories: markets served exclusively by foreign insurers, markets served by both foreign and domestic insurers and markets served exclusively by domestic insurers.
- In the case of markets served exclusively by domestic insurers, large reliance on foreign reinsurance or outward reinsurance is inherent, partly determined by the need for foreign currency.

**Degree of the market development:**

- Most developing countries have unbalanced risk portfolios, premium not high enough to meet risk liabilities, undercapitalization, low market development resulting from low level of macro environment (including inflation and governance) and culture.
- The industry is not sufficiently profitable to attract additional capital.
- The industry lacks adequate statistical data regarding risks and experience of insurance management and technical capacity. It is even difficult to obtain balance-of-payments statistics for reinsurance flows.
- The industry seeks relations with cross border reinsurers with the aim of obtaining guidance and training for their staff.
- An increasing rivalry (stiff competition) in the industry for reinsurance business and in return for high commission rates, which often leads to the tendency for low level of retention.
- Intention of developing country primary reinsurers to use insurance earnings to finance other sectors of business.
- Developing countries are characterized by unmatched demand and supply of the reinsurance service.

**Type and size of risks covered:**

- Risks covered in the markets of developing countries are significantly different in nature, size and loss record that have a determining impact on the degree of dependency.
- Compared with the developed market, the risk situation in developing countries is characterized by relatively modest values at risk, a slight degree of sophistication in terms of modern industrial set up, and a low level of claim awareness.
- The need for extensive reinsurance by developing countries is becoming apparent due to development of infrastructure, use of modern technology, development of industry, improvement in communication, and urbanization and yet the local market capacity can absorb only a very small portion of these opportunities.

According to Irukwu (1987) and Zafu (2006), in the early eighties, most developing countries in general and African reinsurances in particular were considered as inconvenient or unsecured in international business to meet external claims, which require the immediate availability of hard currency. These situations have resulted in net outflow of premiums, as the industry basically faces problems in sourcing the required capacity for large and complex risks in terms of leveraging and technical expertise. This in turn influences domestic reinsurance companies to be more expensive and is a burden on the primary insurers because of the costs imposed on them and as most claims to the insurers do have foreign components. In this regard, the African continent is still net purchaser of reinsurance in the world market and even the professional reinsurance in the continent are themselves dependent on the cross border retrocession markets (Appannah, 2009). All these impact the insurance industry to be impotent to uphold the economy of a country and sustain developments (Irukwu, 1987).

UNCTAD (2007) underscores that adequate and effective reinsurance enables insurance companies to share risks with others, and to maintain stable underwriting results by spreading risks. A reinsurer’s strong capital can assist the business development of primary insurers and high quality reinsurers can also provide direct insurers with essential technical knowledge to insurers. In some cases, however, insurance companies use reinsurance contracts only as a means of cash transfer abroad (UNCTAD, 2007). Practices and literature also show that strong domestic reinsurance companies of developing countries:

- Can retain some reinsurance market of the local markets,
- Play a crucial role in strengthening the technical capability of the primary insurers, and even can attract foreign market and generate hard currency into the country.

This helps minimize the outflow that may result from being completely dependent on cross border reinsurers. According to Zafu (2006), reinsurance companies can create foreign currency earnings through dividends and earnings by making cross boarder investment using their resources of skills, capabilities and competencies in emerging market opportunities. A competitive environment and a business of international nature demands a complex organizational architecture including organizational structure, technology, a modern system and skillful human resources in terms of leadership and managerial skills (Hill, 2007).

According to UNCTAD (1980), UN considers the following objectives and strategy in relation to developing countries insurance and reinsurance:

- UN aims to establish sound insurance in developing countries and where necessary the creation of strong and efficient domestic insurance and reinsurance institutions. This objective is considered in view of the rapidly growing economy and need for insurance and the high outflow of foreign exchange.
- UN recommends adequate insurance legislation and supervision of insurance to support the national insurance markets and establishment of sound reinsurance where necessary at regional, sub regional and national levels.
- UN recommends professional insurance training for efficient and sound national insurance and reinsurance institutions.

UNCTAD (2007) identifies the following as factors that can promote the realization of insurance service (export opportunities) by developing countries:

- Outsourcing and off-shoring insurance queries, marketing and claim settlements, such as actuarial and risk assessment service. To capture these, developing countries need to build language skills, understand the culture of the target market, comply with standards, and develop the necessary infrastructure.

- Strive for insurance services abroad particularly in neighboring countries,
- Distribution of insurance services and insurance intermediation for successful insurance penetration by providing local knowledge of domestic markets to foreign suppliers and international knowledge of foreign markets to domestic suppliers,
- Acquiring local knowledge via partnerships with local firms in developing countries that can also offer distribution channels, effective marketing strategies, and niche areas of operation,
- Building up niche areas of service exports, such as insurance services aligned to health.
- Developing insurance management software services for domestic and global use such as website for insurance development marketing promotion and software for insurance activities comprising: claim settlements, actuarial services and risk assessment.

### 2.2.5 Insurance industry and Economic Growth

According to Outreville (1990:488), “the importance of the relationship between financial development and economic growth has been well recognized and emphasized in the field of economic literature”. UNCTAD (2007) underlines the insurance industry as one of the pillars of the finance sector that plays a key and dual role (of infrastructural service and commercial service) which are both crucial to the economic development of a country:

- From infrastructural perspective, a well-functioning insurance enables efficient allocation of capital, mobilize and channel savings; support trade, commerce and entrepreneurship and improve the quality of lives of individuals in a given country.
- From a commercial service perspective, insurance companies promote the domestic financial sector, become significant players in the international capital market, and give financial confidence for investments.

Some of the contributions of the insurance industry to economic development as (Davies and Podpiera, 2003) state are:

- Insurance promotes financial stability through transfer and pool of risks, thereby encouraging individuals and firms to specialize, create wealth, and undertake beneficial projects they would not otherwise consider.
- Insurance mobilizes savings and channels them to the capital markets, and developing countries with higher savings rates tend to show faster growth and investment.
- Strong insurance can relieve pressure on government budget. It can play an important role in personal retirement planning and health insurance programs, and to that extent can reduce demands on government social security and health programs.
- Insurance supports trade, commerce and entrepreneurial activity to have heavy influence on all economic and commercial activities.
- Insurance may lower the total risk faced by the economy through risk diversification across border as well as to promote risk mitigation activities.
- Insurance improves individuals' quality of life and increase social stability through, for example, individual health, life insurance, pension funds and worker's compensation.

Insurance has grown in quantitative importance as part of the general development of financial institutions. In fact, recently, the economic importance of the insurance industry has been increasing in most developed and some developing ones (UNCTAD, 2007). The study entitled: "The role of insurance in economic development and the link between market trends and the case for liberalization", conducted by UNCTAD (2007) underscore that insurance markets grow faster than national income and for emerging market economies insurance has been growing a multiple of three or four times than the economy as a whole. For mature insurance markets, however, according to UNCTAD (2007), the multiple is lower but, even so growth has been faster than the expansion in the national income of the respective countries. As a result, many developing countries governments have been committed to incorporating and strengthening insurance institutions not only for insurance services but also to achieve social and macroeconomic objectives such as increased employment and foreign exchange reserves (Outreville, 1996). Today, most developing countries have established insurance companies to cover local insurance markets (UNCTAD, 1984, 1988). The importance of insurance to the developing countries was emphasized by the United Nations Conference on Trade and

Development (UNCTAD) in its first session in 1964 and formally acknowledged that "a sound national insurance market is an essential characteristics of economic growth" (UNCTAD, 1964:55). For developing countries, however, insurance in terms of product type and quality of service and the respective premium and net insurance earned as measured by per capita, is very low (UNCTAD,1980).

UNCTAD (2007) underscore that developing countries' dependency on foreign re-insurance is extensively high, which has implications for the contribution of the insurance industry to national development, in particular with respect to savings promotion and mobilization. According to the study by UNCTCAD (1980), the non-life reinsurance premiums have increased faster than the insurance premiums. Life insurance normally does not entail large reinsurance premiums and has not reached the desirable proportion in many developing countries.

According to UNCTAD (2007), insurance performance or the level of maturity in an economy is measured via three broad yardsticks:

- "Insurance density" (total premium income per person in a country's population),
- "insurance premium" index (percentage or share of the country of a certain insurance market (underwriting Premium), and
- "Insurance Penetration" correlative index reflecting the relationship between the insurance industry and the economy of a country (underwriting gross premium (GP) to GDP) the global premium.

However, as emphasized by Donald and Behan (2004), cross border differences could make difficult it to evaluate the financial situation of a foreign reinsurance and grade because it is based on standards and measurements that have been set by another country. Besides, the lack of transparency may also be insurmountable in understanding the local condition.

### 2.2.6 Reinsurance Business Environment and Regulatory Requirements

Irukwu (1987) underscores that the concept of government control over insurance operations and transactions has been accepted by all countries. Countries issue sets of statutory rules and regulations to control the business activities of insurers. In general, the role of the regulator in the insurance industry is to ensure the viability, integrity and stability of the financial system, as well as to ensure that public confidence in the institutional financial structure of the economy as a whole is maintained. The rationale for regulation and supervision of the insurance industry is basically to ensure the growth and stability of the sector and to protect the interests of policyholders (Zeleke, 2007). This author underscores that governments of countries across the globe intervene to regulate and supervise the insurance industry to protect the interests of policy holders and to ensure a stable financial sector. According to him, supervision of insurance company refers to the continuous monitoring of insurance companies to ensure that they are operating in accordance with the insurance proclamation and regulations. He also highlights that stability and growth of the insurance sector partly contributes to the stability and growth of the overall financial sector and the economy of any nation. According to UNCTAD (2007), financial services are probably the most heavily regulated sectors in most economies. UNCTAD (2007) also stress that prudential regulation and supervision is an absolute necessity in a normal domestic life, let alone cross borer (international) trade, for the protection of the public and to maintain the integrity and confidence of the finance service in all countries.

UNCTAD (2007) underline that lack of clear and comprehensive guidance has lagged behind the reform to foster emerging market economies and aggravated the problem of the insurance industry. Establishing principles and guidance helps emerging market economies to promote the market and have impact. A legal environment and high quality insurance regulations, assure market participants to come up with sound practices being applied, increases market transparency and confidence. In developing the guidance and standards to the insurance industry of emerging market economies, the supervisory body must consider, among others:

- The amount of credit allowed to reducing liabilities for amounts recoverable under reinsurance arrangements.
- Establishing data that help evaluate sufficiency of technical provisions that are crucial for maintaining the solvency of insurance companies and establishing stability of insurance markets.
- Means and mechanisms where reinsurance transactions can be monitored, as in some cases, insurance companies use reinsurance contracts as a means of cash transfer abroad.

- The methods that enable to review reinsurance arrangements to assess the degree of reliance placed on these arrangements and its appropriateness,
- The method for the collection and monitoring of information relating to reinsurance companies.

According to Wang (2003), the development of appropriate regulatory frameworks regarding reinsurance business is becoming crucial for the stability of both the insurance and reinsurance market. The author also stressed that the reinsurers and reinsurance arrangements should be appropriately regulated to protect the solvency of the primary insurers. In line with this, Wang (2003) underlined that for emerging markets, establishing a comprehensive and viable regulatory system is becoming essential to provide safe and sound flooring to the increasing competitive environment.

Otherwise, difficulties (insolvency) in the reinsurance market is a threat for both the insurance industry and the insured parties stability (Wang, 2003).There are similarities on the general framework and basic provisions of the insurance control rules and regulations. Some of the provisions that are related to reinsurance business include:

- The requirements for reinsurance transactions or reinsurance arrangements,
- Issues of directions regarding reinsurance treaties, and volume and limit of ceded for approval and selection of reinsurance mate, and
- Establishment of reinsurance Company and citizenship of insurance managers.

According to UNCTAD (2007), the regulatory infrastructure of developing countries is often inadequate leading to a gap between insurance regulatory frameworks in developing and developed countries, though there are also experiences of difficulties and failures in the developed countries:

- The regulations and supervisions of the insurance industry are far from being consistent even among developed countries;
- There are differences with regard to capital adequacy and reinsurance supervision, which create the danger of leaving regulators and supervisors ill-equipped to monitor the financial strength and risk profiles of insurers and reinsurers;

- Developing countries face additional challenges of having to deal with quickly evolving domestic insurance markets that are affected by global trends in the industry.

Hence, Insurance regulations may be looked from the perspectives of market-impacting, market conduct, prudence, and transparency (information).

A number of developing countries, however, do have insurance regulations that include provisions of insurance and reinsurance and some countries do have a separate reinsurance Act. (Irukwu, 1987) and UNCTAD (1980) disclose that some of the provisions in the insurance regulations of some developing countries include:

- Some developing countries prohibit or limit seeking of full cross border reinsurance: In Mexico for example, direct insurance companies are required to reinsure at least 50% of the surplus in the local reinsurer.
- Some developing countries even prohibit primary writing companies from reinsuring with cross border reinsurers, requiring them to place the excess of their retention or to cede a stipulated portion of each risk, to a domestic central reinsurance company. Examples include: India, Iraq, Kenya, Nigeria, Pakistan, Turkey, and many others.
- In a number of developing countries, reinsurance treaties have to be submitted to the supervisory authorities for approval before they are concluded. This allows monetary authorities to judge whether reinsurance proposal is in line with the economic and financial interests of the country, though it has proved always helpful.
- Still some countries even resort to discriminatory taxation to discourage reinsurance abroad and place restriction on the remittance of funds between the ceding company and the reinsurer.
- The reinsurance requirements coupled with a desire to save foreign exchange, force many of developing countries to set up central reinsurance companies, endowed with compulsory or agreed cessions from all primary underwriting companies operating in the market. However, in some countries the insurance market is small and less able to meet the needs of the national economy to safeguard from potential risks.

Reinsurers, as international businesses, generally operate worldwide in different countries that have different legal and regulatory frameworks, with the license obtained in their respective country of domicile. In most countries, licensing of reinsurers is subject to comply with the legal framework of the direct writers' terms and conditions (Leichtling, *et al.*, 2005). In general Wang (2003) and Irukwu (1987) underscore the primary purposes for the reinsurance rules and regulations and the motive of governments' to control the business as follows:

- To ensure protection of the interests of the insured, claimants, ceding insurers and the public and protect against predators and unethical practitioners,
- To ensure the maintenance of efficient insurance service and appropriate capital structure and to develop domestic capacity in a country,
- To maintain financial solvency of both primary insurers and reinsurers,
- To protect the local insurance and reinsurance market environment,
- To ensure that the insurance industry contributes to the economic development and well-being of a nation at large,
- To ensure reinsurance and reinsurer arrangements of primary insurers are well managed, and
- To regulate the security of reinsurance and insurance businesses.

Unlike the provisions for primary insurance, the regulation provisions for reinsurance transactions are less stringent. This is due to the fact that reinsurance business is international in nature and enjoys recognition by both developed and developing countries and international agencies Wang (2003).

In the context of regulations, according to Wang (2003), developing countries' national interests are concerned with the protection of local insurance and reinsurance from foreign competition and avoid unnecessary loss of foreign exchange through the purchase of reinsurance from cross border. Dependence on cross border reinsurance may affect a country's balance-of-payments and foreign-currency holdings. UNCTAD (2007) underlines that many countries in Africa need to review their legislation to enable the smooth functioning harmoniously with international practice and set up regulatory and supervisory instruments and structures that can effectively regulate the insurance industry. Like with the technological innovations in the fast changing global trends, governments, however; face difficult challenges in relation to the insurance regulatory environment (UNCTAD, 2007). Moreover, according to UNCTAD (2007), developing countries regulatory infrastructure is inadequate to regulate and harmonize the prudential and regulatory structures and for the smooth operations of the industry and contribute to the national economic development.

### 2.2.7 The Insurance Industry and Reinsurance Business in Ethiopia

The Ethiopian insurance industry does not have a long history of development despite the country's long history of civilization. Ethiopia is one of the few countries with long history namely China, Persia, Greece and Egypt, and Roman Empire. Despite this, its level of development has been one of the lowest in the world, deprived of modernity, technology, innovations, and modern way of preserving from potential risks.

Schaefer (1992) indicates that the emergence of modern insurance in Ethiopia is traced back to the establishment of the Bank of Abyssinia in 1905.The Bank had been acting as an agent for a foreign insurance companies to underwrite fire and marine policies. The first domestic private insurance company was established in 1951 with a share capital of Eth $1,000,000. In the 1960s domestic private companies started to increase in number. In 1962, according to the survey of the Central Statistical Agency (CSA), there were 34 companies in Ethiopia, of which two were domestic and the rest foreign represented by 18 agents before the enactment of the first insurance proclamation in 1970. In other words, the origin of Ethiopia's insurance industry is linked to expatriates and foreign insurance companies (Zeleke, 2007).

Following the overthrow of the imperial regime by the Marxist Military government, private insurance companies were nationalized in 1975. A sole public insurance company was established under the name Ethiopian Insurance Corporation (EIC), which had been a monopoly in the insurance industry for 19 years. According to Zeleke (2007:84), the industry in particular and the economy in general are "characterized by government monopoly, lack of dynamism and innovation, volatile premium growth rates and reliance on only two classes of business, namely motor and marine". This had an adverse effect on the growth of the insurance industry. Following the regime change in 1991, there was a shift to a market economy and a new insurance proclamation "Licensing and Supervision of Insurance", No. 86/1994, was issued in 1994 (TGE, 1994).

The law allowed private sector participation in the insurance business. The total number of insurance companies, branches and their capital increased significantly. For example, during the period, 2004 to 2008, the total number of branches of insurance companies went up by 51 percent to reach 172 in 2008. Meanwhile, the total capital of the insurance companies grew by 43 percent reaching Birr 582.1 million in 2008 (NBE, 2008).

However, the Ethiopian insurance industry is among the lowest in the world and African countries in terms of the three measures namely: Insurance premium market share, market penetration rate and insurance density (insurance premium per capita) UNCTAD (2007). Zeleke (2007) based on a survey of nine insurance companies and four insurance brokers, insurance market, identifies some features characterize the Ethiopian insurance industry. These include:

- High market concentration and weak competition with the market controlled by one or two insurance companies.
- The insurance companies rely on undue rate-cutting.
- The companies operate under lax credit sales to attract and retain customers (repercussion of imprudent credit sales as a competition tool is evident).
- There is no product differentiation (insurers offer identical underwriting policies to their customers).
- The industry lacks the capacity to exploit the benefits of ICT (example on-line or modern way of doing business, monitoring, and controlling using on line reports).
- There is no enabling environment, such as code of conduct that can protect the industry from illegal and harmful market practices.

Another study by Zeleke (2002) highlights the adverse effects of imprudent credit sales by insurers and how serious the situation is. According to Zeleke (2007), national competitiveness is maintained and enhanced when there exist vigorous domestic inter-industry and itra-industry competition. In the absence of a vibrant and competitive domestic market, it would be difficult for insurance companies to become competitive in the global market.

With respect to reinsurance business, according to Zeleke (2007), all the Ethiopian insurance companies transact inward (import the service of reinsurance) with cross border reinsurers. Adding, Zelek (2007: 119) describes the situation of reinsurance arrangements with cross border as, “in most cases, the reinsurers have the upper hand in the reinsurance agreements”. There are rarely any outward reinsurance service transaction records. However, that is transacted mainly by the state owned insurance company with insurance and reinsurance companies operating mostly in Africa and to some extent from Middle East and Asia, (Zeleke, 2007 and Workneh and Alamirew, 2006).

In this context, Zafu (2006) argues that reinsurance business classes with the least loss ratios have experienced the highest reinsurance dependency (cession rate). According to Zafu, establishing a national reinsurance in the Ethiopian insurance industry is a meant to create more retention capacity in the market, reduction of dependency on cross border reinsurance, and minimization of foreign exchange by way of reinsurance premiums, and possibly to sell reinsurance for inward business. The same author strongly emphasize the importance of collaboration of cross border reinsurers and national reinsurers where the role of the latter, in addition to minimization of foreign exchange, shall be strengthening reciprocal trade and by strongly negotiating for improved retention, reinsurance terms and conditions for the market. It is also highlighted that having domestic reinsurer early is crucial as full and complete liberalization of all trade including finance and is a primordial for the country to be a member of the WTO. As to Zafu, the Ethiopian insurance industry has shortage of skilled and professional manpower that currently is said to be succumbing to the vagaries of competition, that bringing premium rates down, deteriorating the quality of underwriting and claims and intense competition. For this idea, Alamirew (2006) also points out that the Ethiopian insurance industry has been a potential reinsurance market over the last thirty years not only in terms of profitability but also easy access to remittance. This greatly helps develop interest in the Ethiopian reinsurance market from many parts of the world.

With respect to the legal and regulatory issue, the Ethiopian insurance industry seems to lack consistent and comprehensive legal and regulatory frameworks in its history. According to Zeleke (2007), in Ethiopia, there were no insurance laws and supervisory body put in place until the issuance of the commercial code in 1960 and the first insurance proclamation, Proclamation No.281/1970 followed by regulations, Legal Notice No.393/197. They were issued in 1970 and in 1971, respectively while insurance companies had been in business prior to 1960. The issuance of the proclamation and the regulations led to the formation of the insurance Council and an Office of Insurance Controller which were then responsible for regulating and supervising the insurance business in the country. Some of the insurance matters covered in the insurance regulation were: submission of application for license, issuance and renewal of licenses, qualification requirements of insurance auxiliaries and actuaries, submission of annual financial statements to the controller, issuance of shares, and assignment or transfer of shares.

In 1976, the Provisional Military Administration Council (PMAC) issued a new monetary and banking proclamation, Proclamation No. 99/1976 replacing the previous ones. In this proclamation the supervision and regulation of the insurance industry along other financial institutions was given to the National Bank of Ethiopia (NBE), the country's central bank. Following the downfall of the military regime in 1991, the Transitional Government of Ethiopia (TGE) issued Monetary and Banking proclamation, (Proclamation No.83/1994), in 1994, revoking the earlier proclamation. Consequently, the powers and duties of the NBE include:

- License, supervisory and regulate banks, insurance and other financial institutions,
- Promote and encourage the dissemination of banking and insurance services throughout the country,
- Prepare periodic economic studies, together with forecasts of the balance of payments, money supply, prices and other relevant statistical indicators of the Ethiopian economy useful for analysis and formulation and determination by Bank monetary, saving and exchange policies, and
- Make short and long-term refinancing facilities available to banks and other financial institutions.

Following this proclamation, TGE issued Licensing and Supervision of Insurance Business proclamation, Proclamation No. 86/1994. The proclamation, similar to the previous ones (281/1970 and 68/1975), contains provisions pertaining to: conditions to be fulfilled to establish an insurance company, type and issuance of shares, licensing of insurers and cancellation of licenses, statutory deposit and legal reserve requirements, reserve accounts (provisions), actuarial investigation and report, margin of solvency, insurance auxiliaries; restriction on loans and advances, the manner in which reinsurance business may be transacted, and separation of accounts/funds-general and long-term insurance.

With regard to the reinsurance business of the Ethiopian insurance industry, the insurance proclamation, (Proclamation No. 86/1994), states that the supervisory body, NBE, shall issue directives specifying the manner in which insurers can transact reinsurance business. More specifically, under Article 37 of the proclamation it is stipulated that “the manner in which reinsurance business may be transacted shall be determined by directives to be issued by the Bank” (Ethiopia House of Representative, 1994). The current Ethiopian Insurance Industry structure is shown on Figure 2.2.

However, no such directives or detailed guidelines related to “the manner in which reinsurance business may be transacted in Ethiopia”, has been issued. Workneh (2006) claims that, the regulatory requirement for the reinsurance business that may transact between the insurer and reinsurer, which is postponed, should have been included otherwise.

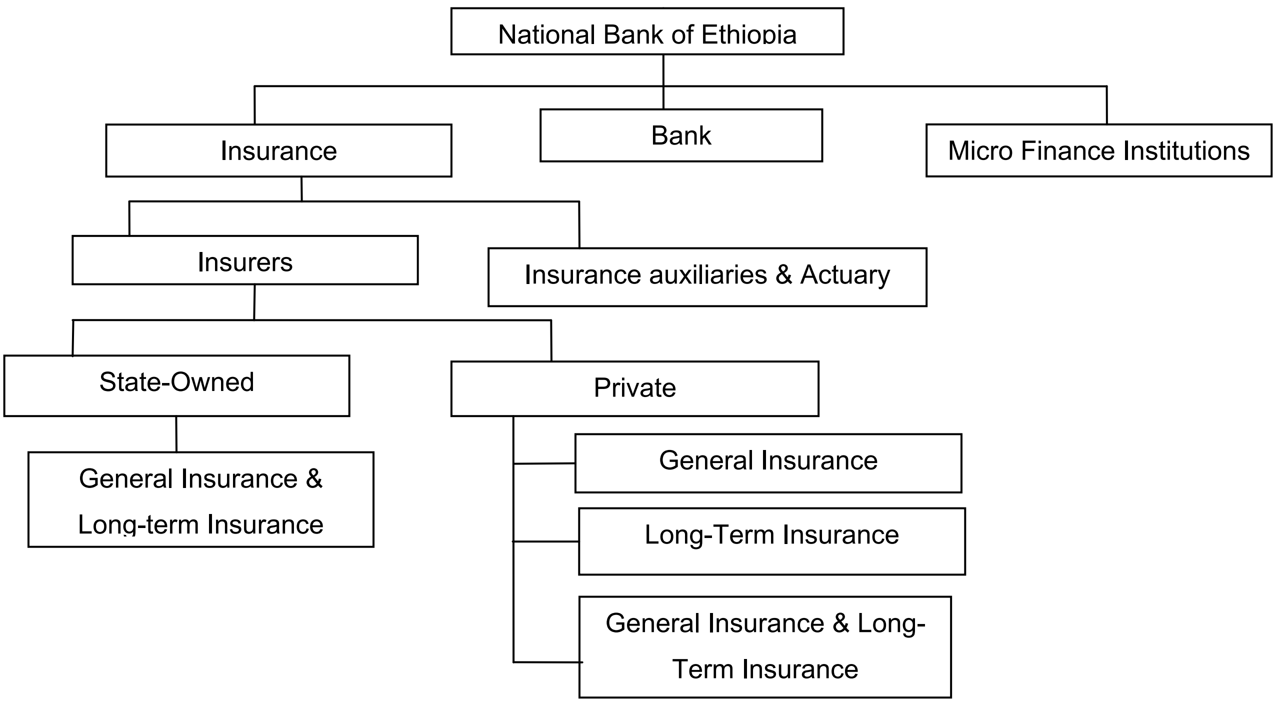


**Figure 2.2 Partial Organizational Structure of NBE and Structure of the Ethiopian Insurance Industry**

Source: Adapted Organizational Structure of NBE (www.nbe.org) and Zeleke (2007)

Zeleke (2007) the “licensing and supervision of Insurance” (proclamation no. 86/1994) postponed the manner in which reinsurance business may transact (Negarit Gazeta No. 46, 1994) and emphasized that this makes the challenge more difficult for the industry’s competitiveness. On the other hand, Zafu (2006) stress that Ethiopia already been in the reinsurance business, buying millions of it every year and the appropriate question should be whether the country is optimizing the retention and the purchase of reinsurance.

## 2.3 Literature Review

Beenstock, Dickinson, & Khajuria (1988) on the relationship between property-liability premiums per capita taking a cross-section of 45 developed and developing countries into account that there is a strong correlation between economic growth (GDP) and financial intermediaries. Many other empirical studies including (UNCTAD, 2007, and Patrick, 1966) have also attested this fact. The study by Beenstock, *et al.* (1988) underlines that, once a country’s domestic economy starts to grow, insurance market becomes qualitatively more important due to the increase of risks and uncertainties in all economic activities of the economy. Patrick (1966) identifies two patterns of relationship between financial demand and economic growth: (i) the “demand-following” approach or relationship, where the demand for financial service can induce growth of financial institutions and their services and (ii) the “supply-leading” approach when the service growth of the finance sector precedes the demand for it, or where economic growth can be induced through the supply of financial service.

Based on the model of Patrick, Outreville (1990) in the study revolving around property-liability insurance demand, tested and explored with a cross-section of 55 developing countries, whether the economic importance of the insurance industry is measured by means of the ratio of gross premiums written (GP) to gross domestic product (GDP). The study suggested the insurance industry is significantly important for the general development of financial institutions. However, to measure the contribution of the industry to the national economy and the relationship of the insurance industry to the financial sector, developing countries in general lack the required quantitative evidence.

Broad money, M2, is instead taken as an adequate measure of the financial sector in developing countries in view of the predominance of the banking sector, as well as owing to the lack of data on other financial assets (Herming and Manson, 1988, and Liu and Woo, 1994). Hence insurance development is measured as the ratio of GP to GDP, whereas financial development is measured by the ratio of M2, broad money (money plus quasi-money) to GDP. These empirical results clearly indicate that:

- Demand for insurance increases significantly when the service of the finance ratio to GDP increases;
- There is a strong positive relationship between the demand for insurance and the level of financial development and developing countries have a supply-leading causality pattern to development;
- More attention is required to supply forces of the insurance market;
- The study noted that the demand for insurance in developing countries may differ fundamentally according to country specific-variables including human capital endowment and agricultural status of a country.

The empirical study by Outreville (1990) finds out that the demand for insurance is insufficient for most developing countries and is limited to low expense coverage such as automobile insurance and high risk coverage such as insurance on aircraft and target risks that leave insurers with unbalanced portfolio of risks and an inadequate structure. Outreville (1990) identifies that the influence of insurance industry in an economy can be viewed from two perspectives: the service of security to the economy (indemnification) and as institutional investor. The research indicated that the average ratio of Gross premium to GDP for the sample was 1.11% compared to 4.5% for the developed countries and that of Ethiopia is computed to be around 1.3%.

A Study by UNCTAD (2007) has also indicated that there is a positive strong correlation between a country's level of economic development and insurance coverage. For example, the share of developed countries in the world insurance market in the year 2004 was more than 88% compared with 11% for emerging markets of which the majority are developing countries. Likewise, insurance penetration (GP to GDP growth rate) for industrialized countries stood at more than 9 per cent, whereas for the emerging (developing) countries it was less than 4 per cent. In the same year, the developing countries, however, stood at higher overall GDP penetrating rate (growth rate) of 7.5% while that of the industrialized countries is 1.7%). This indicates the existence of substantial potential within emerging markets. In terms of insurance density the average premium per capita, for the world, industrialized, emerging markets and Africa respectively was $602, $2,966, $687, and $43.4 in the same year. According to the study, these results indicate that there is a significant difference between the two blocks of the economy and even between the developing countries depending on size, culture, GDP, and insurance regulations. According to the study, the African insurance industry market is found at varying stages of development, and the share of the total premium generated in the continent closely correlates with the level of economic development of the respective countries:

- South Africa has the most developed economy and insurance industry produce around $30 billion out of the $38 billion or 79 percent of the continent's gross premium in the same year.
- Ten African countries (namely: Algeria, Cameroon, Cote d' Ivoire, Egypt, Kenya, Mauritius, Morocco, Namibia, Nigeria, and Tunisia) generate 15 percent of the continent's insurance and reinsurance premium, amounting to $5.7 billon.
- The rest of the continent, comprising 40 countries, has a share of 9 percent or $3.4 billion

According to UNCTAD (2007), despite the fact that in Africa agricultural insurance in rural areas and insurance of the informal sector in urban areas affect more than 50 percent of the total population, only five countries provide such insurance. Agricultural insurance schemes are well developed by Mauritius, South Africa and Zimbabwe for commercial farmers and key economic crops but negligible insurance operations take place in Ethiopia and Nigeria.

UNCTAD (2007) find out that a number of reinsurance companies of the continent performed well in conserving resources, reducing outgoing reinsurance premiums and at difficult times providing reinsurance cover to small respective countries' insurance companies that would have been in difficult position to get adequate and affordable reinsurance cover internationally. In addition to the establishment of local reinsurance companies, a few successful sub-regional, continental and multinational reinsurance companies, mainly pushed for economic integration and cooperation initiatives, were set up in the 1970s and 1980s. These include: Preferential Trade

Area (PTA) in East and Southern (COMESA) PTA Re, the 12 French- speaking countries in West and Central Africa sub region CIRA Re, and at the continental level, 37 African countries Africa Re.

However, the performance and growth of Africa's insurance industry in general and the reinsurance companies in particular has been hampered and challenged by a number of factors including: lack of adequate capitalization, shortage of qualified or professional staff, outdated insurance legislation, non existence of Information System and national insurance statistics, and lack of confidence in their security by the majority of insurance that they try to serve, both within and outside of their companies (UNCTAD, 2007).

Chen, Hamwi & Hudson (2001) state that, primary insurance companies can improve their financial stability by diversifying their portfolio through reinsurers, though excessive use of it could be a sign of financial difficulties for the company. The study also showed that insurers who are incapable of raising more capital in the financial market tend to use more reinsurance to improve their solvency. Based on the result therefore, the authors advised that regulators need to pay extra attention to the insurers that overly use of reinsurance can lead it vulnerable for high risk and ultimately for insolvency.

Empirical study by UNCTAD (2007) has also indicated that the insurance industry is a significant contributor to economic growth and financial system through efficient transfer of risk, resource allocation and mobilizing of funds. The industry is a growing segment within the financial sector in most developed and some emerging market and developing countries. Reinsurance remains a key component of the insurance market and source for risk placement for primary insurers in the non-life sector. According to the same study, reinsurance practices can have a significant effect on the balance sheet and the ability to comply with capital adequacy and structure requirements. Extensive use of reinsurance means effective use of the capital of third party (the reinsurer) by the insurers and retaining that capital by means of reinsurance premiums. But excessive use of reinsurance is subject to credit risk posed by the reinsurers unless managed properly.

Leichtling and Paredes (2005) find out that reinsurance in the Latin American countries is playing an important role, for instance by reducing the exposure of the respective countries insurers to catastrophic losses and providing more economic solvency and capacity, and even through the essential mechanisms to support the economic development necessary for globalization. According to the report, all Latin American countries have codes and regulatory frameworks to insurance and most specifically to reinsurance, though, in most cases the general insurance codes may also apply to reinsurers. In some instances, the general insurance law provisions that are related to the reinsurance are modified in a way that can benefit more the original policyholder.

With regard to the preference of reinsurance by the primary insurers, research results by Powell and Sommer (2005), show that there are cost-based and structural differences in the use of external and cross border reinsurers, besides some factors in common. The global presence of the insurance industry has been increasing like other businesses driven by both the growth in industries, information technology, accelerated deregulations, changes in the preference of the market, and diverse culture. In line with this, the study result by Elango (2003) has shown that the market for insurance service has been growing rapidly as percentage of world GDP and insurance premiums doubled between the years 1984 and 1993.

Research by Holzheu and Lechner (2005), find out that, in the year 2003, the average cession rates were 13% and 1.9 % of the direct premiums for non life and life insurances, respectively. The emerging market share was 13% of the reinsurance business, which constituted 11% of the direct global direct premiums. The study also showed that emerging markets constituted 14% of ceded non- life compared to 10% share of direct insurance business and 5% of worldwide life reinsurance market. The cession rates of life reinsurance are generally very low, due to the nature of the line of business which predominantly aligns to saving products.

With respect to the regional distribution as measured by net premiums written in 2003 by the same study shows that 92% of the global reinsurance market was dominated by eight countries namely: Germany (30%), U.S. (21%), Switzerland (12%), UK (8%), Japan (7%), Bermuda (8%), France (4%), and Ireland (2%). The remaining eight percent goes to the other countries across the globe, and particularly emerging markets often have one or two reinsurers, usually focusing on their home market. Moreover, the report indicates that cession share of non-developed economies is disproportionately low due to smaller capital bases of local primary insurers. Besides, the same research report reveals that developing countries account for a lion's share of the reinsurance demand; and cedes a big percentage of the underwriting income (premium) to the cross border market, which in turn shows more hard currency is traded off (capital flight), and there would be of course high cost of reinsurance as the demand for reinsurance is very high.

Cummins, Dionne, Gagne, & Nouira, (2008) empirically shows that reinsurance increases significantly the reinsured costs of producing insurance services, which contrast to the premises that reinsurance leverages the financial capacity of the primary insurances. A certain results of the research on the contrary proved that reinsurance significantly reduces the volatility of loss ratio.

Empirical research by Mier and Outreville (2006) has shown that the reinsurance prices have strong influence on the primary insurance market. On the other hand, the study by Cummins, *et al.* (2008) underscored that global diversification requires less capital by international reinsurers to mitigate catastrophic risks than the capital needed by local reinsurers.

UNCTAD (2007) disclose that the Ethiopian insurance industry is among the lowest in the world and African countries in terms of the three measures: Insurance premium market share, market penetration rate and insurance density (per capita insurance premium). According to UNCTAD, Ethiopia stood 18$^{th}$ in terms of gross premium and registered growth penetration of 1.05 percent at the end of 2004. Egypt and Nigeria ranked fourth and seventh in terms of gross premium with 6.6 percent and 2.0 percent in terms of penetration rate respectively in the same year. UNCTAD underlined that African countries insurance laws are generally found to be inadequate. Out of some 50 African countries, only less than 10 have recently updated the laws. Hence, UNCTAD recommended that African countries need to review their insurance laws and assess compliance with internationally established standards and core principles.

## 2.4 Summary

Many of both the theoretical foundations and the literature review have exhibit that reinsurance is crucial and fundamental to the insurance industry, not only by distributing of portfolios of risks but also by improving the insurers' financial solvency and by creating managerial and technical capabilities. The authors describe reinsurance as a source of capital structure, and anchors for market share growth, innovation and competitiveness in a marketplace. According to these scholars, reinsurance companies are professional entities, that operate internationally and who indeed hold more diversified risk portfolios by national boundaries and across lines more than any insurers. In this regard, Cummins, et al., (2008) highlights that the amount of capital needed by international reinsurers with global diversification to mitigate catastrophic risks is much lower than the capital required by local reinsurers. Moreover, the theories show that legal and regulatory requirements are essential for efficient performance for both the insurance industry and reinsurance business. Besides, some authors highlight that insurance companies face challenge in determining the retention and the cession to the reinsurer and such issues usually become very difficult to the insurance industry of the developing countries.

On the other hand, other authors claim that reinsurance increases the cost of the insurance service products and ultimately lead to the deterioration of the industry. In this regard Cummins, *et al.* (2008) empirical research result shows that reinsurance increases significantly the reinsured costs of producing insurance services which contrast to the premises that reinsurance leverages the financial capacity of the primary insurances. The same research, however, has ascertained that reinsurance reduces significantly the volatility of loss ratio.

Some other authors, though support the role of reinsurance, including cross border reinsurers, claim that nations in particular developing countries should develop national reinsurance companies to minimize the outflow of hard currency. Besides, many studies underscore the importance of know - how and argued that capital transfer from the reinsurers in developed economies is still crucial as developing countries insurance industries are far behind to anchor the economy of their respective countries. The authors stress that governments must support to strengthen the local insurance industries through policies, strategies, and changes in the culture and attitudes of the citizens through all possible means. In this regard, Swiss Re (2004), for example underlines the importance of reinsurance in that, the reinsurer plays pivotal role in assessing potential underwriting risks and in assisting insurers' efforts to handle claims efficiently.

From the perspectives of reinsurance and economic development, literature suggests a strong positive correlation between economic growth and insurance coverage and financial development and economic growth. It is highlighted in the literature that, for emerging market economies, insurance has been growing a multiple of three or four times than in the economy as a whole. On the other hand, other authors underscore that, developing countries that are excessively dependent on foreign reinsurance face negative consequence in terms of the contribution of the insurance industry to the national development.

As regard to the legal and regulatory issues, many scholars emphasized that prudential regulation and supervision is an absolute necessity in a normal domestic life, let alone cross border (international) trade. According to these scholars, establishing principles and guidance helps emerging market economies to promote the market. Such laws are crucial for the stability of both the insurance and reinsurance market of developing countries by way of avoiding unnecessary loss of foreign exchange through the purchase of reinsurance from cross border countries. For example, Wang (2003), stress that the reinsurers and reinsurance arrangements should be appropriately regulated to protect the solvency of the primary insurers and foreign currency holding reasons.

In the context of the reinsurance business in the Ethiopian insurance industry, Proclamation No.86/1994 postponed the regulatory requirement. There have not been any such directives or guidelines issued by the supervisory yet. In spite of its absence, reinsurance business transactions have been underway in the country for many years, buying millions of it every year.

In light of all these theoretical ad empirical underpinnings, this study attempts to fill the gap through identifying the research problems and analyzing data collected and facts inferred from the Ethiopian context.

# CHAPTER THREE
# PROBLEM STATEMENT AND RESEARCH QUESTIONS

## 3.1 Introduction

The previous chapter presented the theoretical foundation and literature review of the reinsurance business in general and challenges of the insurance industry of developing countries in particular. The first part of the previous chapter focused on the theoretical foundation. The second one dealt with the empirical part of the literature. This chapter focuses on synthesis of the various views discussed in the previous chapter and identifying the research problems. It also provides the research questions for the study based on the research problems, which are also derived from the literature review. Moreover, the chapter outlines the research hypotheses.

## 3.2 Problem Statement

**Research Problem One:**

The importance of strong insurance and reinsurance business for economic growth has been emphasized by various scholars. For example, a study by Wang (2003) shows that many developing countries have been striving to establish their own reinsurance companies to minimize their reliance on foreign reinsurance. UNCTAD (1987, 55), claims that “a sound national insurance and reinsurance market is an essential characteristic of economic growth”. Similarly, UNCTAD (1980) highlights that developing countries are concerned about cost in foreign currency and the negative impact that excessive recourse to reinsurance has on the growth and development of domestic insurance industry due to foreign reinsurance.

However, the Ethiopian insurance industry is still exclusively dependent on cross-border reinsurance, despite the significant growth in the economy and the financial sector. In this regard: Alamerew, Webetu and Zafu (2006), notwithstanding the importance of reinsurance to the economy, strongly claim that due attention is not given to the reinsurance business.

Generally, there are two contrasting views with regard to the impact of cross-border reinsurance business on the insurance industry and economic growth of a country.

- On one side, it is argued that exclusive dependency on cross-border reinsurers imperatively entails two-fold challenges.
    - First, cost of reinsurance can rise due to high demand from the potential reinsured side, and in return may increase the price of underwriting premium.
    - Second, as the Ethiopian currency is continuously depreciating against hard currencies, such situations can bring increases both in the price of insurance and reinsurance services costs. If these phenomena continue, it inevitably discourages investments in the industry and ultimately leaves the economy with unstable and impotent insurance industry.
    - According to UNCTAD (1980) and Alamerew, Zafu, and Woubetu (2006), it is emphasized that the absence of domestic reinsurance and exclusive dependency on cross border reinsurers affects the industry and the economy negatively. Wang (2003) underlines those developing countries that are entirely dependent on cross-border reinsurance, are the most negatively affected ones due to foreign currency holdings.

- On the other hand, Powell and Sommer (2007) underscore the importance of cross border reinsurance in spreading or transferring higher catastrophic risks. Similarly, Wang (2003) underline how the absence of cross border reinsurance can affect the local insurance industry and economic development in terms of know- how transfer and capital in the current situation. Zafu (2006) also underpins that cross border is still crucial in selected areas of risk.

These two contrasting views clearly indicate that the significance of the effect of cross border reinsurance is not conclusive. Therefore, in the context insurance industry, this study aims at empirically analyzing the influence of the cross-border reinsurance business on the insurance industry and the Ethiopian economy.

**Research Problem Two:**

Much of economic literature suggests a strong positive correlation between financial development and economic growth and insurance coverage. However, with regard to the insurance industry and economic growth relationship in general, there are two contrasting views that can be drawn from the preceding literature review: (i) Extensive dependency on foreign reinsurance has a negative impact on the contribution of the industry to national development. (ii) Insurance industry and economic growth do have a strong positive correlation and the former significantly contributes to the latter. In the Ethiopian context, the economy is growing remarkably while the insurance industry is exclusively dependent on cross border reinsurance business. Thus, the study aims at empirically reviewing whether the Ethiopian insurance industry is contributing significantly to the economic development of the country.

**Research Problem Three:**

In the Literature, it is proposed that, for a well performing reinsurance business, one key component is having a legal and regulatory requirement framework in place. According to UNCTAD (2007), financial services are probably the most heavily regulated sectors in most economies. Similarly, Wang (2003) underlines that the development of appropriate regulatory frameworks regarding reinsurance business is becoming crucial for the stability of both the insurance and reinsurance market arena. Wang (2003) stress that reinsurance arrangements should be appropriately regulated to protect the solvency of the primary insurers and to enhance the competitiveness of the local insurance industries in the global market.

Despite the legal and economic significance of such regulations, the Licensing and Supervision of Insurance Proclamation No. 86/1994 has postponed that of reinsurance, as stated, “The manner in which reinsurance business transacted shall be determined by directives to be issued by the Bank”. Conducting a research on the Ethiopian industry, Zeleke (2007) discloses that many in the industry are waiting for reinsurance business regulations. However, no such directives or a detailed guideline related to “the manner in which reinsurance business may be transacted in Ethiopia” has been issued. Whereas, on the other hand, Zafu (2006) underlines that the country is transacting in millions of Dollars in reinsurance business every year for many years without problems. These different views indicate not only the Ethiopian insurance has been in the reinsurance business for long without the regulations, but also there has been gap of perception about it. The absence of the reinsurance business regulations combined with vague awareness about these regulations is critical for the safety and potential contributions of the Ethiopian insurance industry. This must, thus, get due attention. Therefore, one of the problems of the research is "Why has that the Ethiopian insurance industry taken long time to put the reinsurance business regulations in place despite the significance of the regulations". This may be due to awareness gap by the corporate body (top management) about the reinsurance business regulations and the impact thereof on the industry and on the country's economy. Therefore, the study aims at empirically investigating the prevalence of perception gap and its extent in the industry by analyzing the conceptual difference between the top management and the middle management.

The basic assumption is that, the nature of responsibilities at the two ranks (middle and top) of management is different. Whereas top managers devise strategies, policies, regulations and direct the overall operations of the insurance businesses, middle managers are highly involved in day-to-day operations. Hence, top managers (being architect of their company policy) have better understanding of the legal environment and its implications than middle management. Generally, the study revolves around the following research objectives:

- To analyze the significance of the influence of the cross-border reinsurance on the insurance industry and on the economy.
- To Review whether the insurance industry is performing in line with the economic growth of the country.
- To assess whether there is perception difference or not in the insurance industry management regarding legal and regulatory requirements in relation to the reinsurance business.

## 3.3 Research Questions

Based on the objectives of the study and the research problems provided in the previous sections, the following research questions and hypotheses/propositions are set out.

### 3.3.1 Research Problem One:

The study aims at analyzing the significance of the influence of the cross-border reinsurance on the insurance industry and on the economy.

### 3.3.1 Research Question One:

Is the cross-border reinsurance business strengthening the local insurance industry or otherwise?

The study attempts to verify the following hypotheses.

**Hypotheses:**

- The cross-border reinsurance has a negative influence on the local insurance industry of Ethiopia.
- The cross-border reinsurance has a negative influence on the economy of Ethiopia.

### 3.3.2 Research Problem Two

The study aims at examining whether the Ethiopian insurance industry is growing or contributing to the economic development of the country.

### 3.3.2 Research Question Two

Is the Ethiopian insurance industry contributing and growing in line with the economic development of the country or otherwise?

The study attempts to verify the following hypotheses in due course of addressing the question stated above.

**Hypotheses**:

- There is a positive correlation between the growth of the insurance industry (gross underwriting premium) and the economy.
- There is a positive correlation between the growth of the insurance industry and the financial sector (M2) of the country.
- There is a positive correlation between the financial sector (M2) and the economy

### 3.3.3 Research Problem Three:

The study assesses whether there is perception difference or not in the Ethiopian insurance industry in relation to the regulations of the reinsurance business.

### 3.3.3 Research questions three:

"Why has that the Ethiopian insurance industry taken long to put the reinsurance business regulations in place despite all the significance of such regulations"?

Depending on the results of the analysis to the hypotheses presented below two alternative implications can be drawn.

If there is a difference, it implies that the top management has the understanding about reinsurance regulations and yet (i) the reinsurance industry is operating on an ad hoc basis without a common understanding and consensus in response to arising circumstances. No common forums exist where all stakeholders can discuss common issues and petition agendas to the regulation issuing body. This is quite a basic problem which requires special attention, including government intervention with regard to policies and strategic directions. (ii) Top management does not have initiation and lack national vision leaving it up to the government. If there is no difference of perception, it means that: (i) the top management has not thought at all about the need for regulatory framework. The top management or corporate management lacks knowledge about the reinsurance business regulations and the impact thereof. Their management in the reinsurance industry is limited in scope and their decision is driven by precedents and past experience. This means the top management has knowledge gap and the same is true with operational managers (middle management). This is a sign of inefficiency. As a result, decision making (top management) needs consultation and can take quite a while.

In addressing the questions, the study tries to verify the following hypotheses.

**Hypotheses:**

- There is perception difference in the Ethiopian insurance industry between management groups regarding whether there are regulations on reinsurance business arrangements.
- There is perception difference in the Ethiopian insurance industry between management groups whether the Ethiopian insurance proclamation provides reinsurance business provisions.

- There is perception difference in the Ethiopian insurance industry between management groups whether the absence of the legal and regulatory requirements is a barrier to the reinsurance business.

## 3.4 Summary

The chapter has briefly discussed the problem statement and research questions of the study in line with the reinsurance business in Ethiopia. The discussion wrapped up by outlining statements of the problems of the study which focused on the influence of cross border reinsurance business on the Ethiopian insurance industry and the economy; the insurance industry and economic growth of the country; and the reinsurance business regulatory requirements in the Ethiopian insurance industry. Three research questions along with pertinent research hypotheses are stated. The next chapter presents the research design and analyses approaches of the study.

# CHAPTER FOUR
# RESEARCH DESIGN AND ANALYSIS

## 4.1 Introduction

In the previous chapter, the research problems were discussed. Research questions and a set of research hypotheses were outlined as well. In short, three main research questions and eight hypotheses were formulated. This chapter deals with discussions of the major research design and methods employed to conduct the research. Specifically, the chapter covers: research approach, sampling techniques, measuring instrument(s), and data analysis techniques. Moreover, the chapter talks about validity of the research method, and ethical considerations.

## 4.2 Research Approach

To address the research questions, both quantitative and qualitative research approaches are used. According to Leedy and Ormrod (2005) combining these two approaches would have the following advantages:

- First, qualitative research helps to develop an instrument to be used in quantifying results.
- Second, using both approaches increases the validity and reliability of the research findings as it is possible to confirm the results by means of triangulation of a means consists of different data sources.
- Third, using both approaches helps capture the various dimensions of a phenomenon

The quantitative research approach deals with numerical data and statistical analyses to answer questions about relationships among measured variables. The study uses both primary and secondary data where the former is collected from the insurance companies directly whereas the latter is obtained from the supervising authority.

The motive to use quantitative survey research data is, to acquire primary data (information) about the industry directly from the targeted population by way of sampling. According to Leedy and Ormrod (2005: 89), primary data are “often the most valid, the most illuminating, and the most truth-manifesting”. The data were collected from a sample of two management groups of the insurance industry, namely: top management and middle management through a pre-designed questionnaire. The secondary data (panel data) is collected from NBE and encompasses information on nine companies for a period of ten years.

Both the primary and the secondary data are analyzed using descriptive and inferential statistics. To conduct this analysis, SPSS software tool is used. Regarding the inferential analysis, appropriate measurement that shows correlation between variables and hypothesis testing techniques was applied. The choice of these analytic techniques and the tools that are used to analyze the relationship between variables mainly depends on the level of measurement of the variable and the type of hypothesis to be tested.

On the other hand, qualitative research is typically used to answer questions of complex phenomena on which data can be collected using instruments like structured and unstructured interviews, group discussions, observation and reflection field notes, various texts like reflexive Journals, pictures, and analysis of documents and the literature. Qualitative research design includes Case study, Ethnography, Phenomenological study, Grounded theory study, and Content Analysis (Leedy and Ormrod, 2005).The qualitative method has twofold advantages:

- First, it focuses on phenomena that occur in natural settings in that it involves studying those phenomena in the context of complex socio-economic settings.
- Second, qualitative research is often used to generate possible leads and ideas which can be used to formulate a realistic and testable hypothesis, to gain deep insights about the phenomenon. Any hypothesis can then be comprehensively tested and mathematically analyzed with standard quantitative research methods.

This study used a phenomenological qualitative approach to capture the degree of perceptions and understandings among the management groups of the industry, regarding its legal and regulatory issues of the reinsurance business. The researcher collected the data using survey questionnaires from a sample drawn from the two management groups of the insurance industry (Top and middle management) including the supervising authority. The questionnaires were developed after preliminary discussions with some experienced professionals in the industry and pre tests were made for further refinement.

In sum, the study used both quantitative and qualitative research approaches (Mixed methodology) to address the research questions and research hypotheses. The research also utilized various descriptive tools such as frequency tables, graphs, and statistical tests for different hypothesis.

## 4.3 Sampling

Two different sampling designs are often used for different situations. The sampling techniques can broadly be divided as probability sampling and non-probability sampling. Probability sampling includes: Simple Random Sampling, Stratified Random Sampling, Proportional Random Sampling, Cluster Sampling, and Systematic Sampling. Non-Probability Sampling includes: Convenience or Accidental Sampling, Quota Sampling, and Purposive Sampling (Leedy and Ormrod, 2005).

In this study, stratified random sampling technique is employed where the various insurance companies are used as strata. During the preliminary survey study, the average number of top and middle managers are estimated to be six on the average for each of the companies under study. Accordingly, 50% of the management staff is included in the sample. As a result, three top and three middle level managers from each of the 12 companies were randomly selected for interview. This makes the sample to be representative of the management groups. On top of this, the sample included four staff from the supervising authority to capture any possible perception variation between insurance industries and their supervising authorities. Thus, the sample size is 76, which is approximately 50% of the population size.

The top management is defined to include: general manager, deputy general manager, department heads, director of insurance supervision directorate, and principal insurance examiner, whereas, that of middle management comprises division heads, section heads, senior officers, and senior supervisors, and senior insurance examiners.

Selecting respondents from the two hierarchies has mainly taken nature of the business, the exposure of the domains to the business and the degree of exposure to the legal and regulatory issues of the industry into consideration. The reinsurance business in its very nature is professional, skill intensive and managerial rank sensitive. The other rationale for taking the sample was time and cost constraints. The study has tried to include a sample from the insurance brokers. As it was found difficult to identify reasonable domains that at an institution level it was dropped.

Data response rate was also another survey concern. Babbie (2008) underlines that overall response rate is a guide to the responsiveness of a sample of respondents. Similarly Biemer and Lyberg (2003) highlight that response rates are generally considered to be the most widely compared statistic for judging the quality of survey. According to Babbie (2008), published research suggests that 50 percent, 60 percent and 70 percent are considered adequate, good and very good respectively as rough guides. As to Biemer and Lyberg ( 2003), in a purposive sample of 18 well known social science journals, uncovers that, with a few notable exceptions, many of the prominent journals are routinely published ones with no explicit or definitive formula for response rates. Going through these studies, one editor commented that 20% is too low; 80% is a de facto standard. Similarly, another editor did indicate that only in 'rare' instances did a study with a response rate of less than 60% get accepted for publication (Johnson and Owens, 2003).

## 4.4 Measuring Instrument

There are different measurement levels that yield metric (interval or ratio) and non metric (nominal and ordinal) data (Diamantopoulos and Schlegelmilch, 2000). The researcher used different measuring instruments (scales) depending on the values of the unit of measurement and the variables with a view to responding the research questions. For instance:

- The level of measurement (measuring instrument) for the gross premium, net premium, net cession premium, net insurance claims incurred, and net ceded claims are ratio scales.
- The level of measurement for the legal and regulatory relevant to the reinsurance business transactions is nominal.

## 4.5 The Data and Data Analysis

As indicated in the previous sections, primary and secondary data are used in the study. Both quantitative and qualitative data analysis techniques and procedures are applied too. Details of the nature of the data and the data analysis techniques are presented as follows.

### 4.5.1 Primary Data

The primary data has quantitative and qualitative nature. It was obtained from the insurance companies and the supervising authority. Data were collected through a well designed survey questionnaire via interview. The following formal questionnaire designing procedure is implemented in the study:

- First, draft questions were formulated based on theories and in line with the objective of the study.
- Second, based on the questions, a preliminary interview was conducted with professionals and long career holders in the industry.
- Third, the questionnaire was sent to the academic promoter for comments and valuable ideas and comments were obtained.
- Fourth, the questionnaire was pretested via pilot survey accommodating three companies.
- Fifth, the questionnaire was revised based on the inputs obtained from the academic promoter, preliminary interview and other experiences. The questionnaire incorporated these valuable comments obtained from people that have ample experience in conducting research and survey questionnaire.
- Finally, interview with the sample firm staff and supervising authority staff, accompanied with a letter of purpose of the study and guaranteed anonymity, was conducted based on the final questionnaire.

The questionnaire encompasses both quantitative and qualitative variables. All the responses were edited to avoid ambiguities and errors in the data matrix. Then, to transfer the questionnaire into computer readable format or symbols, every variable in the data set was coded. The SPSS statistics package software was thus, used to process the data. The coding and labeling of the variables include:

- Unique name is given to each of the variables in the data set
- Each variable is labeled in understandable manner
- Values that can create ambiguities are labeled
- The types of the variables and level of measurement are well defined
- The missing values are coded and labeled

The data is then analyzed using appropriate statistical and mathematical techniques. Frequency tables, graphs, crosstabs, fisher exact test, Pearson's chi-square test and other nonparametric statics are widely used in the analysis of the primary data. The details of each technique and the reasons to choose them are discussed in the data analysis section (see 4.5.4 below).

On the other hand, the qualitative data collected through interview based on the questionnaire is summarized and analyzed using the conventional qualitative analysis methods. Data analysis for qualitative research is a process that is less discrete than that found in quantitative research, and allows the researcher to bring meaning to large amounts of collected data (Struwig and Stead, 2001).

### 4.5.2 Secondary Data

For the analysis of the correlation between (i) reinsurance business and the insurance industry and the economy and (ii) the insurance industry and the economy, secondary data was obtained from the NBE (supervising authority).

Panel data (a combination of cross sectional and longitudinal data or time series data) was collected from the supervising authority using the following steps:

- First, the data questionnaire sheet was drafted and discussed with the supervising authority staff, so that common understanding is established about the required data.
- Final data questionnaire was developed after consensus was reached on the overall format of the questionnaire.

- Then, the financial data was collected from 12 companies for a period of ten years from 2000 to 2009. However, data for three companies were missing for many of the variables for various years. Thus, the study dropped the three companies from the analysis. On top of that, of the nine insurance companies under study, only one insurance company undertook a life insurance transaction. Hence, the analysis is limited to non-life insurance transactions and to non-life sub-sector of the industry.
- The insurance transaction, among others, includes underwriting (gross) premium, net premium, net ceded premium, net claims incurred, and net ceded claim. The insurance companies transact with policy holders (downstream) on activities of underwriting(gross premium) and claims administration, and transacts with reinsurance companies (upper stream) on activities of cession premiums, ceded claims (reinsurance claims) and cession commissions.
- Subsequently, the data is coded at different levels of numerical measurements. The level of measurement of all the variables is ratio scale. Thus, the study is analyzed using parametric statistics. The SPSS software is used to undertake the various statistical tests and correlation matrices and graphs.
- During cleaning of the secondary data, mathematical errors were ratified and corrected. Missing values are also filled by doing relevant calculations and refining various documents in particular, the following actions were undertaken in the process of cleaning the data.
    - ◊ Three companies that have service years of less than three years in the industry are dropped from the database.
    - ◊ Mathematical editing was considered for the amount ‘net premium’ for the year 2000 for the nine companies, as it was missing. Net premium (retention) is the difference between gross premium and net ceded premium as per the article 18 of the proclamation no. 86/1994.

- The data is analyzed using both descriptive and inferential statistics.
    - ◊ The relationship between net ceded premium and net premium, net ceded claims and net ceded premium, and net

claims incurred and net ceded claim, is described and analyzed using graphs and charts.

◊ As the net premium, net ceded premium, net ceded claim and net claim incurred are ratio variables, correlation matrices in particular the Pearson's product movement correlation and t-test in conjunction with the 5% significance level is used for the inferential statistics analysis.

The other secondary data required for the analysis of the relationship between the insurance industry and the economy; and the relationship between the insurance industry and the financial sector are the gross domestic product (GDP) and broad money (M2). Broad money (M2) represents the money in circulation in the economy including that of the insurance companies. The GDP and M2 data are available only for the period 2000-2009 from NBE. GDP and M2 data can also be accessed from the website of NBE.

### 4.5.3 Document Analysis

In addition to the primary and secondary data described above, additional relevant information (data) are analyzed in the area of the reinsurance legal and regulatory issues. Such information is collected from various published and unpublished papers and different websites (experience of other countries) in relation to the reinsurance business arrangement (transaction) vis-à-vis the legal and regulatory requirements. In other words, the study used the insurance laws of other developing countries as a benchmark for analysis, particularly to analyze the legal and regulatory requirements, in relation to reinsurance business transactions.

### 4.5.4 Data Analysis

The study used various descriptive and inferential statistical tools such as frequency tables, graphs and simple tables to test the various research hypotheses. Moreover, the study used qualitative data analysis procedures for the analysis of qualitative data. The specific analysis techniques used for addressing the various research objectives are described below in tune with research questions and hypothesis.

### A. The Cross Border Reinsurance and Insurance Industry and the Economy

**Research Question ONE:**

Is the cross-border reinsurance business strengthening the local insurance industry or otherwise?

**Research Hypotheses:**

**Hypothesis ONE:** The cross-border reinsurance is negatively correlated with the local insurance industry.

To test this hypothesis, the study uses net ceded premium and net premium as a measure of cross border reinsurance and local insurance industry respectively. To test the null hypothesis, the study selects the 5% level of significance which is a typical value of Type I error. The conventional t-test, more specifically a one-tailed t-test, is selected as an appropriate statistical test since this hypothesis examines the association between two ratio variables and as the alternative hypothesis is directional. Hence, the one- tailed t-test in conjunction with a 5% significance level is used to assess the strength of the association between the net premium and net ceded premium and thereby between cross border reinsurance and local insurance industry. The p-value, instead of critical values is used in the study since the latter is test specific and needs to memorize and cross check the critical values for the various statistical values with statistical tables. The interpretation of critical value provides a bit more information on how far the result lies down in the significant region. Moreover, the test is widely used including by articles in scientific journals to discuss their results (Diamantopoulos and Schlegelmilch, 2000). Since the level of significance (α), is set to be 0.05, and hence if the p-value (or significance value) related to the hypothesis test is greater than 0.05, it implies that the null-hypothesis can't be rejected. However, if the P-value, is less than 0.05, implies that there is a strong evidence to reject the null hypothesis, the alternative hypothesis (H1) is thus supported.

The Pearson product moment correlation is used only to examine linear relationship between the two ratio variables. In other words, if two variables are linked by non-linear relationship, Pearson product moment correlation coefficient can't detect it. To avoid such pitfall, it is always advisable to plot scatter gram and inspect the relationship (Diamantopoulos and Schlegelmilch, 2000). The data used for the analysis are the net premium and the net ceded premium secondary data of the nine insurance companies in the Ethiopian insurance industry. Moreover, prior to inferential analysis, comparison is made between the growth of the underwriting gross premium (GP) and the net ceded premium using descriptive data of the insurance industry.

**Hypotheses TWO:** The cross-border reinsurance has a negative influence on the economy.

To identify the effect of the reinsurance business on the economy, two alternatives analyses are considered: (i) the correlation and mean difference between “net ceded premium” and “net ceded claim “ and (ii) the mean difference between “Net claim incurred” and “net ceded claim”.

A paired sample t- test is used to test these hypotheses because the variables under study are ratio and the interest is the comparison of the relative values of these variables. This test is appropriate when the mean in the two variables are not different. By default, the SPSS software provides paired sample statistics and paired sample correlation. The former test helps judge the mean values of the two variables and thereby to determine the direction of relationship while the latter helps examine whether the two variables are linearly correlated.

This analysis is also complemented with graphical analysis. Moreover, to uncover the influence of the devaluation of the local currency against the hard currencies, specifically with USD, on cross-border reinsurance, a ten year trend analysis table is constructed.

### B. The Insurance Industry and Economic Growth

**Research Question TWO:**

Is the growth of the insurance industry aligned to the economic growth of the country or otherwise?

**Research Hypotheses:**

**Hypotheses THREE:** There is a positive correlation between the growth of the industry (gross underwriting premium) and the economy.

**Hypotheses FOUR:** There is a significant positive correlation between the growth of the insurance industry and the financial sector (M2) of the country.

**Hypotheses FIVE:** There is a positive correlation between the financial sector (M2) and the economy.

To find out whether the Ethiopian insurance industry is contributing to the growth of the Ethiopian economy, the study reviews the correlation between (i) the growth of the insurance industry and the economy, (ii) the growth of the insurance industry and the financial sector, and (iii) the growth of financial sector and the economy. The proxy variables used for the analysis are gross premium (GP), the financial sector (M2) and the Economy (GDP). The study also applies the GP to GDP ratio, which is one of the insurance industry performance measurements to identify the insurance coverage status of the country. The most common measurements are insurance market share, insurance growth rate, insurance penetration (GP to GDP ratio), and the insurance density. In addition to penetration rate, the density measurement is applied by incorporating population size.

For the analyses of the correlation between the insurance industry and the economy and between the insurance industry and the financial sector, the study is unable to formally test the hypotheses: three and four above, to the extent that data for gross premium is available only for ten years from 2000-2009. Hence, the study used only graphs to describe the relationships. For the insurance penetration or growth rate, and the insurance density analyses, tables and simple mathematical analytical tools are used.

The hypothesis “there is a positive correlation between the financial sector (M2) and the economy”, hypothesis five above, can be tested using the formal hypothesis testing procedure because data for M2 and GDP is available from 1976 to 2008. The Pearson product moment correlation coefficient is used to see the direction of the association and the t-test to examine the strength of the association. On top of that, the mean variance is computed to assess the degree of association between the two variables.

### C. Reinsurance Business Regulatory Requirement and the Insurance Industry

**Research question: THREE:**
"Why has that the Ethiopian insurance industry taken long time to put the reinsurance business regulations in place despite the significance of the regulations?"

To assess the prevalence of the perception gap and its extent and capture the prevailing practice of the Ethiopian insurance industry in the reinsurance business, a sample of top and middle managers in the insurance industry were asked various questions tailored to the issue.

The study considered the management groups as category variables and their opinion on the legal and regulatory as outcome variables. The nature of responsibilities at the two ranks (middle and top) of management is different. Top managers devise strategies, policies, legal frameworks, and direct the overall operations of the insurance businesses whereas, middle managers are highly involved in day-to-day operations. The top management is supposed to have better knowledge about reinsurance regulations and international business features than the middle level management. This could be a source of difference in awareness and hence opinion about the legal framework between the two group. In this regard, the following hypotheses are outlined. According to Diamantopoulos and Schlegelmilch (2000), comparisons often provide meaning.

**Hypothesis SIX:** There is perception gap in the Ethiopian Insurance Industry managements "whether there are regulations for exercising decisions on the reinsurance business arrangements (specified)".

**Hypothesis SEVEN:** There is perception gap in the Ethiopian insurance industry managements "whether the Ethiopian Insurance Proclamation No."86/1994" provides the required provisions regarding reinsurance business".

**Hypothesis EIGHT:** There is perception gap in the Ethiopian insurance industry managements "whether the absence of the legal and regulatory requirements is a barrier to the reinsurance business in Ethiopia".

Hypothesis six, seven and eight compare, whether there is perception difference between the top management and middle level management regarding the legal and regulatory issues of the reinsurance business. The hypothesis is exploratory and the variable is non-parametric dichotomous (2x2) nominal. Thus, the hypotheses can be tested using the Fisher's exact test (Chi-squared test of independence). In fact, for the test to be legitimate, one has to ensure that no more than 20% of the cells in the table have expected values of less than 5 and none of the expected values is less than one. In line with this, a 5% level of significance is set to test the hypotheses. Moreover, the qualitative analysis is conducted based on the responses. The analysis for the qualitative data is conducted using frequency tabulation tables for various opinions and descriptive statistics such as percentages are used to summarize the opinions of the respondents.

## 4.6 Validity of Research Methodology

Necessary steps were taken to ensure the adequacy of the questionnaire for the required information and the interviews through pilot-testing and professional comments. The approach to questioning is done in such a way that helps avoid any pitfalls that are likely to compromise the results. Moreover, the study gives due attention to the selection of the sample and appropriate statistical techniques (descriptive, hypothesis testing and estimation techniques) and hence the methodology employed in the present study is valid.

## 4.7 Ethical Considerations

With regard to ethics, the consent of respondents was sought before interviews. The respondents were randomly selected. Only those personnel and organizations who are voluntary to participate in the research were contacted for the survey. They were also assured that their names and organizations will not be revealed in the study. For reasons of ensuring that respondents remain anonymous, direct quotations from them are merely ascribed to unnamed respondents. Confidentiality is maintained and steps were taken to ensure that no ethical considerations are violated. For these reasons, the study is unlikely to raise any ethical concerns.

## 4.8 Summary

This chapter discussed the research methodology employed to conduct the study. Both quantitative and qualitative approaches were used for data collection and analyses. Primary and Secondary data were collected pertaining to the study. The primary data has quantitative and qualitative nature. It was obtained from the insurance companies and the supervising authority. The primary data were collected through a well designed survey questionnaire via interview. Secondary data related to the operation of the insurance industry in line with the primary insurance (underwriting) and reinsurance business of the insurance industry was obtained from the NBE. The other secondary data required for the study were the gross domestic (GDP) and broad money (M2), obtained from NBE. The study used the insurance law of other developing countries as a benchmarking analysis particularly to analyze the legal and regulatory requirements, in relation to reinsurance business. The primary and secondary data were processed electronically using SPSS program. The study applied various descriptive and inferential statistical tools such as frequency tables' graphs and simple tables to test the various research hypotheses.

This chapter also addressed aspects relating to validity and ethical considerations. The next chapter presents results of the study under the different study objectives.

# CHAPTER FIVE
# RESULTS

## 5.1 Introduction

In the previous chapter, the research methodologies were discussed and outlined. This study is initiated to assess the situation of the reinsurance business in Ethiopia. The objectives set for the study encompass: analyzing the effect of cross boarder reinsurance on the insurance industry and Ethiopian economy, examining whether there is strong correlation between the growth of insurance industry and the growth of the economy, examining the legal and regulatory requirements applying to reinsurance transaction from the Ethiopian insurance industry perspective, and recommending remedial measures to strengthen the reinsurance business the insurance industry eventually.

The first two objectives are attested based on the secondary data obtained from the NBE. The third objective is addressed by analyzing the primary data collected from the sample drawn from insurance firms and the supervising authority. The fourth or one is addressed on chapter six subsequent to the insights gained from the literature review and findings of this study.

In meeting the study objectives, the research questions provided in chapter three are taken as a base. The first and second problem statements and the respective questions and hypotheses are tackled using secondary data accessed from CBE. The third problem statement and the respective questions are analyzed using survey data collected from the insurance companies and supervising authority.

## 5.2 The Data

The secondary data is obtained from the NBE, the supervising authority of the financial sector. The primary data is collected from the insurance firms and supervising authority in accordance with the designed questionnaire.

### 5.2.1 The Secondary Data

The data comprise ten years time series financial transactions at macro, industry and firm level obtained from the NBE. The data from the insurance firms represent financial transactions transacted by the local insurance companies in the insurance industry with both the policy holders and the cross border reinsurers during 2000 to 2009. It covers nine insurance companies that have been in operation for more than five years. Similarly, the other secondary data for the economy (GDP), broad money (M2) and population size of Ethiopia represent ten years time series data from the years 2000 to 2009.

Data from the insurance firms show that the Ethiopian insurance industry like many other countries transacts in both insurance business sectors namely: life insurance and non-life insurance. However, as shown in Table 5.1, the life insurance underwriting premium during ten years time is 5.5% of the industry's total underwriting premium. The life insurance transaction in Ethiopia is not only minimal but also it is transacted by one company only, indicating that the sector is at its early stage as a business. This study is therefore, limited to the non life insurance sector of the insurance industry.  It is not because of the volume of transaction, and transacted by one company, but like most of developing countries insurance industries, Ethiopian life insurance sector contributes little to the reinsurance business and to the underwriting and ceded premiums.

**Table 5.1 Insurance underwriting premium in both insurance business sectors ('000 ETB) for the period 2000-2009**

| Company name | Underwriting Premium Non life insurance | Underwriting premium life insurance | Total underwriting premium | Firm Market share (in percent) |
|---|---|---|---|---|
| a | 3,390,351 | 437,942 | 3,828,293 | 50.6 |
| b | 607,804 | | 607,804 | 8.0 |
| c | 96,679 | | 96,679 | 1.3 |
| d | 730,968 | | 730,968 | 9.7 |
| e | 360,028 | | 360,028 | 4.8 |
| f | 674,815 | | 674,815 | 8.9 |
| g | 419,310 | | 419,310 | 0.6 |
| h | 649,209 | | 649,209 | 8.6 |
| i | 574,377 | | 574,377 | 7.6 |
| Total | 7,503,541 | 437,942 | 7,941,483 | |
| | 94.5% | 5.5% | 100% | |

Source: NBE

Among the nine companies involved in the insurance business, a single company accounts for close to 50 percent of the market share. The rest of the market share is almost evenly distributed among the remaining companies, except two of the companies which have very small market share. This indicates that a single company still dominates the insurance industry even long after liberalization of the market. As shown in Table 7.1, the firms in the insurance industry transact in more than ten non-life (general) insurance services (products) including: aviation, engineering, fire, liability, marine, motor, accident and health, pecuniary, workmen compensation, and others. Over the last ten years, of the non-life insurance products, motor insurance registered the highest turnover (ETB 1.8billion) accounting for about 41 percent followed by Marine (17.3 percent), aviation (8.8 percent), and engineering (8.4 percent). On the other hand, liability or guarantee bond registered the lowest turnover (ETB 50 million) accounting for only one percent of the total non life insurance products. This shows that the Ethiopian insurance industry insurance service is not only limited to a few products but also is, less diversified and less balanced.

Like most of the industries across the world, the Ethiopian insurance industry transacts both: downstream with underwriting policy holders and upstream with reinsurance businesses. Transactions with the policy holders mainly include the gross premium and insurance claims while transactions with the reinsurers mainly include: Ceded premium, ceded claims, and reinsurance commissions. Hence, the data used for the analysis comprise ten years time series and cross sectional data that include: Gross (underwriting) premium (GP), net claims incurred (NCI), net ceded premium (NCP), net ceded claims (NCC), and Net premium (NP) (gross premium less net ceded premium). Ten years data on these is presented on Table 5.2 below. The data is used to analyze the relationship between the reinsurance business and the insurance industry and the reinsurance business and the economy.

**Table 5.2 Nine firms' ten years aggregate financial transactions ('000ETB)**

| Year | GP | NP | NCP | NCC | NCI |
|---|---|---|---|---|---|
| **2000** | 420,101 | 323,344 | 96,757 | 50,426 | - |
| **2001** | 450,272 | 330,755 | 96,368 | 59,611 | 368,129 |
| **2002** | 554,331 | 356,262 | 110,538 | -351 | 386,143 |
| **2003** | 555,574 | 385,979 | 203,259 | -31,794 | 219,947 |
| **2004** | 568,226 | 403,063 | 154,738 | 51,488 | 236,427 |
| **2005** | 640,228 | 455,841 | 158,551 | 18,540 | 256,776 |
| **2006** | 796,867 | 551,973 | 193,510 | 113,421 | 323,950 |
| **2007** | 1,002,680 | 714,055 | 241,813 | 116,006 | 441,099 |
| **2008** | 1,174,217 | 832,383 | 323,438 | 115,891 | 549,431 |
| **2009** | 1,341,048 | 928,441 | 351,431 | 140,745 | 640,105 |

Source: NBE

The other data used to analyze the relationship between the insurance industry and the economy includes GDP and the financial sector broad money (M2) for the period 1976 to 2009. Table 5.3 below, shows the performance of the industry in current (market) price and the Ethiopian population during the period 2000-2009.

**Table 5.3 Ten years aggregate GP, GDP and M2 (in ' million ETB) and Population in 'million**

| Year | GP | M2 | GDP | Share of GP to GDP (%) | Share of GP to M2 (%) | Share of M2 to GDP ( %) | Population in million |
|---|---|---|---|---|---|---|---|
| **2000** | 420 | 22,178 | 66,648 | 0.6 | 1.9 | 33.3 | 60.0 |
| **2001** | 450 | 24,516 | 68,027 | 0.7 | 1.8 | 36.0 | 61.6 |
| **2002** | 554 | 27,322 | 66,557 | 0.8 | 2.0 | 41.1 | 63.2 |
| **2003** | 556 | 30,090 | 73,432 | 0.8 | 1.8 | 41.0 | 64.8 |
| **2004** | 568 | 34,656 | 86,661 | 0.7 | 1.6 | 40.0 | 66.5 |
| **2005** | 640 | 40,212 | 106,473 | 0.6 | 1.6 | 37.8 | 68.3 |
| **2006** | 797 | 46,377 | 131,641 | 0.6 | 1.7 | 35.2 | 70.0 |
| **2007** | 1,003 | 56,652 | 171,989 | 0.6 | 1.8 | 32.9 | 72.4 |
| **2008** | 1,174 | 68,182 | 248,605 | 0.5 | 1.7 | 27.4 | 74.9 |
| **2009** | 1,341 | 82,510 | 336,106 | 0.4 | 1.6 | 24.5 | 76.8 |
| **Total** | 7,503 | 432,695 | 1,356,140 | | | | |

Source: NBE

### 5.2.2 Profile of the Survey Respondents

A sample of 76 was targeted from the total target population of 150 in the insurance industry. Though the rate of response on each question varied considerably, a total of 66 respondents completed the full set of questions, giving a response rate of 87%. The responses from top and middle managements were 50% each. The composition of the respondents by job level is presented in Figure 5.1below.

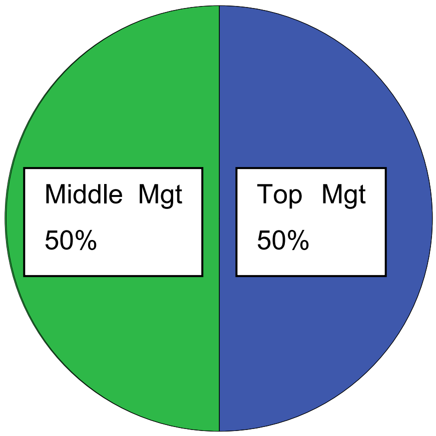


**Figure 5.1 Composition of the respondents**

A number of questions were forwarded to the sample respondents in the survey. Three of these questions were considered for the purpose of this study. The responses of these three questions are described below:

- The respondents were asked "whether there exist regulations that affect decisions related to reinsurance business arrangements?" (Such as: terms and conditions, reinsurance methods, reinsurance commission, dispute resolution, amount or rate of cession, and premium due settlement. The overall, response is 80 percent of which 53 percent are top management while 47% are middle management as shown on Table 5.4 below.

**Table 5.4 Response rate for "whether there are Regulation to effect decision on reinsurance business arrangements?"**

| Job level | Sample size(n) | Respond | | Missed | |
|---|---|---|---|---|---|
| | | n | % | n | % |
| Top management | 33 | 28 | 85 | 5 | 15 |
| Middle management | 33 | 25 | 76 | 8 | 24 |
| Total | 66 | 53 | 80 | 13 | 20 |

- Similarly, the respondents were asked whether the current proclamation ("Licensing and Supervision of Insurance No.86/1994") provides the insurance companies appropriate provision in transacting reinsurance business. The overall response rate was 77%, of which 53% are top management while 47% are middle management as shown on Table 5.5 below.

**Table 5.5 Response rate for "whether the current proclamation "Licensing and Supervision of Insurance No.86/1994" provides adequate provisions for reinsurance business?"**

| Job level | Sample size(n) | Respond | | Missed | |
|---|---|---|---|---|---|
| | | n | % | n | % |
| Top management | 33 | 27 | 82 | 6 | 18 |
| Middle management | 33 | 24 | 73 | 9 | 27 |
| Total | 66 | 51 | 77 | 15 | 23 |

- Moreover, the respondents were asked "whether the absence of the legal and regulatory requirement is an impediment to the reinsurance business" in Ethiopia. The overall response rate was 89%, of which 53% are top management and 47% are middle management as shown on Table 5.6 below.

**Table 5.6 Response rate "whether the absence of Legal and Regulatory requirement is a barrier for the reinsurance business?"**

| Job level | Sample size(n) | Respond | | Missed | |
|---|---|---|---|---|---|
| | | n | % | n | % |
| Top management | 33 | 31 | 94 | 2 | 6 |
| Middle management | 33 | 28 | 85 | 5 | 15 |
| Total | 66 | 59 | 89 | 7 | 11 |

Overall, the response rate for the three questions shown above is over 75%. The results of these questions responses are adequate as per the rough guides by literature, indicating that there is high accuracy in the survey data and the interviewed sample is more likely representative of the overall population.  Therefore, it is sound to make generalization based on the survey data.

## 5.3 Research Results

### 5.3.1 The Cross-Border Reinsurance Business and the Influence on the Ethiopian Insurance Industry and Economy

As explained in chapter three, there are two opposing views on the effect of cross boarder reinsurance on the local insurance industry and the economy as a whole. One view argues that cross boarder reinsurance affects the local insurance industry negatively by way of increasing the price of underwritten premium and aggravates the trade balance deficit of a country by increasing the outflow of foreign exchange. An opposing view argues that cross boarder reinsurance has a positive effect on local insurance industries by way of spreading or transferring catastrophic risks and increasing the underwriting gross premium and net premium of the insurance industries and facilitating knowledge transfer from developed to developing countries.

This study argues that the effect of cross boarder reinsurance on local insurance industries should be an empirical question, given the aforementioned opposing views. Thus, this section examines empirically whether the Ethiopian cross boarder reinsurance business negatively affects local reinsurance industry and the economy.

#### A. The Relationship between Cross Border Reinsurance and the Ethiopian Insurance Industry

To empirically analyze the relationship between the cross boarder reinsurance and the local insurance industry, this study uses net ceded premium and net premium as a measure of cross border reinsurance and local insurance respectively. Thus, it appeals to the bi-variate association between cross boarder reinsurance and local insurance. In line with the second view, the merit of cross border reinsurance business, the following directional hypotheses are formulated.

Ho: There is no correlation between net ceded premium and net premium
H1: There is a positive correlation between net ceded premium and net premium

To test the null hypothesis, the study selects the 5% level of significance which is a typical value of type I error. The conventional t-test is selected as an appropriate statistical test since this hypothesis examines the association between two ratio variables. More specifically, a one-tailed t-test is used as the alternative hypothesis is directional. Hence, a one- tailed t-test in conjunction with a 5% significance level is used to assess the strength of the association between the net premium and net ceded premium and thereby between cross border reinsurance and local insurance industry. The Pearson product moment correlation is employed to examine the relationship between the two variables as both of them are ratio variables. However, Pearson product moment correlation coefficient can't detect bi-variate variables linked by non-linear relationship (Diamantopoulos and Schlegelmilch, 2000). To avoid such pitfall first the relationship between the two variables are plotted below.

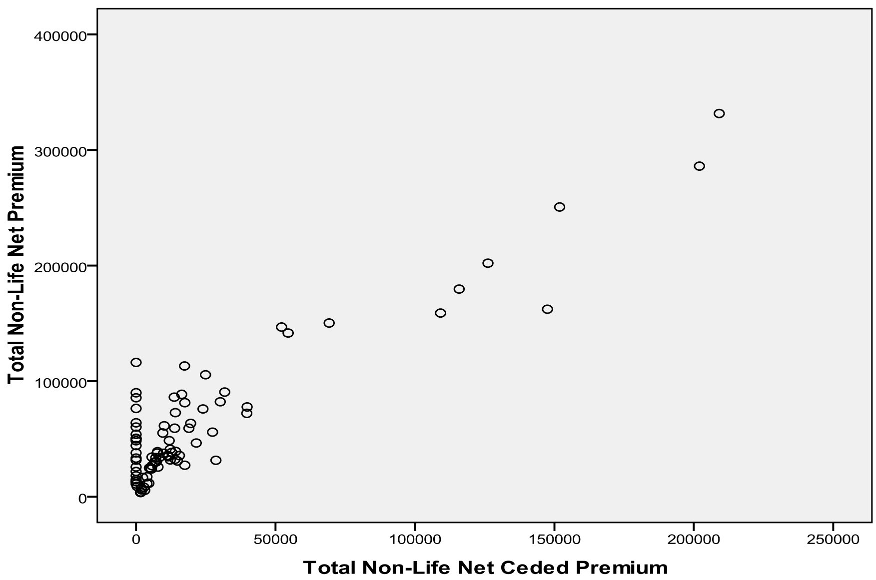


**Figure 5.2 Scatter Diagram showing the relationship between NCP and NP (firm level)**

Visual inspection of Figure 5.2 suggests a tendency of linear relationship between net premium and net ceded premium indicating the appropriateness of the Pearson product moment correlation coefficient to measure the association between these two variables. The Pearson product moment correlation coefficient along with the corresponding statistical test is reported on Table 5.7 below.

**Table 5.7 Correlation between NCP and NP**

| | | Total Non-life Net Premium | Total Non-Life Net Ceded Premium |
|---|---|---|---|
| Total Non-Life Net Premium | Pearson Correlation | 1 | .944** |
| | Sig. (1-tailed) | | .000 |
| | N | 87 | 66 |
| Total Non-Life Net Ceded Premium | Pearson Correlation | .944** | 1 |
| | Sig. (1-tailed) | .000 | |
| | N | 66 | 66 |

** Correlation is significant at the 0.01 level (1-tailed).

As is evident from Table 5.7 above, the p-value associated with a one-tailed t-test is 0.000 which is much lower than the specified significance level. It indicates statistically significant linear relationship exists between the net ceded premium and net premium. This aspect also suggests that there is a strong correlation between cross border reinsurance and local insurance industry. The Pearson correlation coefficient is positive and close to unity (r=0.94) indicating a strong positive relationship between cross border reinsurance and local insurance industry contrary to the initial hypothesis. The proportion of variance, which is the square of the Pearson correlation coefficient ($r^2$), is 0.88.This means that 88% of the variation in net premium (local insurance industry) can be explained by the variation in net ceded premium (cross border reinsurance).

Looking at the figures in Table 7.2 (descriptive presentation of the two) and the time series graph on Figure 5.3 below, it can be noted that both net premium and net ceded premium are increasing over time confirming the test result, above. Nevertheless, the fact that nominal figures are compared in the test may mask the relative size of the two items over time. Alternatively, it is worthwhile to compare the relative size of net premium and net ceded premium as a percentage of gross premium. As one can see from Figure 5.4 below, net premium as a percentage of gross premiums decreased from 77 percent in 2001to 69 percent in 2009 while net ceded premium as percentage of gross premium increased from 23 percent to 26 percent in the same period. This indicates that cross border reinsurance is negatively affecting the local insurance industry.

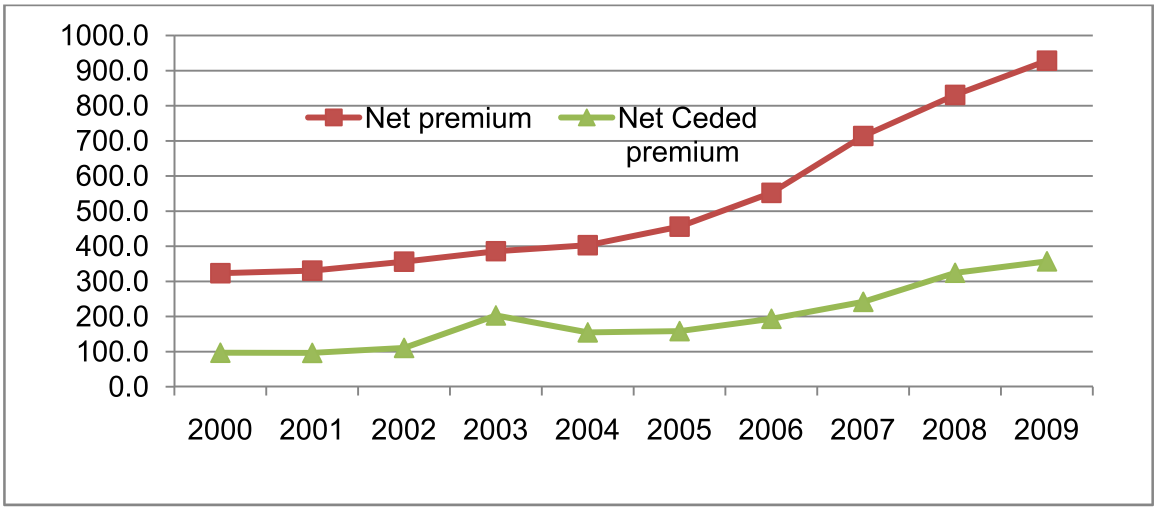


**Figure 5.3 Trend of Relationship between NP and NCP**

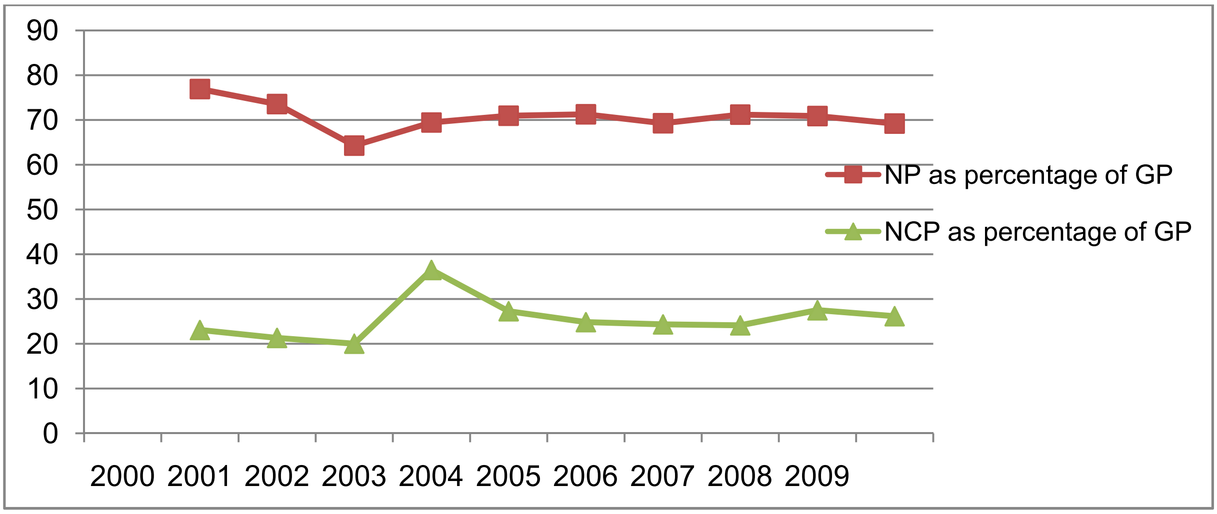


**Figure 5.4 Trend of Relationship between NP and NCP, as a percentage of GP**

Hence, other things being constant, despite the existence of positive correlation between the net ceded premium and net premiums (retention), the comparison between the relative size of the growth rates confirms that the reinsurance business is negatively influencing the Ethiopian insurance industry due to its entire dependency on cross border reinsurance.

### B. The Influence of Cross Border Reinsurance on the Ethiopian Economy

The cross border reinsurance business influences the insurance industry and the economy of a country through hard currency inflows and outflows. As discussed in chapter two, the net currency out flow due to net ceded premium over the currency inflow in the form of net ceded claim is overwhelming. This, in turn, does have a negative effect on the local industry and on the economy causing foreign exchange shortage and aggravating the balance of payment deficit. On the other hand, if the inflow outweighs the outflow, cross border reinsurance does have a positive influence on the overall economy by reducing the foreign exchange constraint of the latter. Thus, the effect of cross border reinsurance on the overall economy of Ethiopia cannot be determined a priori. To identify the effect of cross border reinsurance on Ethiopian economy, this study examines the relationship between proxy variables: (i) “Net Ceded Premium” and “Net Ceded claim“, (ii) “Net Claim Incurred ” and “Net Ceded claim”, of which Net Ceded Premium (NCP) represents the outflow and the Net Ceded Claim (NCC) represents the inflow of hard currencies. Net claims incurred (NCI) is the difference between gross claims incurred and the reinsurance recoveries. The correlations are analyzed below.

(i) To analyze whether the net ceded claim received from cross border reinsurance is comparable to what is paid out in terms of net ceded premium, the study tests the following hypotheses.

Ho: There is no mean difference between net ceded premium and net ceded claim

H1: There is a mean difference between net ceded premium and net ceded claim.

Since the interest is to compare two ratio variables and the hypothesis is exploratory, two tailed pair sample test is employed. Results of the test are reported in table 5.8 below. As one can see, the test statistic is significant showing that the net ceded premium and net ceded claim are not equal. Indeed, judging from the mean values, the net ceded premium is much higher than the net ceded claim. In addition, the paired sample correlation coefficient is positive (r=0.54) and highly significant (p value= 0.000).This implies that, as far the foreign currency is concerned, cross border reinsurance has a statistically significant negative impact on the overall performance of the Ethiopian industry and economy, as the net foreign currency out flow is much higher than the inflow.

**Table 5.8 Paired Sample Statistics, Test and Correlation between NCP and NCC**

**Paired sample statistics**

| | Mean | N | Std. Deviation | Std. Error Mean |
|---|---|---|---|---|
| Total Non-Life Net Ceded Premium | 29248.53 | 66 | 46104.087 | 5675.021 |
| Total non life Net Ceded claim | 9043.98 | 66 | 19244.776 | 2368.868 |

**Paired sample test**

| Paired differences | | | | | | | |
|---|---|---|---|---|---|---|---|
| Mean | Std. Deviation | Std. Error Mean | 95% Confidence Interval of the Difference | | t | df | Sig. (2-tailed) |
| | | | Lower | Upper | | | |
| 20204.545 | 39194.122 | 4824.463 | 10569.428 | 29839.663 | 4.188 | 65 | .000 |

**Paired sample correlation**

| N | Correlation | Sig. |
|---|---|---|
| 66 | .541 | .000 |

It can also be deduced from Figure 5.5 below, that the net ceded premium is consistently higher than the net ceded claim. More importantly, the gap between ceded premium and ceded claim is getting wider over time indicating an increase in that net currency outflow due to cross border reinsurance. This suggests the cost of reinsurance in terms of foreign exchange loss, has been considerable during the period under study. Had the industry partly reinsured some of the insurance products locally, the country would have retained foreign currency that can be used for productive investment. Hence, cross-border reinsurance affects the Ethiopian economy negatively as far as the foreign exchange is concerned.

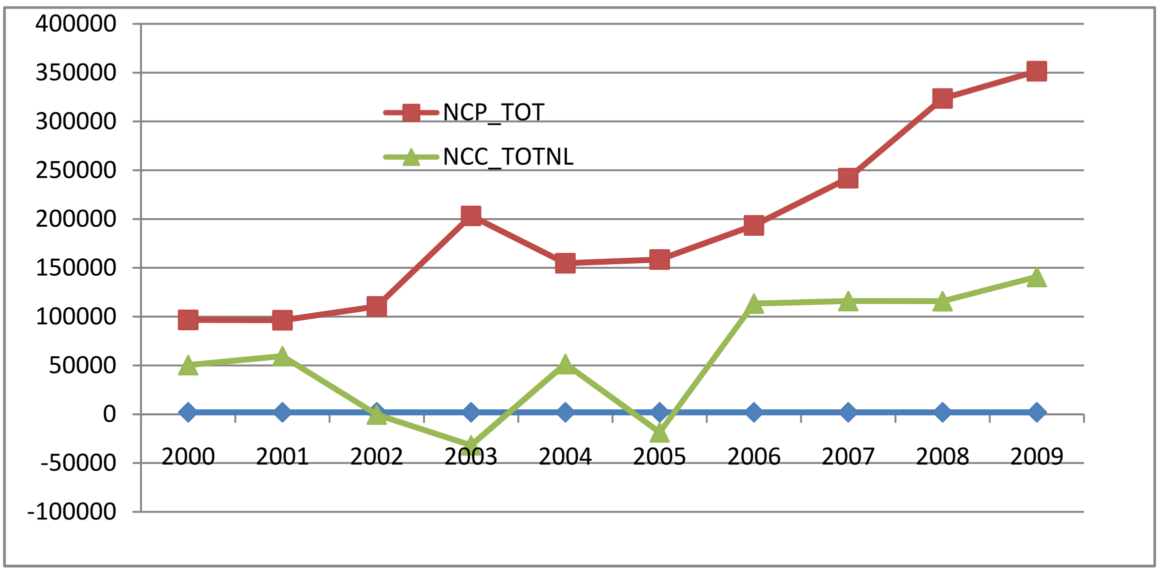


**Figure 5.5 Trend of Relationship between NCP and NCC**

(ii) In what follows, the study investigates whether the net claim incurred by policy holders are adequately supported by cross border reinsurers. In view of this, the study tests the following hypothesis:

Ho: There is no mean difference between net claims incurred and net ceded claim

H1: There is a mean difference between net claim incurred and net ceded claim.

Similarly, the hypothesis is tested using two tailed paired sample t-test since net claim incurred and net ceded claim are ratio variables and the hypothesis to be tested is exploratory. The result of the test together with some important statistics and correlation coefficient is reported in Table 5.9 below.

**Table 5.9 Paired Sample Statistics, Test and Correlation between NCC and NCI**

**Paired sample statistics**

| | Mean | N | Std. Deviation | Std. Error Mean | Std. Error Mean |
|---|---|---|---|---|---|
| Total non life Net Ceded claim | 6590.76 | 86 | 17091.557 | 1843.030 | 6590.76 |
| Total Net claims | 39790.7820 | 86 | 47403.72116 | 5111.67471 | 39790.7820 |

**Paired sample test**

| | Paired differences | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | Mean | Std. Deviation | Std. Error Mean | 95% Confidence Interval of the Difference | | t | df | Sig. (2-tailed) |
| | | | | Lower | Upper | | | |
| | -33200.02 | 40899.86 | 4410.34 | -41968.97 | -24431.07 | -7.528 | 85 | .000 |

**Paired sample correlation**

| | N | Correlation | Sig. |
|---|---|---|---|
| | 86 | .535 | .000 |

As can be seen from Table 5.9 above, the null hypothesis is rejected at 5% level of significance. Similarly, the paired sample correlation coefficient is positive (r=0.535) and highly significant (p value= 0.000). This indicates there is a statistically significant mean difference between net claim incurred and net ceded claim. In fact, judging from the mean values, the net ceded Claim is much lower than the net claims incurred by policy holders. This implies that the cross border reinsurance has a statistically significant negative impact on the overall performance of the Ethiopian economy, as the net foreign currency out flow is much higher than the inflow. This reflects the fact that insurance claims by policy holders are not proportionally supported by the cross border reinsurers. This again indicates the negative impact of cross border reinsurance on the growth of local insurance industry in particular and the economy in general. For visual comparison, the trend in net claim incurred and net ceded claim overtime is depicted in Figure 5.6 below. It can be seen that the gap between net claim incurred and net ceded claim was wide between 2000 and 2003 but it got narrow until 2005. Since 2005, the gap has been significantly widening confirming the above conclusion that only a small portion of the claim incurred is covered by cross border reinsurance relative to the size of net ceded premium. From both inferential and the visual comparison, it can be concluded that the net claims incurred are compensated little by the reinsurance business in terms of net ceded claims. This, in turn, suggests the outflow of hard currency due to reinsurance is not comparatively compensated in times of risk recovery process, which is contrary to the theory that the higher the premium ceded, the higher the risk transferred, the higher the risk compensation (net ceded claims). Thus the country's balance of trade deficit is aggravating.

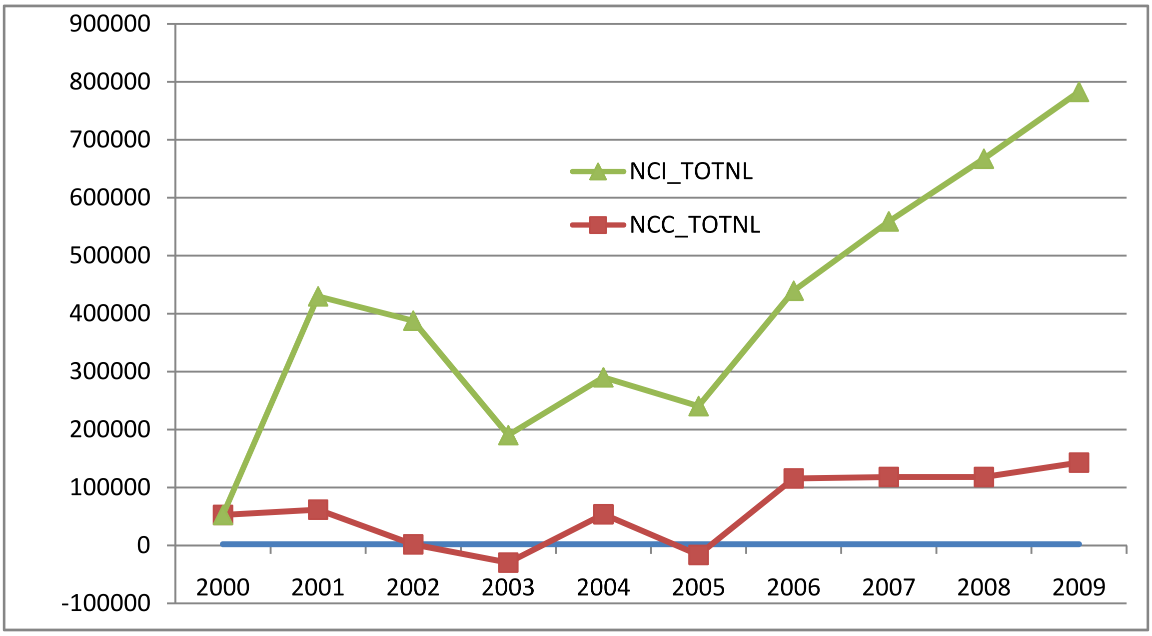


**Figure 5.6 Trend of Relationship between NCI and NCC (industry level)**

### 5.3.2 Insurance industry and Economic Growth of Ethiopia

Many of economic literature suggest a strong positive correlation between financial development and economic growth and insurance coverage. Some other studies suggest that extensive dependency on foreign reinsurance has an impact on the contribution of the industry to the national development; whereas, others claim that insurance industry and economic growth do have a strong positive correlation and the former significantly contributes to the economic development of a nation. As far as in the Ethiopian context is concerned, its economy is growing remarkably on the one hand the insurance industry is exclusively dependent on cross border reinsurance on the other. Thus, the study aims at reviewing whether the Ethiopian insurance industry is growing or contributing to the economic development of the country. Consequently, the study analyzes the correlation between (i) the growth of the insurance industry and the economy, (ii) the growth of the insurance industry and the financial sector, and (iii) the financial sector and the economy. Gross Premium (GP), Gross domestic Product (GDP) and Broad money supply (M2) are used as a proxy to measure the performance of the industry, against the economy and the financial sector respectively. Therese relationships are analyzed below.

**i) The Relationship between Growth of the Economy and the Insurance Industry:**

The absence of data for gross premium for the years before 2000 makes hypothesis testing difficult since the sample size becomes too small (N=10). In view of this, only graphical tools are applied to do the exploratory analysis. Figure 5.7 shows the relationship between gross premium (GP) and gross domestic product during the period 2000-2009. It can be seen that GDP grows at an increasing rate while GP remains stagnant over the study period. This indicates that the performance of the insurance industry is lagging behind the overall growth of the economy. This in turn implies that the insurance industry is contributing little to the development of the economy not alone, to be in a position to secure from potential risks.

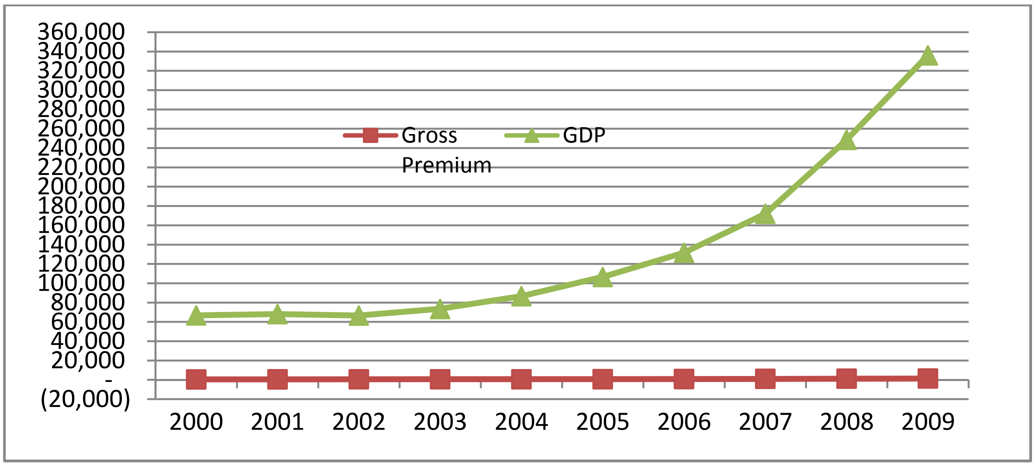


**Figure 5.7 Trend of relationship between GP and GDP**

Similarly, the penetration rate index of the industry (GP to GDP ratio) shows less than one percent and surprisingly the rate continued decreasing from year to year in the period under study. As shown in Table 5.3, the penetration rate reduced from 0.8% and 0.7% in the years 2003 and 2004 to 0.5% and 0.4% in the years 2008 and 2009 respectively. The insurance density for insurance industry in Ethiopia is nearly around USD one per capita. This implies that the coverage capacity of the insurance industry relative to the size of the economy is small. It also indicates that the industry is making meager economic significance to the economic growth of the country (see Table 7.2).

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**ii) The Relationship between Growth of the financial sector and the Insurance Industry:**

Figure 5.8 below shows the relationship between the financial sector and insurance industry in Ethiopia. Inspection of the figure below seems to indicate a weak relationship between the growth of the financial sector and insurance industry in Ethiopia. This implies that the demand for insurance and the level of financial development in Ethiopia is extremely meager when compared the economic growth of the country. The figure shows the insurance industry has been creeping for long with little or scanty improvements relatively to financial development. This in turn implies that the insurance industry is not in a position to support and anchor the financial sector of the country.

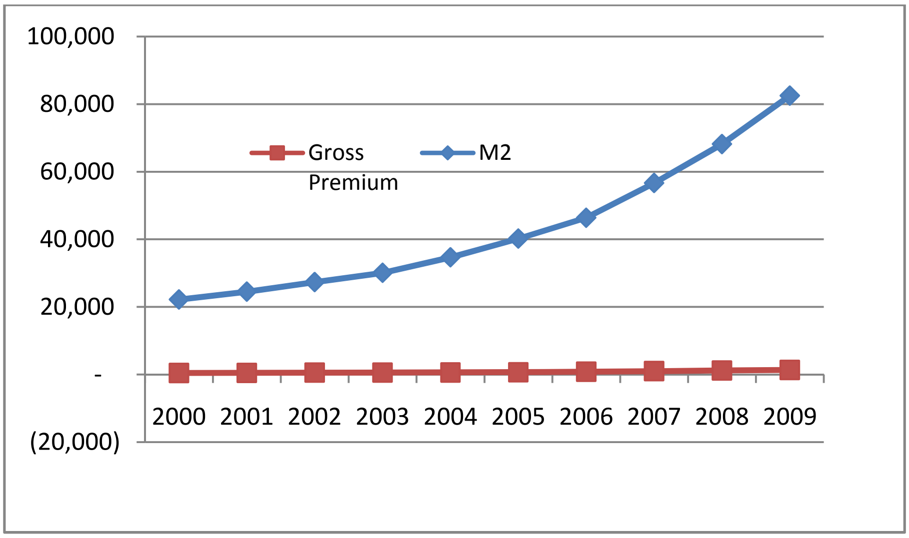


**Figure 5.8 Trend of relationship of GP and M2**

**iii) The Relationship between the Financial Sector and the Economy.**

Economic literature pronounce strong relationship between financial development and economic growth. From the Ethiopian perspective, to review whether there is a significant alignment between the two, the null and alternative hypothesis can be formulated as follows:

H0: There is no positive relationship between the growths of financial sector (M2) and the economy (GDP).
H1: There is positive relationship between the growth of the financial sector and the economy (GDP).

The hypothesis is tested using the conventional t-test since this hypothesis examines the association between M2 and GDP as they are ratio variables. A one-tailed t-test at a 5% level of significance is used as the relationship is assumed to be directional. The Pearson product moment correlation is used to determine the relationship between the two variables.

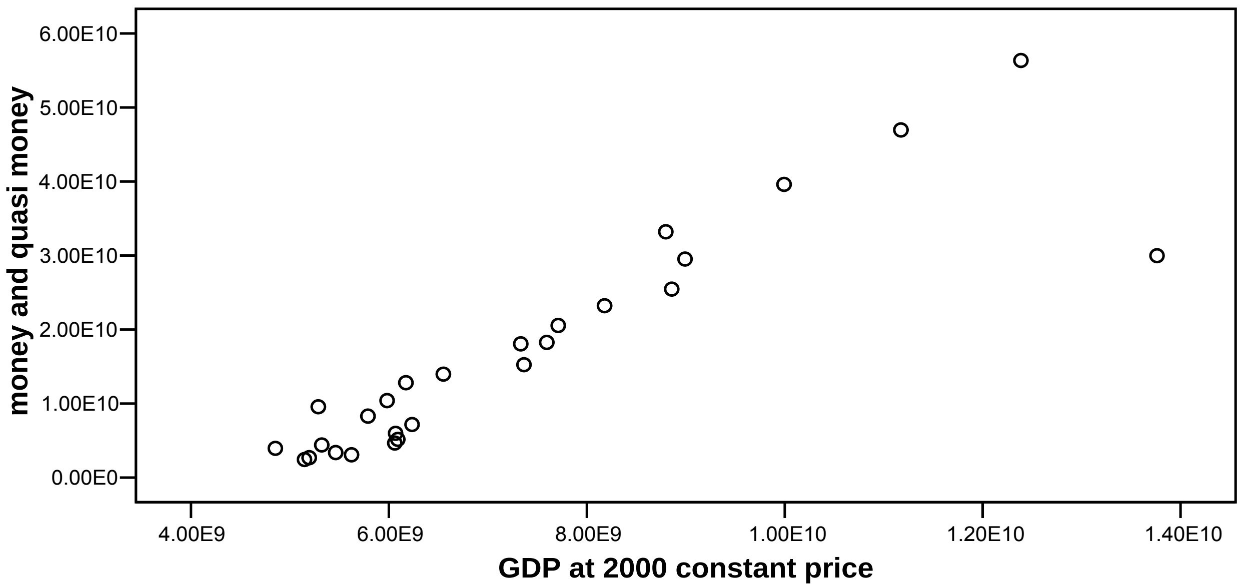


**Figure 5.9 Scatter Diagram showing the Relationship between GDP and M2**

The visual inspection of Figure 5.9 suggests a linear relationship between broad money and real GDP. The Pearson product moment correlation coefficient along with the corresponding statistical test is reported below.

**Table 5.10 Correlations between M2 and GDP**

| | | money and quasi money | GDP at 2000 constant price |
|---|---|---|---|
| **money and quasi money** | Pearson Correlation | 1 | .904(**) |
| | Sig. (1-tailed) | . | .000 |
| | N | 27 | 27 |
| **GDP at 2000 constant price** | Pearson Correlation | .904(**) | 1 |
| | Sig. (1-tailed) | .000 | . |
| | N | 32 | 33 |

** Correlation is significant at the 0.01 level (1-tailed).

As shown in Table 5.10, the correlation implies a statistically significant linear relationship between the growth of financial sector and the economy. The Pearson correlation coefficient is positive and close to unity (r=0.9) suggesting a strong positive relationship between the growth of financial sector and the economy .The proportion of variance is 0.81. This means 81% of the variation in the growth of the economy can be explained by the variation in the growth of the financial sector and vice versa.

Figure 5.10 also represents the relationship between the financial sector (M2) and gross domestic product (GDP) of Ethiopia from 2000 to 2009. It can be seen that the degree of the relationship between the two variables is significant and positive. GDP grows at an increasing rate while M2 follows at a lower rate. This indicates that unlike the insurance industry the financial sector is performing somewhat good to meet the country's fast growing economic performance. This means, the economy is growing faster than the growth in the finance sector. This also implies that the Ethiopian economy is demand leading, which requires extra effort to enhance the supply side of the economy (strengthening the performance of the finance sector, including the insurance industry).

The analyses made on sub topics (i), (ii) and (iii) above jointly indicate that the insurance industry is not contributing to the development of the financial sector and to the development of the national economy.

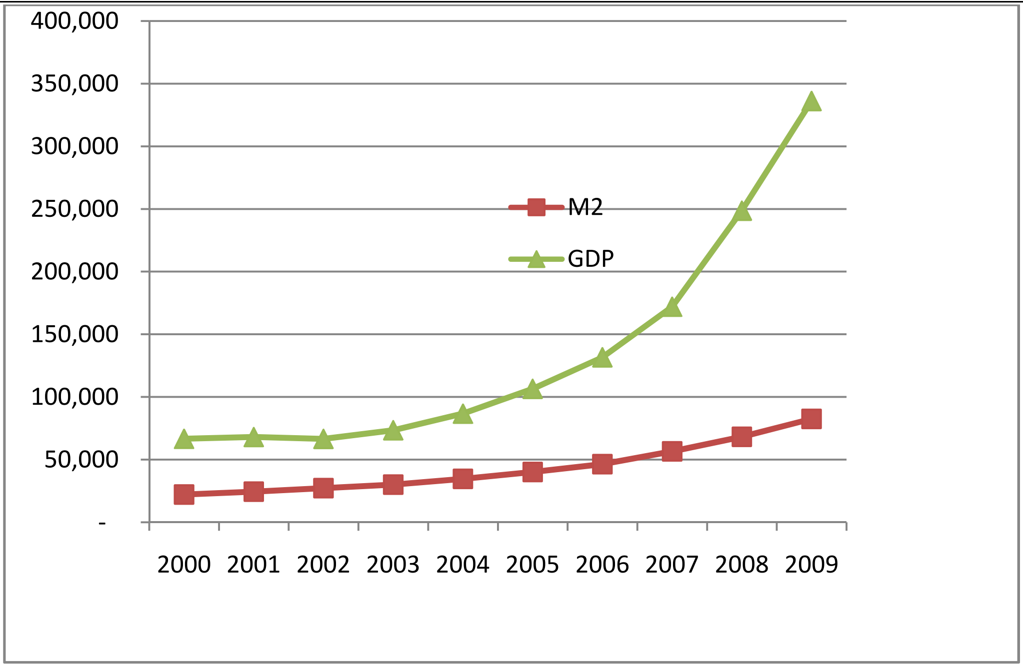


**Figure 5.10 Trend of relationship between GDP and M2**

This further explores that not only the insurance industry is weak and contributing little but also the financial sector and the national economy at large are without adequate insurance coverage and less anchored against potential risks. The analyses further explores that there is a wide gap between the demand side (the economy) and the finance sector, depicting that the Ethiopian economy is demand leading and the supply side is lagging behind. These imply that extra effort is required to enhance the capacity of the financial sector in general and the insurance industry in particular.

### 5.3.3 Reinsurance Business Regulatory Requirements for the Ethiopian Insurance Industry

In order to ensure healthy undertaking of reinsurance activities, it is necessary to establish detailed legal and regulatory framework pertaining to the entire reinsurance business. Reinsurance regulatory framework is an essential tool for both competitiveness and solvency flooring of the insurance industry. Unfortunately, the Ethiopian insurance industry does not have regulations for the reinsurance business. Despite lack of the regulatory framework for the reinsurance business, two opposing views are raised. (i) The one that pronounces for the non existence and (ii) the other stipulates that the industry has been transacting in the reinsurance business in millions per year for a number of years. The non existence of the regulations combined with gap of awareness about the regulations and the impact thereof is critical and timing. To assess the prevalence of the perception difference and its extent in the industry and capture insurance providers' opinion about various aspects of the legal framework for reinsurance, a sample of middle and top managers in the insurance industry were asked various issue-tailored questions.

**I) whether there are regulations concerning reinsurance arrangements**

The respondents were asked whether there exist regulations concerning reinsurance arrangements (such as terms and conditions, reinsurance methods, reinsurance commission, dispute resolution, amount of cession and premium due) for the reinsurance business. The results on Table 7.3 show that the majority of respondents (more than 60 percent) reported that there are no such regulations. Looking at the response for each aspect of reinsurance arrangement, the proportion of respondents who said there are no regulations is as high as 81 percent and as low as 60 percent regarding reinsurance business arrangements. This suggests that there is ambiguity among respondents on reinsurance regulations in relation to reinsurance business arrangements. Moreover, the proportion of respondents in top management group who reported there are no regulations is slightly higher than those in the middle management group for each aspect of reinsurance arrangement. This may indicate that there is some gap and difference in opinion between the two management groups.

The nature of responsibilities at the two ranks (middle and top) of management is different. Whereas top managers devise strategies, policies, legal frameworks, and direct the overall operations of the insurance businesses, middle managers are mainly involved in day-to-day operations and implementations of various strategies. This could be the source of difference in awareness and hence opinion between the two groups about the legal framework. To test formally whether there is significant difference in opinion between the two management groups, the following pair of hypothesis is considered.

Ho: There is no significant opinion difference between the two management groups whether there are regulations to effect decisions on reinsurance business arrangements.

H1: There is a significant opinion difference between the two management groups whether there are regulations to exercise decisions on the reinsurance business arrangements.

To test the above hypothesis, each of the different aspects of reinsurance arrangement was considered separately. Summary of the Chi-Square test statistics is reported in Table 5.11. The p-value associated with the Fisher's exact test (two sided) for the reinsurance arrangement, namely: terms and conditions, amount of cession, dispute resolution, reinsurance commission, reinsurance methods, and premium due settlement, is in the range from 0.337 to 1.000, which is greater than 0.05. This implies that not enough evidence exists to reject the null hypothesis. Hence, the result is contrary to the initial deduction that there is significant opinion difference between the two management groups. This implies that the two management groups have similar understanding about whether there are regulations to execute reinsurance business arrangements, despite its absence.

**Table 5.11 Summary statistics of Chi-Square test "whether there are Regulations in relation to reinsurance business arrangement?"**

| Test for regulation regarding… | Type of test | Value | Df | Asymp. Sig. (2-sided) | Exact Sig. (2-sided) | Exact Sig. (1-sided) |
|---|---|---|---|---|---|---|
| Terms and conditions | Pearson Chi-Square | .379 | 1 | .538 | | |
| | Fisher's Exact Test | | | | .584 | .369 |
| Reinsurance method | Pearson Chi-Square | 1.192 | 1 | .275 | | |
| | Fisher's Exact Test | | | | .337 | .224 |
| Amount of cession | Pearson Chi-Square | .050 | 1 | .823 | | |
| | Fisher's Exact Test | | | | 1.000 | .540 |
| Reinsurance commission | Pearson Chi-Square | .254 | 1 | .614 | | |
| | Fisher's Exact Test | | | | .732 | .441 |
| Dispute Resolution | Pearson Chi-Square | .084 | 1 | .772 | | |
| | Fisher's Exact Test | | | | 1.000 | .511 |
| Premium due settlement | Pearson Chi-Square | .050 | 1 | .823 | | |
| | Fisher's Exact Test | | | | 1.000 | .540 |

Respondents who reported that ´there are no regulations´ were further asked as to how they manage reinsurance transactions in the absence of regulations. They reported that negotiations, treaty agreement and use of international standards as the most common mechanisms of managing transactions (Table 7.4.1-6).

In general, though the descriptive analysis indicates slight differences, the inferential results show no significant difference. The qualitative results also indicate that there are no clear cut procedures and directives that are consistent and transparent to all stakeholders. Hence, the results hint that each company operates in its own way as it perceives the problems it faces. This means the perception of the top management who design the policies and regulations is not significantly different from that of the middle level management. This in a way implies that there is awareness gap in the industry and the top management is not substantively better than the middle about the reinsurance business regulations.

**ii) Whether the Insurance Proclamation No. “86/1994” provides provisions for reinsurance business**

The Insurance Proclamation, No. “86/1994”, doesn’t give detailed information about the manner in which reinsurance business should be transacted. It simply says the transaction should be determined by directives to be issued by the National Bank (Central Bank). Nevertheless, some practitioners in the insurance business wrongly consider the proclamation as providing adequate provision for reinsurance business. To see whether this ambiguity exists among middle and top level managers in the insurance industry, the question ´does the insurance proclamation, "Licensing and Supervision of Insurance", No 86/1994, provide adequate provisions for the insurance companies to transact reinsurance business?’ was posed to the respondents during the survey. Surprisingly, about 43 percent of the respondents believe that the proclamation does provide adequate provision. The descriptive analysis is shown on Table7.3. This is a vivid instance for lack of awareness in the industry as far as reinsurance is concerned. Disaggregating the response by manager group, it can be noted that larger proportion of middle level managers (50 percent) believes the proclamation provides adequate provision compared to only 37 percent in the top management group. This may suggest that top managers have better understanding of the legal environment than middle managers. To infer the descriptive information and its extent in the industry, the following paired hypothesis is formulated.

Ho: There is no significant opinion difference between the two management groups whether the Insurance Proclamation No. “86/1994 gives detail information about the manner in which reinsurance business should be transacted.

H1: There is a significant opinion difference between the two management groups whether the Insurance Proclamation No. “86/1994” gives detailed information about the manner in which reinsurance business should be transacted.

Result of the Chi-Square test is summarized in Table 5.12 below. The p-value associated with the Fisher’s exact test (two sided) is 0.405, greater than the null hypothesis at 0.05 significance level. This implies that not enough evidence exists to reject the null hypothesis. Hence, the result suggests that the management groups have similar opinions on the Insurance Proclamation, No.86/1994.

**Table 5.12 Chi-Square tests for the Insurance Proclamation No.”86/1994”Whther it provides provisions with regard to reinsurance business arrangements?**

| | Value | df | Asymp. Sig. (2-sided) | Exact Sig. (2-sided) | Exact Sig. (1-sided) |
|---|---|---|---|---|---|
| Pearson Chi-Square | .870 | 1 | .351 | | |
| Continuity Correction | .422 | 1 | .516 | | |
| Likelihood Ratio | .872 | 1 | .350 | | |
| Fisher's Exact Test | | | | .405 | .258 |
| Linear-by-Linear Association | .853 | 1 | .356 | | |
| N of Valid Cases | 51 | | | | |

Computed only for a 2x2 table, 0 cells (.0%) have expected count less than 5. The minimum expected count is 10.35.

During the survey, those managers who believe the proclamation doesn’t provide adequate provision were further asked why they think so, (See Table 7.4.8). About 78.3 percent of these respondents stated that there is no such provision in the proclamation about reinsurance. Other reasons include the law is only concerned about insurance (around nine percent) and the proclamation is based on international standards (four percent). In general, though the descriptive analysis indicates a slight difference, the inferential results show no significant difference. This, in turn, implies that the top management, who are responsible for device of policies, strategies and regulations, do not have better understanding about the current proclamation of the industry than the middle level.

**iii) Whether the absence of legal and regulatory requirement is a barrier for reinsurance transaction.**

Understanding what practitioners in the insurance industry think about absence of legal framework for reinsurance business is central to design proper legal and regulatory requirements and thus ensure effective implementation when the laws are put in place. Accordingly, the respondents were asked whether the absence of legal and regulatory requirement is a barrier for reinsurance transaction. The study reveals that only 46 percent of the respondents believe absence of legal and regulatory requirement is a barrier for the reinsurance business (Table 7.3). The proportions of respondents in the middle management group who have the same opinion (50 percent) are higher than those in the top management (41.9 percent). This may indicate that there is some difference in opinion between the two management groups. To corroborate the above deduction, a formal test of the following hypothesis was carried out.

Ho: There is no significant opinion difference between the management groups whether the absence of reinsurance business regulations has hampered the reinsurance business.

H1: There is significant opinion difference between the management groups whether the absence of reinsurance business regulations has hampered the reinsurance business.

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As inferred from the result of the Chi-Square test summarized in Table 5.13 below, the null hypothesis at 0.05 significance level can't be rejected, suggesting that both middle and top managers seem to have more or less similar opinion regarding the effect of absence of explicit law related to reinsurance business. This is contrary to the expectation that top managers (being architect of their company policy) have better understanding of the legal environment and its impact than middle managers.

**Table 5.13 Chi-Square Tests for the absence of legal and regulatory requirement**

| | Value | df | Asymp. Sig. (2-sided) | Exact Sig. (2-sided) | Exact Sig. (1-sided) |
|---|---|---|---|---|---|
| Pearson Chi-Square | .385[a] | 1 | .535 | | |
| Continuity Correction[b] | .129 | 1 | .719 | | |
| Likelihood Ratio | .386 | 1 | .535 | | |
| Fisher's Exact Test | | | | .606 | .360 |
| Linear-by-Linear Association | .379 | 1 | .538 | | |
| N of Valid Cases | 59 | | | | |

Computed only for a 2x2 table, 0 cells (.0%) have expected count less than 5. The minimum expected count is 10.35.

The respondents who consider absence of explicit law related to reinsurance as a barrier for reinsurance transaction anchor their stance on a number of reasons. Main reasons include: it doesn't allow working effectively; it affects the speed of transaction and it makes circumstances difficult to open Reinsurance Corporation (Table 7.4.9). On the other hand, the majority of respondents (82 percent) who said it isn't a barrier reported that they haven't encountered any practical problems due to absence of explicit law (Table 7.4.10). Furthermore, although few (four percent) in number, some respondents also believe that if there is explicit law, there would be operational problems. Hence, from the responses, it can be suggested that the management groups in general are still more or less vague of the provisions of reinsurance business and the merit and demerit of the legal framework. In general, the descriptive results show slight difference. However, the inferential statistic shows the perception of the management groups whether the absence of the regulations is a barrier is statistically insignificant. The qualitative result indicates the managements are vague of the importance and impacts of reinsurance regulations to the industry and to the country.

In summary, though three of the descriptive analyses results show some degree of difference between the top and the middle management, all the inferential statistics show statistically insignificant perception difference regarding reinsurance regulations. The qualitative analyses results reveal not only the industry is without clear-cut procedures and directives that are consistent and transparent to all the stakeholders, but a good number of respondents from both the managements groups are not aware of the merits and demerits of the reinsurance business regulations and the impact thereof. This implies that the firms in the industry are intuitively operating the way they perceive issues. This, in consequence, communicates that there is awareness gap in the industry about reinsurance regulations. This in turn shows that the management may not be aware of the international business features. The awareness gap in the industry about reinsurance regulations induce the country to continue to transact in the international business without appropriate legal environment.

## 5.4 Summary

This chapter presented the results of the research questions under three main headings, from the Ethiopian perspective, namely: The Cross-Border Reinsurance Business and the Insurance Industry, Insurance Industry and Economic Growth and Reinsurance Business and Regulatory Requirements of the Ethiopian Insurance Industry.

As far as the relationship of the cross border reinsurance business and the insurance industry and the economy in the Ethiopian perspective is concerned; the relationships between the net premium and net ceded premium shows positive correlation. This communicates that the cross border reinsurance has positive influence on the insurance industry. However, the net premium (retention) decreases over time, while the NCP increases when compared in relation to the size of the gross premium. This shows that the cross border business does have a negative influence over the insurance industry. Similarly, the results, of the analysis of relationship between net ceded premium and the net ceded claim and between the insurance claims incurred and the net ceded claim show an overwhelm of the outflow of hard currency over the inflow. This perspective shows that the deterioration of foreign currency holdings deterioration and high deficit of the balance of payment. Hence, as far as the financial transaction is concerned, cross-border reinsurance affects negatively the insurance industry and the economy.

With regard to the Ethiopian insurance industry and economic growth relationships: the analyses results show that the insurance industry is contributing little to economic growth and to the financial sector. This, in turn, implies that the Ethiopian insurance industry is meager and less capable of upholding the economy and the finance sector from potential risks.

Analyzing the reinsurance business regulatory requirements and the Ethiopian insurance industry; the study find out that no statistically significant knowledge gap between the management groups of the insurance industry with respect to reinsurance regulations. This implies that the top management has no better understanding about the regulations than the middle. This, in turn, indicates that the perception problem persists in both the management levels that make the matter worst. In effect, the middle management is not facing problems in transacting in the international business. The qualitative results show that firms in the industry deal with the reinsurance business in disintegrated and inconsistent manner and the way every company wishes and faces problems. This is a sign as to why the industry refrained from integrating the new system for a number of years despite all the benefits from having the regulation.

The next chapter discusses the results presented in chapter five against various theories and empirical results of other studies. Moreover, the ensuing chapter presents conclusions and recommendations of the study.

# CHAPTER SIX
# DISCUSSION, CONCLUSIONS AND RECOMMENDATIONS

## 6.1 Introduction

In chapter five, the outcomes of the different research questions were reported. This chapter is dedicated to discussion, conclusion and recommendations of the study. The findings pertaining to each of the research questions of the study are presented and discussed in the ensuing sections of the chapter, with reference to the underlying theories and other relevant empirical studies. The study results are based on the analyses made on the financial transactions of the Ethiopian insurance industry and regulations of the reinsurance business from the perspectives of Ethiopian insurance industry.

## 6.2 Discussion of Results

Discussions on the results are provided below under three major themes: (i) the cross border reinsurance business and its influence on the insurance industry and the economy, (ii) the insurance industry and economic growth of the country, and (iii) the reinsurance business regulatory requirements and the insurance industry.

### 6.2.1 The Cross-Border Reinsurance Business and the Influence on the Ethiopian Insurance Industry and the Economy

Over the last six years (2004-2009), the Ethiopian economy has been growing remarkably, and consequently registers an overall economic performance of 11.5% on average measured by growth in real Gross Domestic Product (GDP). These economic performance indicators show that the economy is not only growing but also becoming diversified in terms of mix, complexity and degree of monetization MoFED, 2010). Developing countries including Ethiopia, to come out of the trap of poverty, backwardness, and risks of natural disasters like drought, are required to invest in long term investments like dams, electric powers, industries, and IT technologies (Todaro and Smith 2009).This ultimately needs to have a strong financial sector in general and an efficient, sound and a well performing insurance industry in particular (Ahmed, et al., 2006). Besides, Ethiopia has pronounced overall and sectorial policies and strategies of economic growth rigorous efforts have been exerted for the industrial development to be guided by export-oriented industrialization and import substitution strategies since 2003 (MoTI, 2002 and MoFED, 2002, 2006). The strategies are aimed at strengthening foreign exchange holdings, capitalization and through international business competitiveness. The Ethiopian insurance industry is, however, entirely dependent on cross border reinsures. Some literature, (UNCTAD, 2007 and Wang, 2003) underline that extensive dependency on cross border reinsurance business, not only adversely affects the competitiveness of the industry, but also aggravates balance of payment deficit and shortage of foreign currency holdings, among others. The study therefore, examines the influence of the cross-border reinsurance business on the Ethiopian insurance industry and on the economy.

### A. The Relationship between Cross-Border Reinsurance and the Local Insurance Industry

Various literature underscore the importance of cross border reinsurance business for the sustainability and growth of the domestic insurance industry. In this respect, findings by Meir and Utreville (2003) underline that cross border reinsurance avail financial leverage and capacity to boost the underwriting revenue of the primary insurer. In contrast, other literature claim that cross border reinsurance business entails negative influence over the local insurance industry. For example, Cummins, et al., (2008) and Wang (2003) underscore that reinsurance increases significantly the reinsured costs of producing insurance and ultimately reduces the underwriting premium and the retention (net premium). Provided that the Ethiopian insurance industry has been long dependent entirely on cross border reinsurance business, the study considered the analysis of the relationship between the cross border reinsurance and the insurance industry, through two variables: Net Premium (NP) and Net Ceded Premium (NCP).

The result shows positive correlation, indicating that cross border reinsurance has positive influence on the insurance industry. It means that the cross border increases the underwriting revenue and retention. However, when the NP and NCP are compared in terms of their relative size and time covered the NP decreases over time, while the NCP increases. This shows that the cross border business does have a negative influence over the insurance industry. The results further imply that excessive dependency on cross border reinsurance can create financial pressure on the local insurance industries due to various factors, including foreign exchange and competition, besides the benefits that can be gained from cross border reinsurance. In this regard, UNCTAD (1980 and 1987) underline the negative impact due to excessive recourse to foreign reinsurance. This is supported by the findings of Wang (2003). Wang claims, full cross border reinsurance like any import business requires foreign currency that may increase costs of insurance service products (ultimately harm the underwriting premium) and contributes to the deterioration of foreign currency holdings and imbalance of trade. The later are persistent challenges in developing countries. However, cross border reinsurance business has advantages of boosting underwriting revenue of the primary insurer.

To summarize, cross border reinsurance business has the benefits of boosting the underwriting revenue through financial leveraging and availing foreign currency. Yet, when the dependency becomes excessive, it affects the industry negatively. Hence balancing the two extremes is an appropriate measure. This, in return, requires skilled management and competitive management systems.

### B. The Relationship between Cross Border Reinsurance and the Economy

Similarly, some literature propose the importance of cross border reinsurance for the sustainability of the insurance industry and economic growth of developing countries by way of availing capital and foreign exchange, among others. Outeville (2002) for example, underscores that cross-border reinsurances provide financial leverage and also avails foreign exchange, in times of claims and through strengthening the sustainability of insurance industry and economic growth of developing countries.

On the contrary other literature emphasizes the disadvantage of cross border reinsurance on the developing countries and the economy. For example, Irukwu (1987) claims cross border reinsurance requires foreign currency and as a result contributes to the deterioration of foreign currency holdings and causes imbalance of payments. Likewise, UNCTAD (1980) highlights developing countries concern about cost in foreign currency and the negative impact due to foreign insurers. According to Wang (2003), many developing countries have been striving to establish their own reinsurance companies to minimize their reliance on foreign reinsurance and improve their hard currency holdings.

Thus, to identify the impact of the cross border reinsurance on the Ethiopian economy, the study analyzed the relationship between the Ethiopian insurance industry and the cross border through three indicators: Net Ceded Premium (NCP), Net ceded Claims (NCC) and Net Claims Incurred (NCI). The NCP represents the outflow, NCC is the inflow in time of claims, and the NCI is the insurance coverage made by insurers to the policy holders.

The result of the relationship analysis between net ceded premium and the net ceded claim shows overwhelm of the outflow over the inflow over the period under study. Rationally, the relationship between the ceded premium outflow and net ceded claim (inflow) should have a linear (proportionate) relationship, though it is difficult to expect a one to one relationship. Similarly, the outcome of the relationship analysis between net claim incurred and net ceded claim (recovery from reinsurers) indicates that, the net ceded claim is much lower than the net claims incurred to policy holders over the study period. This reflects the fact that insurance claims by policy holders are not commensurately or proportionally supported by the cross border reinsurers.

In summary, the results are in sharp contrast to the general principle of reinsurance: the higher the premium ceded, the higher is the risk transferred, and the higher is the ceded claimed or recovered (The Chartered Insurance Institute, 2004). In both cases, the results indicate that the rate of hard currency outflow due to cross border reinsurance is growing over time disproportionately. This, in turn, shows that the country's foreign currency holdings and balance of payment is being affected negatively, due to the cross border reinsurance business. Thus, the result of the study implies that both the net ceded premium and net insurance claim incurred is persistently growing for the period under study, without or little change on the corresponding net ceded claim. Hence, as far as the financial transaction is concerned, cross-border reinsurance affects negatively the insurance industry and the economy. If the phenomena persist, it inevitably precludes the local industry from improvement and growth, and ultimately adversely affects the economy.

The results correspond with other findings in literature related to the insurance industries of developing countries. For example, Holzheu & Lechner (2005) indicate that developing countries cede a big percentage of the underwriting income (premium) to the cross border market, indicating more hard currency flights. However, other literature are optimistic about developing countries improvements in this regard. UNCTAD (2007) empirically argues that insurance industries in developing countries in general and in African continent in particular are performing reasonably well in conserving resources, reducing outgoing reinsurance premiums and at difficult times providing reinsurance cover to small-country insurance companies. By the same token, Zafu (2006) recommends developing countries to have domestic reinsurance companies, so that not only can retain some reinsurance market of the local markets but can also play a crucial role in strengthening the technical capability of the primary insurers, attracting foreign market as well as generating hard currency into the country. For example, with respect to the Ethiopian insurance industry, there is evidence of inward reinsurance transaction on a reciprocal basis with insurance companies operating in Afro-Asian context, minimize the hard currency outflow volume of the industry (Zeleke, 2007). Moreover Zafu and Alamrew (2006) highlight some glaring problems of the Ethiopian insurance industry. They indicate that a good number of insurance business classes in the Ethiopian insurance industry have experience of least loss ratio highest cession. They also recommend firms in the industry to retain reinsuring of low loss ratio business classes as it aggravates the increase in the premium ceded without correspondingly proportional increase in the ceded claim. Inappropriate reinsurance methods can also increase the volume of outflow higher than the growth in ceded claim. The problems raised and recommendations forwarded by Zafu and Alamrew (2006) may be some of the causes for overwhelm of the outflow over the inflow which must be addressed by the industry.

From the results and discussions above, it can be concluded that though cross border reinsurance has the benefits of boosting the underwriting revenue through financial leveraging and foreign currency avails. It negatively affects insurance industry and economies of developing countries unless excessive dependency is minimized and the business is managed properly. Hence, it requires balancing of the two extremes by which the optimal point for retention and cession rate can be attained (Outreville, 2002).

### 6.2.2 Insurance Industry and Economic Growth of Ethiopia

Many economic literature suggest a strong positive correlation between financial development and economic growth and insurance coverage. For example, according to UNCTAD (2007), a country's level of economic development and insurance coverage do have positive and strong correlation. Besides, the study by Outreville (1990) and Patrick, 1966) propose a strong positive correlation between the demand for insurance and the level of financial development and economic growth. Similarly, as to the study by UNCTAD (2007), insurance markets grow faster than national income and for emerging market economies insurance has been growing by a multiple of three or four times than growth in the economy as a whole.

Others, for example, UNCTAD (2007) also underline that extensive dependency on cross border reinsurance has a negative impact on the contribution of the industry to the national development. The Ethiopian economy is growing remarkably. On the other hand, the Ethiopian insurance industry is exclusively dependent on cross border reinsurance.

In light of these premises, therefore, the study has analyzed whether the Ethiopian insurance industry is growing in line with the economic development of the country. The study analyses on the relationship between (i) the growth of the insurance industry and the economy, (ii) the growth of the insurance industry and the financial sector, and (iii) performance of the financial sector and the economy. Moreover, the study used insurance penetration ratio and insurance density to measure the performance of the Ethiopian insurance industry.

The result shows little relationship during the period under study. The GDP grows at an increasing rate while the insurance industry (GP) remains almost stagnant over the study period. This implies that the insurance industry is not growing in line with the growth of the Ethiopian economy. Similarly, the study result shows little correlation between the growth of the insurance industry (GP) and the financial sector (M2) over the entire study period. It shows that the financial sector grows steadily and fast while the insurance industry moves in sluggish pace witnessing some changes, very little improvement attained over the last few years particularly which the study covers. The result implies that the industry contributes little to the growth of the financial sector of Ethiopia. On the other hand, the study finds positive association between the growth of the financial sector (M2) and the economy (GDP). The GDP has grown consistently at an increasing rate, while the financial sector is only moderately, especially since 2002. It still lags behind the growth of the GDP. This shows the contribution of the financial sector to the economic growth is being affected by low performance of the insurance industry as confirmed from the results of the relationship analysis between GP with GDP and M2. The contribution of the finance sector to the GDP can be credited mainly to the performance of the banks.

Moreover, it is found that GP to GDP ratio (penetration index) of the industry is below one percent. The insurance density is around USD one per capita. Surprisingly, penetration rate of the industry is continually decreasing from year to year. It was 0.6% at the end of 2000 and it went down to 0.4% at the end of 2009. Study by UNCTAD (2007), in relation to insurance penetration rate of the African countries, disclosed that the Ethiopian insurance industry is among the lowest in the world and African countries in terms of the three measures namely: Insurance premium market share, market penetration rate and insurance density (per capita insurance premium). According to UNCTAD, 2007), Ethiopia stood $18^{th}$ in terms of gross premium and growth penetration at the end of 2004 out of African 43 countries.

Taken together the results above, therefore, one can deduce that the insurance industry contributes very little to the growth of the Ethiopian economy in general. In other words, the results show growth of the Ethiopian insurance industry little in line with the pace of economic growth. This clearly indicates that the Ethiopian insurance industry contributes little. The industry is not growing in pace of the economic development. Hence, the performance assessment of Ethiopian insurance industry under the study period reveals that the industry is dwindling instead of playing a leading role in the economic development. This, in turn, indicates that the industry is meager and less capable of upholding the economy and the finance sector from potential risks. The results therefore, imply that the performance of the industry during the study period was, not only the low but also contrary to the theories and empirical results of some of the studies. For example, studies by UNCTAD (2007) in the year 2004, overall insurance penetration (GP to GDP growth rate) for the emerging (developing) countries was around 4 per cent. In terms of insurance density the average premium per capita for Africa was $43.4 in the same year. In both cases, these are extremely incomparable with the performance of the Ethiopian insurance industry.

Thus, results of the Ethiopian insurance industry performance under the study period, compared with the findings of other literature, have indicated that it is lagging behind instead of playing a leading role in the economic development of the country. The entire dependency of the industry on cross border reinsurance may be raised as an argument for its weak performance. The previous results presented in section 6.2.1 of the chapter have shown the negative influence of the cross border reinsurance on the industry. Obviously, as far as the financial transaction is concerned, cross-border reinsurance affects negatively the insurance industry and the economy. It is believed that the cross border reinsurance business can have its own negative contribution to the insurance industry and to the national economy. But it is difficult to assert, at this juncture and relate the problems of the insurance industry to the cross border reinsurance business and to the financial transactions only. Cross border reinsurance business product services other than financial leverage and availing foreign exchange, such as professional expertise and knowledge transfer has to be assessed. Besides, the influence of the cross border, however, there are still other weaknesses raised about the Ethiopian insurance industry. These weaknesses rather focus on the internal capacity and macro environment of the industry. To name a few, inefficiency, stagnancy, and lack of dynamism in the industry. For example, Zeleke (2007) claims that the insurance industry in Ethiopia, despite its relatively long history in the economy, has failed to adequately support the latter. According to this author, national competitiveness can only be enhanced when there are vigorous domestic inter-industry and intra-industry competition and when the government plays its role in creating an enabling environment. In relation to the macro environment, Zeleke also highlights that the government policies and strategies that have been put in place during the last one decade such as “Sustainable Development and Poverty Reduction Program (SDPRP)” and “Plan for Accelerated and Sustained Development to End Poverty (PASDEP)”, even have paid little attention to the industry.

### 6.2.3 Reinsurance Business Regulatory Requirements and the Ethiopian Insurance Industry

Much Literature pronounces the importance of insurance legislations to protect the public and maintain the integrity and reliability of the finance sector. UNCTAD (2007) underlines, financial services are probably the most heavily regulated sectors in most economies. UNCTAD (2007) and Wang (2003) emphasize the development of appropriate regulatory frameworks regarding reinsurance business, is crucial for the stability of both the insurance and reinsurance market. In many countries that have already set out regulatory framework for reinsurance, the basic provision on control and regulation related to reinsurance include (a) requirements for reinsurance transaction and reinsurance arrangements; (b) issues of directions regarding reinsurance treaties, and volume and limit of ceded for approval and selection of reinsurance mate; and (c) establishment of reinsurance company and citizenship of insurance managers (UNCTAD, 1980 and 2007; Irukwu, 1987 and Wang, 2003).

Despite the legal and economic significance of such regulations, the Ethiopian insurance proclamation, “Licensing and Supervision of Insurance Proclamation No. 86/1994” has postponed it. According to Zeleke (2007), many in the industry are awaiting for reinsurance business regulations. However, no such directives or a detailed guideline related to “the manner in which reinsurance business may be transacted in Ethiopia” has been issued. Whereas on the other hand, Zafu (2006) underlines that the country is transacting in millions of Dollars in reinsurance business every year without problems. These different views indicate that the Ethiopian insurance has been in the reinsurance business for a number of years, not only without the regulations but also with perception differences about it. To assess the prevalence of the awareness gap and its extent and capture the prevailing practice of the Ethiopian insurance industry in the reinsurance business, a sample of middle and top managers in the insurance industry were asked various tailored questions.

The inferential statistics results of the analyses show dearth of awareness differences between the management groups of the insurance industry regarding reinsurance business regulations. This implies that the top and the middle management not only have awareness gap but also perception problem persists in both levels that make difficult to address the regulatory aspects of the reinsurance business and insight its effects to the industry. This is contrary to the expectation that top managers (being architect of their company policy) have better understanding of the legal environment than middle managers. The nature of responsibilities at the two ranks of management is different. Whereas top managers devise and implement strategies and policies, and direct the overall operations of the insurance businesses, middle managers are highly involved in day-to-day operations. As a result, the Ethiopian insurance industry is still continuing without introducing the reinsurance business regulations, regardless of the crucial benefits it provides with.

As discussed in the previous chapter, descriptive results of the respondents in the survey also confirmed that there exists no regulation concerning various aspects (such as terms and conditions, reinsurance methods, reinsurance commission, dispute resolution, amount of cession and premium due) of the reinsurance business. The respondents reported to use negotiations, treaty agreement and international standards as the most common mechanisms of managing transactions. Results of qualitative analyses show inconsistent responses among the managements for different but basically the same concept questions. Some of the responses were also fragmented and inconsistent. The problem persists in both management levels. That is, this outcome hints that different management groups and individuals do not share a common understanding and wavelength.

In general, firms in the industry do not have clear cut procedures and directives, transparent to all the stakeholders and can guide them to transact with their counterparts. Each company operates in its own way and the way it faces problems. Any insurance company of the Ethiopian insurance industry to transact with reinsurance companies doesn’t need to obtain prior authorization from the Supervising Authority.

In summary, despite all these, the management of the industry, in particular the top management has no significant awareness difference about the reinsurance business regulations. The top management (corporate management lacks knowledge about the reinsurance business regulations and the impact thereof. Their management in the reinsurance industry is limited in scope and their decision is driven by precedents and past experience. This is a sign of inefficiency. As a result, decision making (top management) needs consultation and can take, quite a while. The problem of the absence of the regulation has been long rooted in the industry. For example, Alamirew (2006) appeals that the industry has been transacting for the last thirty years or so, freely (without any regulations) with cross border reinsurers and reinsurers have no difficulty in getting remittances timely.

Literature, however, underscored that many developing countries, are concerned about regulations, not only for the protection of local insurance and reinsurance from foreign competition but also to avoid unnecessary loss of foreign exchange through the purchase of reinsurance from cross border companies. For instance, in Mexico, direct insurance companies are required to reinsure at least 50 % of the surplus in the local reinsurer. The law also prohibits primary writing companies from reinsuring with cross border reinsurers. Moreover, they are required to place excess of their retention or to cede a stipulated portion of each risk. In countries like Kenya, Nigeria, Iraq, Pakistan, Turkey, and many others, reinsurance treaties have to be submitted to the supervisory authorities for approval before they are concluded (UNCTAD, 1980).
In line with these concepts and practices on the ground, therefore, the regulations of the reinsurance business should not be postponed. In most of the local literature, which this study accessed, many seek to see the regulation, for one purpose, to have a local reinsurance company. Most disregards the macro-economic issues of the reinsurance business that must be addressed. Of course, a provision in relation to establishment of a company is admittedly one of the many aspects of the reinsurance business as explained in various literature.

An issue that may need close examination is whether to have a comprehensive Act that includes both the insurance and reinsurance or to have a separate act for each of the underwriting and reinsurance business. There are various international practices in this regard. For example, countries in Latin America have codes and regulatory frameworks to insurance and most specific to reinsurance, though; in most, the general insurance codes may also apply to reinsurers (Leichtling and Pardes, 2005). On the other hand, a number of developing countries (including Kenya, Egypt, Nigeria and India) do have insurance regulations that include provisions of insurance and reinsurance (Irukwu, 1987). See practices of these and other countries in Table 7.5. Some countries that used to have separate acts are also updating to a single comprehensive one Act. Nigeria, for example, recently has adopted a new comprehensive law replacing the ones that had been independent for a number of years. Conducting a diagnostic review of the reinsurance business and learning from the experiences of other countries is central to choose which one is appropriate in the Ethiopian context.

## 6.3 Conclusions

Over the last years, Ethiopia has been registering commendable economic growth. The growth has been in all sectors of the economy. This increases the complexity and degree of monetization. Developing countries including Ethiopia, to alleviate problems emanating from poverty and backwardness are required to invest in long term investments. Ethiopia has formulated overall and sectorial policies and strategies of economic growth. Industrial development is envisaged to be guided by export-oriented industrialization and import substitution strategies since 2003. The strategies are aimed at strengthening foreign exchange holdings, capitalization and international business competitiveness. In spite of the continuous growth in the economy and country’s commitment and thrive for foreign exchange holdings and capitalization, the industry is still entirely dependent on cross border reinsurers.

This study has assesses the reinsurance business from the Ethiopian perspective. In particular, it aimed to capture the influence of the cross border reinsurance business on the Ethiopian insurance industry and the economy. The performance of the industry in relation to the Ethiopian’s economic growth, and if there is perception gap in the insurance industry regarding reinsurance business regulations, despite its absence are also touched upon.

The literature review provided theoretical basis and practices on the subject of the reinsurance business with a specified focus on the relationship of the cross border reinsurance business and the insurance industry and economy, insurance and economic growth, and regulations of the reinsurance business. Based on the literature, the problem statements, research design and research approaches were developed.

Both the primary and secondary data were utilized in the process of the analyses. The secondary data focused on the financial transactions both downstream and upper stream ones. The primary data is mainly related to the perception responses of the insurance industry management groups in relation to reinsurance business regulations. The study used both quantitative and qualitative techniques.

The overall result of the analysis of relationships between the cross border reinsurance and the insurance industry and the economy has shown that the cross border business does have a negative influence over the insurance industry and the economy. The outflow due to reinsurance business outweighs disproportionately the claim recovers from the reinsurers over the period under study. Cross-border reinsurance business affects negatively the insurance industry and the economy as far as the financial transaction is concerned. This sharply contrasts with the general principle that the higher the premium ceded the higher is the reinsurance coverage. Thus, the result shows that insurance industry that is entirely dependent on the cross border reinsurance is negatively influenced. Hence this implies balancing of the reinsurance business between extensively dependency and the gains from cross border reinsurers is required.

The analyses of relationships between Ethiopian insurance industry and economic growth show that the insurance industry is contributing little to the economic growth and to the financial sector, implying that the industry is meager and less capable of upholding the economy and the finance sector from potential risks. The result diverges from many empirical works which assert that the insurance industry is one of the pillars of the finance sector and plays a key role in the economic development of a country. This result, in turn, aligns to the theory stating that insurance industry that is excessively dependent on cross border reinsurance business is negatively affected its contribution to the national economy. However, to comprehend all about the industry other aspect of the cross border reinsurance business services such as, overseas of professional expertise and knowledge transfer has to be well addressed, which was not the scope of this study.

All the analyses whether there is perception differences between the insurance industry management groups in relation to reinsurance business regulatory framework show no significant perception difference occurs. This implies that there is awareness gap (low level of awareness) in the management regardless of the difference in managerial position and responsibility and accountability. This is contrary to the expectation that top managers (being architect of their company policy) have better understanding of the legal environment than middle managers. Hence, low level of awareness in the management regarding reinsurance business makes the industry to transact in the international business without appropriate reinsurance regulations.

In general, the outcomes of the study and the arguments presented by a number of theories and empirical studies show that the industry is lagging behind in terms of performance and awareness about international business features ,in particular in relation to cross border reinsurance business regulations. As a result, the insurance industry is playing little role in the economic development of the country, and not positioned itself to anchor the economy from potential risks. To conclude, linking all the results of the analyses implies that the industry's problem in relation to cross border reinsurance business emanates basically from lack of awareness of the features of cross border reinsurance business and the implications thereof by the industry. Moreover, there are indications from other literature sources, that there is little attention from the government side especially with issues related to policies and strategies formulated to address industry challenges. In addition, this study observes that all the insurance firms in the industry are not established for the very purpose of profit. It seems, rather they established for support of respective sister commercial banks. Now days, it is a common phenomenon in Ethiopia that whenever a bank is established, establishment of insurance firm resumes immediately. Such phenomena may have an impact in the insurance industry market environment, which requires thorough study.

## 6.4 Limitations of the Study

The scope of this study is on the cross border reinsurance business of the industry and more specifically to the financial transactions and regulatory issues. Others, such as, overseas professional expertise and knowledge transfer cross border reinsurance benefits were not part of this study. As the study has only considered the non life insurance sector of the industry, the life insurance performance data is not included in the analysis. The data is limited to a panel of ten years insurance financial transactions of nine insurance companies. The study did not compare the results with the same data set of other developing countries. Besides, the study data is limited to the insurance companies and the supervising authority only. In addition, for a comprehensive picture about the insurance industry, it would have been more valuable to assess performance of the industry in the context of international market.

## 6.5 Recommendations and Policy Implications

The outcomes of this study, combined with theories and other empirical studies show that the Ethiopian insurance industry is far behind. As a result, the industry is strained from playing its crucial roles in the development of the economy. The problem of the industry in relation to reinsurance business generally emanates from lack of awareness of the cross border reinsurance business and the rules of the game basically concerning legal and regulatory issues. So, from the reinsurance perspective, the industry requires compressive strategies that enable competitiveness in the global or international insurance business arena. Moreover, the direction of the insurance/reinsurance business should be integrated with the country's development strategies.

However, there are literature that show the Ethiopian insurance industry is also in a situation of stagnation in the local market. Hence a market that is not performing competitively internally could not be successful at the global market arena. Hence, generally, the industry seems lacking of direction and guidelines as to how to go side by side with the country's economic development and international competitiveness. Streamlining of strategic directions is a prerequisite in the industry. Therefore, revitalization of the industry is important and timely. This study presents two sets of recommendations: government specific and industry related.

**Government specific:**

Ethiopia needs to review the current insurance proclamation and amend "No.86/1994, in harmony with international practice. In particular, the updated proclamation should include codes and regulatory frameworks specific to the reinsurance business, and set up the necessary regulatory and supervisory instruments and structures, that can effectively regulate the insurance industry.

The government has to set policies, directives and strategies for the enhancement of the industry as has been done to the other sectors of the economy:

- Developing scheme for skilled human resource development of the required capacity for large and complex risks assessments and leveraging technical expertise that can also be used for self employment.
- Developing strategy plan which can lead the industry to be competitive in the local and global market and policies in line with local culture and traditions, and insurance infrastructures for successful insurance penetration. According to various studies, Ethiopia is among the developing countries that are characterized by low culture and attitude towards insurance and low infrastructure and environment for the creation of awareness.
- Directives by which the outflow premium can be minimized and inflows can increase must be set. These may include strengthening the industry and motivating the investment in national reinsurance.
- Continuous awareness creation on policies, strategies and regulatory issues must be given to the managements at the industry.

**Insurance industry specific:**

The insurance companies must develop strategies that enable them to work cooperatively at the industry level to develop the local market and operate in the reinsurance business competitively. Currently, Ethiopia is the lowest insurance per capita country in the world. This shows that the industry has huge market potential for all the companies.

The industry should develop intra-industry awareness about the features of the reinsurance business, the regulations required to operate competitively in the reinsurance business. In this regard, the insurance companies in the industry must strengthen their respective human and capital capacity to be competitive in the global market. In this regard the top management must be the preemptive about the strategic and corporate strategies. The study result has clearly shown that the management in the reinsurance industry is limited in scope. Decisions are driven by precedents and past experience. Hence, continuous consultative and capacity building in the area of strategies and regulations is important.

The companies must automate their respective operations and hence develop insurance management software services for use domestically and globally such as website for insurance development marketing promotion, for insurance activities (such as claim settlements and actuarial services and risk assessment). This enables companies to have strong negotiation capacity with counterpart reinsurers.

The industry must in addition give due attention to standardized database and information exchange systems. Having an information exchange system can help the industry to control duplicate insurance, defaulters; moral and ethical issues .Such systems would also enhance better understanding and co-operation among insurers.

The industry should work in a coordinated manner and in harmony to expand the business not only in the non-life insurance but also in the life insurance. Life insurance normally does not entail large reinsurance premiums and is instrumental in promoting investment savings. These may include building up niche areas of services, such as insurance services aligned to health services, work men compensation, and others like family insurance schemes.

Firms in the insurance industry should give due attention to transacts inward (import the service of reinsurance) with cross border reinsurers and minimize the hard currency outflow of the industry and the country. This may include:

- Outsourcing and off-shoring insurance queries, marketing and claim settlements, such as actuarial and risk assessment service.
- Striving for insurance services abroad particularly in neighboring countries, which are in need.

The industry should take an initiative to collaborate the stakeholders in the finance sector and study the cost and benefits of having a national reinsurance. Establishing insurance firms' association and forums can also help the industry to discuss common problems and take it up to the regulatory and government bodies.

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## ANNEXURE

### Table 7.1 Non-life Underwriting Premium during 2000-2009 ('000 ETB)

| Company | Non life insurance business products | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Aviation | Engin eering | Fire | Liability | Marine | Motor | Accident & Health | Pecuniary | Work men' Compens ation | Others |
| a | 565,911 | 301,942 | 340,729 | 16,609 | 659,154 | 1,043,674 | 251,335 | 72,010 | 110,651 | 28,336 |
| b | | 29,084 | 47,436 | 2,740 | 92,563 | 347,685 | 15,392 | 58,068 | 13,963 | 873 |
| c | - | 1,483 | 5,339 | 412 | 35,768 | 44,297 | 819 | 6,403 | 2,159 | - |
| d | 4,368 | 26,966 | 38,890 | 7,988 | 106,637 | 430,287 | 20,154 | 73,160 | 22,518 | - |
| e | 1,878 | 12,167 | 18,579 | 10,858 | 56,751 | 186,530 | 18,093 | 21,594 | 2,412 | 31,166 |
| f | - | 61,133 | 44,634 | 13,027 | 68,262 | 371,249 | 14,007 | 74,177 | 28,299 | 29 |
| g | - | 32,574 | 19,080 | 6,108 | 45,544 | 186,854 | 27,096 | 90,695 | 11,359 | - |
| h | 29,504 | 48,907 | 46,398 | 9,997 | 72,935 | 318,513 | 48,286 | 34,107 | 36,252 | 4,310 |
| i | 572 | 65,511 | 31,016 | 1,777 | 53,299 | 311,350 | 19,367 | 75,236 | 16,252 | - |
| Total | 602,233 | 579,767 | 539,928 | 67,050 | 1,190,913 | 2,792,347 | 414,549 | 374,797 | 243,865 | 60,835 |
| Share in % | 8.8 | 8.4 | 7.9 | 1.0 | 17.3 | 40.7 | 6.0 | 5.5 | 3.6 | 0.9 |

Source: NBE

## Table 7.2 The Performance of Ethiopian Insurance Industry (ETB)

| Year | Gross Premium (''million) | Net premium ('million) | Ceded premium (million) | M2 | GDP | share of GP to GDP (%) | Share of GP to M2 (%) | Share of M2 to GDP (%) | Population in million | Insurance Density ETB |
|---|---|---|---|---|---|---|---|---|---|---|
| **2000** | **420** | **323** | **97** | 22,178 | 66,648 | 0.6 | 1.9 | 33.3 | 60.0 | 7.0 |
| **2001** | 450 | 331 | 96 | 24,516 | 68,027 | 0.7 | 1.8 | 36.0 | 61.6 | 7.3 |
| **2002** | 554 | 356 | 111 | 27,322 | 66,557 | 0.8 | 2.0 | 41.1 | 63.2 | 8.8 |
| **2003** | 556 | 386 | 203 | 30,090 | 73,432 | 0.8 | 1.8 | 41.0 | 64.8 | 8.6 |
| **2004** | 568 | 403 | 155 | 34,656 | 86,661 | 0.7 | 1.6 | 40.0 | 66.5 | 8.5 |
| **2005** | 640 | 456 | 159 | 40,212 | 106,473 | 0.6 | 1.6 | 37.8 | 68.3 | 9.4 |
| **2006** | 797 | 552 | 194 | 46,377 | 131,641 | 0.6 | 1.7 | 35.2 | 70.0 | 11.4 |
| **2007** | 1,003 | 714 | 242 | 56,652 | 171,989 | 0.6 | 1.8 | 32.9 | 72.4 | 13.9 |
| **2008** | 1,174 | 832 | 323 | 68,182 | 248,605 | 0.5 | 1.7 | 27.4 | 74.9 | 15.7 |
| **2009** | 1,341 | 928 | 351 | 82,510 | 336,106 | 0.4 | 1.6 | 24.5 | 76.8 | 17.5 |
| **Total** | **7,503** | **5,281** | **1,931** | **432,695** | **1,356,140** | | | | | |

Continued…

| Year | Gross Premium (GP) | Net Premium (NP) | NP as percentage of GP | Net Ceded Premium (NCP) | NCP as percentage of GP |
|---|---|---|---|---|---|
| **2000** | 420 | 323 | 77 | 97 | 23 |
| **2001** | 450 | 331 | 74 | 96 | 21 |
| **2002** | 554 | 356 | 64 | 111 | 20 |
| **2003** | 556 | 386 | 69 | 203 | 37 |
| **2004** | 568 | 403 | 71 | 155 | 27 |
| **2005** | 640 | 456 | 71 | 159 | 25 |
| **2006** | 797 | 552 | 69 | 194 | 24 |
| **2007** | 1003 | 714 | 71 | 242 | 24 |
| **2008** | 1174 | 832 | 71 | 323 | 28 |
| **2009** | 1341 | 928 | 69 | 351 | 26 |
| **Total** | **7503** | **5281** | | **1931** | |

Source: NBE

**Table 7.3 Perceptions Regarding Reinsurance Business Regulations**

| Variables | Cross Tab | | | | | |
|---|---|---|---|---|---|---|
| | Position of Respondents | Frequency (n) | | | Percent | |
| | | Yes | No | Total | Yes | No |
| I. Whether there are Regulation Regarding | | | | | | |
| • Terms and Conditions | Top Management | 10 | 18 | 28 | 35.7 | 64.3 |
| | Middle Management | 11 | 14 | 25 | 44.0 | 56.0 |
| | Total | 21 | 32 | 53 | 40 | 60 |
| • Reinsurance Methods | Top Management | 8 | 20 | 28 | 28.6 | 71.4 |
| | Middle Management | 4 | 21 | 25 | 16.0 | 84.0 |
| | Total | 12 | 41 | 53 | 23 | 77 |
| • Amount of cession | Top Management | 6 | 22 | 28 | 21.4 | 78.6 |
| | Middle Management | 6 | 19 | 25 | 24.0 | 76.0 |
| | Total | 12 | 41 | 53 | 23 | 77 |
| • Reinsurance Commission | Top Management | 6 | 22 | 28 | 21.4 | 78.6 |
| | Middle Management | 4 | 21 | 25 | 16.0 | 84.0 |
| | Total | 10 | 43 | 53 | 19 | 81 |
| • Dispute Resolution | Top Management | 8 | 20 | 28 | 28.6 | 71.4 |
| | Middle Management | 6 | 18 | 24 | 25.0 | 75.0 |
| | Total | 14 | 38 | 52 | 27 | 73 |
| • Due Settlement | Top Management | 6 | 22 | 28 | 21.4 | 78.6 |
| | Middle Management | 6 | 19 | 25 | 24.0 | 76.0 |
| | Total | 12 | 41 | 53 | 23 | 77 |
| II. Whether “Licensing and Supervision of Insurance” Proc. No.86/1994 Provides adequate Provision regarding Reinsurance business | Top Management | 10 | 17 | 27 | 37.0 | 63.0 |
| | Middle Management | 12 | 12 | 24 | 50.0 | 50.0 |
| | Total | 22 | 29 | 51 | 43 | 57 |
| III. Whether the absence of legal and regulatory framework is barrier for Reinsurance business in Ethiopia | Top Management | 13 | 18 | 31 | 41.9 | 58.1 |
| | Middle Management | 14 | 14 | 28 | 50.0 | 50.0 |
| | Total | 27 | 32 | 59 | 46 | 54 |

## Table 7.4 Current Practices of Reinsurance Business (by Respondents)

**7.4.1 Mechanisms insurance companies use to manage transaction in the absence of law concerning terms and conditions of reinsurance**

| | Responses | Frequency | Percent | Valid Percent |
|---|---|---|---|---|
| Valid | negotiation | 9 | 13.6 | 30.0 |
| | commonly accepted standards | 3 | 4.5 | 10.0 |
| | treaty agreement | 9 | 13.6 | 30.0 |
| | company's decision | 7 | 10.6 | 23.3 |
| | follow the international standard | 1 | 1.5 | 3.3 |
| | market practice | 1 | 1.5 | 3.3 |
| | Sub -Total | 30 | 45.5 | 100.0 |
| Missing | don't know | 16 | 24.2 | |
| | not applicable | 20 | 30.3 | |
| | Sub -Total | 36 | 54.5 | |
| | Total | 66 | 100.0 | |

**7.4.2 Mechanisms insurance companies use to manage transaction in the absence of law concerning methods of reinsurance**

| | Responses | Frequency | Percent | Valid Percent |
|---|---|---|---|---|
| Valid | negotiation | 10 | 15.2 | 25.6 |
| | international standards | 9 | 13.6 | 23.1 |
| | treaty agreement | 7 | 10.6 | 17.9 |
| | company's decision | 8 | 12.1 | 20.5 |
| | follow ther international practice | 2 | 3.0 | 5.1 |
| | risk profile | 2 | 3.0 | 5.1 |
| | own capacity | 1 | 1.5 | 2.6 |
| | Sub- Total | 39 | 59.1 | 100.0 |
| Missing | don't know | 15 | 22.7 | |
| | not applicable | 12 | 18.2 | |
| | Sub -Total | 27 | 40.9 | |
| | Total | 66 | 100.0 | |

**7.4.3 Mechanisms insurance companies use to manage transaction in the absence of law concerning amount of cession**

| | Responses | Frequency | Percent | Valid Percent |
|---|---|---|---|---|
| Valid | negotiation | 7 | 10.6 | 17.9 |
| | commonly accepted standards | 5 | 7.6 | 12.8 |
| | treaty agreement | 11 | 16.7 | 28.2 |
| | international standards | 13 | 19.7 | 33.3 |
| | risk profile | 3 | 4.5 | 7.7 |
| | Sub- Total | 39 | 59.1 | 100.0 |
| Missing | don't know | 15 | 22.7 | |
| | not applicable | 12 | 18.2 | |
| | Sub -Total | 27 | 40.9 | |
| | Total | 66 | 100.0 | |

**7.4.4 Mechanisms insurance companies use to manage transaction in the absence of law concerning reinsurance commission**

| | Responses | Frequency | Percent | Valid Percent |
|---|---|---|---|---|
| Valid | negotiation | 23 | 34.8 | 56.1 |
| | commonly accepted standards | 3 | 4.5 | 7.3 |
| | treaty agreement | 9 | 13.6 | 22.0 |
| | company's decision | 4 | 6.1 | 9.8 |
| | international standards | 1 | 1.5 | 2.4 |
| | risk profile | 1 | 1.5 | 2.4 |
| Missing | Sub -Total | 41 | 62.1 | 100.0 |
| | don't know | 15 | 22.7 | |
| | not applicable | 10 | 15.2 | |
| | Sub -Total | 25 | 37.9 | |
| | Total | 66 | 100.0 | |

**7.4.5 Mechanisms insurance companies use to manage transaction in the absence of law concerning resolution of dispute**

| | Responses | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|---|
| Valid | negotiation | 4 | 6.1 | 11.4 | 11.4 |
| | commomly accepted standards | 3 | 4.5 | 8.6 | 20.0 |
| | treaty agreemnt | 14 | 21.2 | 40.0 | 60.0 |
| | company's decision | 3 | 4.5 | 8.6 | 68.6 |
| | court of arbitration | 11 | 16.7 | 31.4 | 100.0 |
| | Sub-Total | 35 | 53.0 | 100.0 | |
| Missing | dont know | 16 | 24.2 | | |
| | not applicable | 15 | 22.7 | | |
| | Sub-Total | 31 | 47.0 | | |
| | Total | 66 | 100.0 | | |

**7.4.6 Mechanisms insurance companies use to manage transaction in the absence of law concerning premium due settlement**

| | Responses | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|---|
| Valid | negotiations | 11 | 16.7 | 28.9 | 28.9 |
| | company's decision | 4 | 6.1 | 10.5 | 39.5 |
| | treaty agreement | 20 | 30.3 | 52.6 | 92.1 |
| | company's decision | 3 | 4.5 | 7.9 | 100.0 |
| | Sub-Total | 38 | 57.6 | 100.0 | |
| | don't know | 16 | 24.2 | | |
| Missing | not applicable | 12 | 18.2 | | |
| | Sub-Total | 28 | 42.4 | | |
| | Total | 66 | 100.0 | | |

**7.4.7 Distribution of responses on the question how is the insurance proclamation providing appropriate provision**

| | Responses | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|---|
| Valid | there is no such proclamation | 5 | 7.6 | 38.5 | 38.5 |
| | the proclamation is based on international standard | 2 | 3.0 | 15.4 | 53.8 |
| | Reinsurance is compulsory | 3 | 4.5 | 23.1 | 76.9 |
| | there is the law which is not properly applied | 1 | 1.5 | 7.7 | 84.6 |
| | it is in the commercial code | 2 | 3.0 | 15.4 | 100.0 |
| | Total | 13 | 19.7 | 100.0 | |
| Missing | don't know | 8 | 12.1 | | |
| | not applicable | 45 | 68.2 | | |
| | Total | 53 | 80.3 | | |
| | Total | 66 | 100.0 | | |

**7.4.8 Distribution of responses on the question why the insurance proclamation is not providing appropriate provision**

| | Responses | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|---|
| Valid | there is no such proclamation | 18 | 27.3 | 78.3 | 78.3 |
| | proclamation is based on international standard | 1 | 1.5 | 4.3 | 82.6 |
| | there is a workable background | 1 | 1.5 | 4.3 | 87.0 |
| | the law is concerned about insurance only | 2 | 3.0 | 8.7 | 95.7 |
| | shortage of awareness | 1 | 1.5 | 4.3 | 100.0 |
| | Total | 23 | 34.8 | 100.0 | |
| Missing | don’t know | 6 | 9.1 | | |
| | not applicable | 37 | 56.1 | | |
| | Total | 43 | 65.2 | | |
| | Total | 66 | 100.0 | | |

**7.4.9 Distribution of responses on the question why the absence of legal and regulatory requirement is a barrier for the reinsurance business**

| | Responses | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|---|
| Valid | absence of the proclamation doesn't allow us to work effectively | 3 | 4.5 | 13.0 | 13.0 |
| | we haven't faced any problem | 7 | 10.6 | 30.4 | 43.5 |
| | the law will make the transaction speedy | 7 | 10.6 | 30.4 | 73.9 |
| | difficult to open reinsurance company | 4 | 6.1 | 17.4 | 91.3 |
| | it is based on international law | 2 | 3.0 | 8.7 | 100.0 |
| | Total | 23 | 34.8 | 100.0 | |
| Missing | don't know | 4 | 6.1 | | |
| | not applicable | 39 | 59.1 | | |
| | Total | 43 | 65.2 | | |
| | Total | 66 | 100.0 | | |

**7.4.10 Distribution of responses on why is the absence of legal and regulatory requirement is not a barrier for the reinsurance business**

| | Responses | Frequency | Percent | Valid Percent | Cumulative Percent |
|---|---|---|---|---|---|
| Valid | absence of the proclamation doesn't allow us to work effectively | 2 | 3.0 | 7.1 | 7.1 |
| | we haven't faced any problem | 23 | 34.8 | 82.1 | 89.3 |
| | the law will make the transaction speedy | 1 | 1.5 | 3.6 | 92.9 |
| | the law doesn't allow to open reinsurance company | 1 | 1.5 | 3.6 | 96.4 |
| | it is based on international law | 1 | 1.5 | 3.6 | 100.0 |
| | Total | 28 | 42.4 | 100.0 | |
| Missing | don't know | 4 | 6.1 | | |
| | not applicable | 34 | 51.5 | | |
| | Total | 38 | 57.6 | | |
| | Total | 66 | 100.0 | | |

## Table 7.5 Sample of Insurance Legislations of some Developing Countries

| Country | Proc./Act. No | Act Description | some selected Insurance and Reinsurance related articles that stated in an insurance act of some developing countries and the authority of the supervising thereof. |
|---|---|---|---|
| Kenya | The Insurance Act, 1984 | Act of Parliament to Amend and consolidate the law relating to Insurance, and to regulate the Business of insurance, and for purposes incidental thereto and connected there with. | Part 3 Contains number of provisions on the Subject of Registration or Licensing of insurers, including:<br>• The conditions to be fulfilled before an insurer is registered and the requirements as to capital structure,<br>• The need for appropriate reinsurance arrangements,<br>• The composition of Boards and minimum assets for insurance companies.<br>Part 13 Deals with the Kenya Reinsurance Corporation which is described as the successor to the Kenya Reinsurance Corporation, its Board of Directors, their Tenure of office and remunerations.<br>Part 14 Deals with mandatory reinsurance cessions to the Kenya Reinsurance Corporation. |
| Nigeria | Insurance Act,2003 Act No. 1 27th May 2003 | An Act to provide a new Insurance Act, enacted by National Assembly of the Federal Republic of Nigeria. | Part 1:(5) Subject to this Act, an insurer may be authorized to transact any new category of miscellaneous insurance business if he shows evidence of adequate reinsurance …<br>Art. 6-1: The Commission shall before registering an insurer be satisfied that –<br>• ©. the arrangements relating to reinsurance treaties in respect of the class or category of insurance business to be transacted are adequate and valid.<br>• (m). in the case of reinsurance business, that in addition to the matters referred to in this section, it has complied with section 9 (i) (d) of this Act and any other conditions which may be specified from time to time by the Commission.<br>8. – (1) If, in the case of a registered insurer, the Commission is satisfied that<br>• (j). the insurer has failed to maintain adequate reinsurance arrangements and treaties in respect of the classes or category of insurance business the insurer is authorized to transact;…<br>9. – (1) No insurer shall carry on insurance business in Nigeria unless the insurer has and maintains, while carrying on that business, a paid-up share capital of…<br>• (d). for reinsurance business, not less than N350,000,000 |

| | | | |
|---|---|---|---|
| | | | 72. – (1) No person shall transact an insurance or reinsurance business with a foreign insurer or reinsurer in respect of any life, asset, interest or other properties in Nigeria businesses classified as domestic insurance unless with a company registered under this Act. (2) In subsection (1) of this section, “domestic insurance or reinsurance” business includes-<br>(a) fire insurance and reinsurance business;<br>(b) motor insurance and reinsurance business;<br>(c) liability insurance and reinsurance ;<br>(d) life insurance and reinsurance;<br>(e) accident insurance and reinsurance business; and<br>(f) such other insurance and reinsurance business as the Commission may from time to time prescribe.<br>The previous Acts were two independent acts that relates to:<br>Decree 1976 which regulates the business of insurance in the country<br>Decree No. 49 of 1977 which established the Nigeria Reinsurance transactions in the country |
| Morocco | Vizerial Order of 1941 | | There is a national Reinsurance Company, S.C.R. of Morocco, which obtains compulsory legal cessions of 10% of all direct business form all local insurance companies. |
| India | The Insurance act,1938 | An Act to consolidate and amend the law relating to the business of insurance.<br><br>As amended by insurance Amendment ACT, 2002 | 34F: The Power of the authority to specify, insurers not to renew, or not to enter into the contract with regard to terms and conditions of re- insurance treaty contract between the insurer and re-insurer incase found unfavorable to the insurer and detrimental to the public interest.<br>64VA: insurers’ reserve a sum equal to a percentage to be determined by regulations considering the amount of the direct business and re-insurance Cessions.<br>101A: Requirement: amount may be specified that insurer to re-insure with Indian reinsurers. The authority may also specify percentage of the sum to be reinsured on each policy (shall not exceed 30% of the sum assured on such policy and the % to be allocated among the Indian Re-insurers. The authoritative, may also specify the terms and conditions in respect of any re-insurer business to be transacted and be binding on Indian re-insurers and others. |
| Cameroon | Insurance Ordinance No. 85-3 of 31 st August,1985 | | All reinsurance transactions involving the transfer or retrocession of more than 50% of a risk abroad shall be subject to the prior approval of the supervisory authority, provided the transferor gives proof that it has exhausted the market capacity in Cameroon. All reinsurance agreements with foreign companies shall not involve the transfer of more |

| | | | |
|---|---|---|---|
| | | | than 50% of the premium. |
| Egypt | Act No. 10 of 1981 | Regulates insurance industry activities in Egypt. | All insurance must reinsure part of their direct insurance transactions with the Egyptian reinsurance Company.<br><br>Insurance and reinsurance companies must give priority to other Egyptian Companies when ceding facilitative reinsurance, the latter underwrite according to their capacities. |
| Ghana | Insurance Act 1965 (Act 288) | | The Country's leading insurer is the State Insurance Corporation of Ghana, While the only professional reinsurer in the country is the Ghana Reinsurance Organization (G.R.O)<br>As regards compulsory sessions, the law provides that in the case of non-life business, 20% of every policy shall be ceded to the Ghana Reinsurance<br><br>Organization, but there is no Provision for compulsory cessions of life business to the Ghana Reinsurance Organization. |
| Rwanda | Law nos. 20/75 of 20 June 1975, Law no 18 of 25 May 1982 | | Reinsurance treaties should first be approved by the Board of Directors of the company and then by Ministries of Commerce and Finance before they take effect. |
| Tunisia | Insurance Act of 1959 and 1961 | | 3.1 society Tunisienne d' Assurance et de Reassurance was created by the Ste in 1985. The country's national reinsurance company is the Tunis Re in which the state holds 10% of the Capital and with the insurance companies holding 47%. The Tunis Re does not receive obligatory cessions from the market, but generates 71% of its income locally. |

Source: a.THS INSURANCE ACT, 1938, India *Arrangement of Sections, www.irdaindia.org August 23 2010*

b. FEDERAL REPUBLIC OF NIGERIA OFFICIAL GAZETTE**, No. 37 Lagos - 30th June, 2003 Vol. 90** Government Notice No. 78 *www.**leadway.com/cms/uploads/insuranceact**.**pdf*** Dated August 23 2010

c. Insurance Law in Africa: Cases, Statutes and Principles by J.O. Irukwu, London 1987.

## 7.6 Definition of Financial Insurance terms

Net premium=gross premium-ceded premium

Net Ceded Premium=Gross premium – Retained Premium

Net Earned Premium=Net Premium +unearned premium provision (bought Forward)-unearned Premium carried forward

Net Claims Paid=Gross Claim-ceded Claim

Net Claims Incurred=Net Claims Paid +Outstanding Claims Carried Forward-Outstanding Claims Brought Forward

Net Claims Ceded=Net Claims Incurred-Retained Claims

**Table 7.7 List of Insurance Companies**

| No. | Name of Company | Establishment Date | Paid-Up Capital June 30,2010 (ETB) |
|---|---|---|---|
| 1 | Ethiopian Insurance Corporation | 1975 | 61 |
| 2 | National Insurance Company of Ethiopia | 23/09/94 | 14.3 |
| 3 | Awash Insurance Company S.C. | 1/10/1994 | 44.2 |
| 4 | United Insurance Company S.C. | 9/11/1994 | 46.9 |
| 5 | Africa Insurance Company S.C. | 22/12/1994 | 30 |
| 6 | Nile Insurance Company S.C. | 11/4/1995 | 44.5 |
| 7 | Nyala Insurance Company S.C. | 27/06/1995 | 35 |
| 8 | Global Insurance Company S.C. | 14/01/1997 | 20 |
| 9 | Nib Insurance Company S.C. | 2/5/2002 | 57 |
| 10 | Lion Insurance Company S.C. | 10/7/2007 | 18.7 |
| 11 | E-Life Insurance Company S.C. | 23/10/2008 | 4.7 |
| 12 | Oromia Insurance Company S.C. | 26/01/2009 | 28.1 |
| 13 | Abay Insurance Company S.C. | 26/07/2010 | 7.7 |

*As at September 24,2010*

## 7.8 Questionnaire

**Assessment of the Reinsurance Business in Developing Countries: the case of Ethiopia**

The questionnaire is prepared for the study entitled “An Assessment of the Reinsurance Business in Developing Countries: the Case of Ethiopia” .The purpose of the questionnaire is exclusively for research purpose. Your responses will be treated with extreme confidentiality. In fact all responses will be coded into numbers and no one will be individually identified. Only general, statistical and aggregate analyses will be performed on the data. Hence, there would be no way anyone can trace the results back to the responses of any individual respondent

1. Respondent’s code Number

2. Position of the respondent.

1 Top Management (General Manger, deputy general manager, department heads, director of insurance supervision, directorate principal insurance examiners e.t.c)

2 Middle Management (section Heads, Division heads, Senior Officers, Senior Supervisors, and Senior insurance examiners)

3 Others (specify)…………………………………………

3 which of the following purposes of reinsurance do the local insurance companies most often achieve from the cross border reinsurers (can be multiple)

3.1. Peace of mind and avoidance of risk

3.2. Financial Solvency

3.3 Increasing the market share(underwriting capacity)

3.4. Investment development

3.5 Staff development

3.6 Introducing new types of product (innovation)

4. In your opinion, what are the major disadvantages of being exclusively dependent on cross border reinsurer?

1. ……………………………………………………......................................
……………………………………………………………………………………
……………………………………………………………………………………
2.……………………………………………………………………………………
……………………………………………………………………………………
……………………………………………………………………………………
3.………………………………………………………………………………………
…………………………………………………………………………………………
……………………………………………………………………………

5. At what level of the company's organizational structure is the reinsurance business placed ?

1. at the department level
2. at division level
3. at section level
4. at expert (officer) level
5. Not at all
6. Others (specify)…………………………………………………………………

6. Do you think that the insurance industry needs a local reinsurer?

1. Yes 2.No

7. Consider the following statements about reinsurance in the Ethiopian insurance industry. Rate them on a scale of 1-(not serious) to 5– (extremely serious)

| | code |
|---|---|
| 7.1 Lack of adequate capacity to provide reinsurance service | |
| 7.2 The absence of legal and regulatory framework for the reinsures to function. | |
| 7.3 Lack of confidence by the local insurers to work with local reinsurers. | |
| 7.4.Capacity problems of the regulators | |
| 7.5 Others (specify)………………………………………………………………………… ………………………………………………………………………………… ………………………………………………………………………………… | |

8. Do you think that a local reinsurer can augment the progress of the country?

1. Yes 2.No

8.1 If Yes, How?

…………………………………………………………………………………………
…………………………………………………………………………………………
………………………………………………………………………………

9. How do you tackle the challenges from the reinsurers while negotiating a Reinsurance arrangement? (can be multiple)

1. Using the data base as a negotiating tool
2. Searching for alternative suppliers of reinsurance
3. Developing the Company's capability in analyzing risks
4. Others (specify)……………………………………………………………

10. Rate your reinsurer in terms of the five constructs or dimensions of service quality SEVQUAL( Tangibility, Reliability ,Responsiveness, Assurance and Empathy) at five point scale where 1=very poor, 5=excellent

| SEVQUAL | RATE |
|---|---|
| TANGIBILITY | |
| RELIABILITY | |
| RESPONSIVENESS | |
| ASSURANCE | |
| EMPAPTHY | |

11. In order of importance list the three most important factors that determine the amount of premium ceded.

1………………………………………………………......................................

…………………………………………………………………………………

…………………………………………………………………………………

2…………………………………………………………………………….

…………………………………………………………………………………

…………………………………………………………………………………

3………………………………………………………………………………….

……………………………………………………………………………………

………………………………………………………………………….

12 How do the insurance companies respond to currency devaluation?

(can be multiple) ☐

1. By increasing the underwriting premium
2. By utilizing own capital
3. By reducing the retention rate
4. By being selective in the class of business to be insured
5. Other (specify) ……………………………………………………………………

13. Do you think that the reinsurance commission and the services provided by the Reinsurer adequately compensates the ceded ☐ premium?

1. Yes 2.No

14. Which Classes of Business are more vulnerable to risk and hence need special reinsurance arrangement?

| Class of Business | Is it currently insured? 1.Yes 2.No | Should it be reinsured? 1.Yes 2.No | Rate the degree of vulnerability at five point scale where 1=very low 5=very high |
|---|---|---|---|
| Motor | | | |
| Engineering | | | |
| Marine | | | |
| Workmen's | | | |
| General Accident | | | |
| Fire | | | |
| Bonds | | | |
| Life Assurance | | | |
| Indemnities | | | |
| Aviation | | | |

15. Do you have a database to measure the following?

| | 1.Yes 2.No | Since when |
|---|---|---|
| Severity of loss(claims) | | |
| Frequency of claims | | |
| Claims Ceded | | |
| Ceded Premium | | |

16. Is there regulation(s) to effect the decision between the insurance firm and the reinsurers regarding the following?

| | 1.Yes 2.No | If No, how do you manage? |
|---|---|---|
| 16.1 Terms and Conditions | | |
| 16.2 Reinsurance Methods | | |
| 16.3 Amount of cession | | |
| 16.4 Reinsurance commission | | |
| 16.5 Dispute Resolution | | |
| 16.6 Premium due settlement | | |

17. Does the insurance proclamation (‘’licensing and supervision of insurance’’ no.86/1994) provide appropriate provisions for the insurance companies to transact reinsurance business? 1=yes, 2=no

17.1 Why?

…………………………………………………………………………………………………
…………………………………………………………………………………………………
………………………………………………………………………………………

18. Is the absence of a legal and regulatory requirement a barrier for the reinsurance transaction?

1. Yes 2.No

18.1Why?

……………………………………………………………...............................……………
…………………………………………………………………………………………
………………………………………………………………………………………………..

19. Does Reinsurance exasperate the trade deficit of the country?

1. Yes 2.No

19.1 Why?

…………………………………………………………………..............................

……………………………………………………………………………………

……………………………………………………………………………………

20. In your opinion what are the three most important measures that should be taken to foster the development of the insurance industry in Ethiopia?

1………………………………………………….......................................

……………………………………………………………………………………

……………………………………………………………………………………

2………………………………………………………………………………….

……………………………………………………………………………………

……………………………………………………………………………………

3………………………………………………………………………………………

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21. What are the present and future challenges of the insurance Industry?

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22. What are the gaps in relation to the regulatory framework of the reinsurance business? What needs to be done?

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23. What are the challenges of the local reinsures? And what areas should the local insurers concentrate?

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……………………………………………………………………………………………

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