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Insurance in emerging markets: focus on liability developments

3 Executive Summary

4 Introduction

5 Macroeconomic and insurance developments

15 Determinants of liability insurance

20 Liability insurance in emerging markets

22 Asia: liability premium growth accelerates

27 Latin America: steady growth, low penetration

30 Eastern Europe: EU integration drives growth

33 South Africa and Middle East: diverging liability trends

35 Liability outlook

40 Appendix

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Executive summary

Insurance business growth in emerging markets set to continue in the medium term.

Emerging markets continued to see strong insurance premium growth in 2004, with life and non-life insurance premiums climbing 7.5% and 8.9% in real terms, respectively, to a combined USD 372.2 billion. A supportive economic environment together with favourable changes in taxation and pension systems has helped to sustain the growth momentum. Growth is seen to continue in 2005, but at a slower pace. In the medium term, insurance business in emerging markets will continue to derive support from strong economic fundamentals including high savings rates, the further acceleration of household assets, large-scale infrastructure investment and the implementation of mandatory insurance in some markets. In this context, life insurance is expected to grow by 8%, non-life by 5% yearly between 2005 and 2010, in real terms.

Liability insurance attracts increasing attention.

Non-life business in emerging markets is dominated by motor and property lines, which together account for more than 50% of the non-life premium volume. However, recent developments including increasing globalisation, regional economic cooperation, inflows of foreign direct investment and changes in the legal and corporate sphere have favoured the development of liability lines of business.

Liability premium in emerging markets in 2003 amounted to USD 2.8 billion, with Asia accounting for almost 50% of the total, followed by Latin America and Eastern Europe. South Africa and the Middle East together account for less than 10% of all emerging markets' liability premiums. Within liability insurance, general and product liability covers are the main products in emerging markets, while professional indemnity is more developed in Eastern European countries, in response to the requirements of the European Union. Some markets like Brazil, South Africa and India also report increasing demand for D&O coverage.

Outlook and challenges

The outlook for liability insurance in the emerging markets is positive but not without concerns. On the one hand, the liability regimes in these economies are still at a nascent stage, which if properly nurtured could imply significant business opportunities for the insurance industry. On the other hand, market practitioners need to be aware of several worrisome trends observed in industrialised markets, for example the escalating loss environment in the US, and the negative implications for their business if emerging markets follow similar trends. Furthermore, insurers in emerging markets are being challenged to foster know-how and increase their expertise, as well as to design products according to market needs, correctly incorporating future development into pricing and reserves with the aim of satisfying the growing demand for compensation. Otherwise, the industry could risk major disruptions which could adversely affect economic development in the region.

It is thus a grave challenge to insurers to develop this line of business against the backdrop of a rapidly evolving business and legal environment. Yet this remains a sector with huge untapped potential where premiums can possibly grow at twice the pace of GDP in the medium term (2005–2010).

Overview of emerging insurance markets in 2004

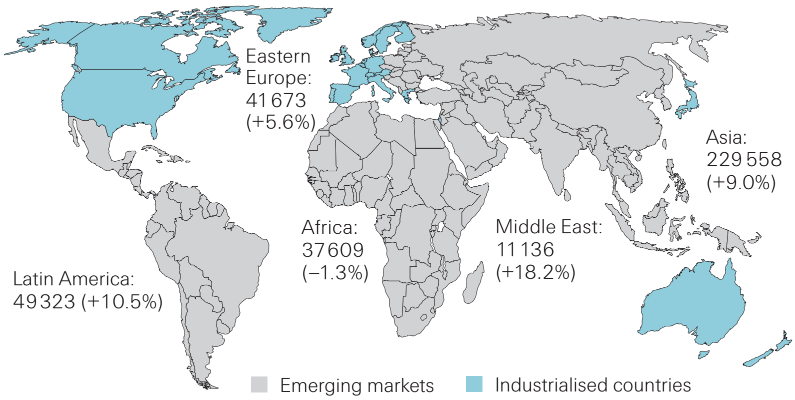
This study continues the series in which *sigma* focuses annually on emerging markets. It consists of two parts: the first part provides an overview of the current state of economic and insurance market developments in emerging markets – including latest performance, major trends and near-term outlook. The second part takes a closer look at the development and prospects of liability insurance in emerging markets.

Five regions covered

This study covers emerging markets in five regions: Asia, Latin America and the Caribbean (referred to as Latin America), Central and Eastern Europe (referred to as Eastern Europe), the Middle East and Turkey (referred to as the Middle East) and Africa.[1]

The most important emerging markets in the regions, in the order of regional total insurance premiums in 2004, are listed below. They collectively account for at least 85% of the premium volume of their respective region.

Figure 1
Regional insurance premiums 2004, in USD million, with real growth rates over the year in brackets



Source: Swiss Re Economic Research & Consulting

- Asia: China, Hong Kong, India, Indonesia, Malaysia, the Philippines, Singapore, South Korea, Taiwan, Thailand and Vietnam.
- Latin America: Argentina, Brazil, Chile, Colombia, Mexico and Venezuela.
- Eastern Europe: Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Russia, Slovakia, Slovenia and Ukraine.
- Africa: Egypt, Morocco and South Africa.
- Middle East: Iran, Kuwait, Lebanon, Saudi Arabia, Turkey and United Arab Emirates.

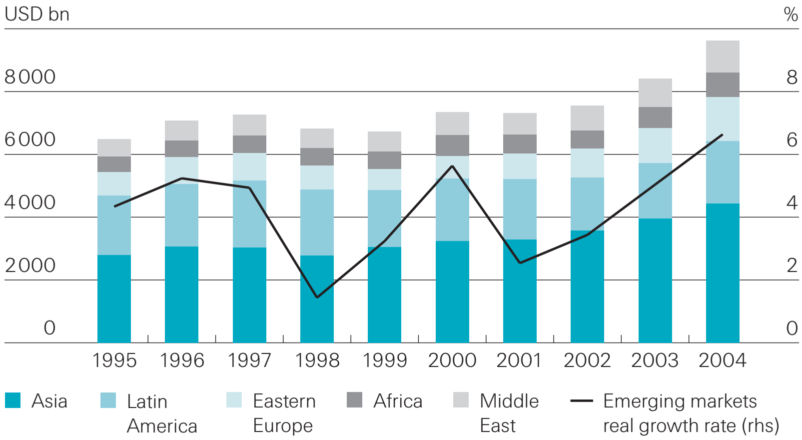
[1] The regional definition as well as the classification of emerging markets in this report differs slightly from Swiss Re, *sigma* No 2/2005, "World insurance in 2004: growing premiums and stronger balance sheets."

2004 – an economic banner year

Economic fundamentals remain sound in emerging markets.

Emerging market economies enjoyed a banner year in 2004. Overall real economic growth accelerated for a third straight year to 6.6% and surpassed the cyclical peaks in 1996 and 2000. In comparison, growth of industrialised economies in 2004 was 3.2%. The upswing was strong across all emerging market regions, led not only by a 7.3% increase in Asia but also by accelerated recovery of the Latin American economies (to 5.4% growth in 2004 from 1.5% in 2003). Eastern Europe, the Middle East and Africa also delivered hearty growth of 6.2%, 7.6% and 5.3%, respectively.

Figure 2
Emerging market GDP and real growth rate, 1995–2004



Sources: Oxford Economic Forecasting, WIIW, Swiss Re Economic Research & Consulting

Strong exports and ample liquidity are among the key supporting factors.

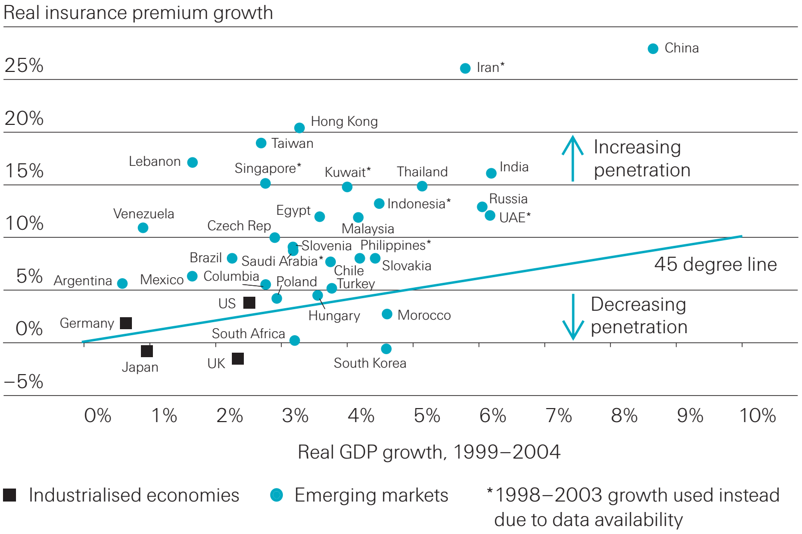
This robust performance was buoyed by at least four factors. First, the general recovery among industrialised economies continued and boosted demand for emerging market exports. Second, continued strength in general commodity sectors (eg, oil, copper, soy) has benefited commodity-rich emerging markets. Third, the benign global interest rate environment has eased monetary conditions in emerging markets. Fourth, significant return of capital flows, either in the form of foreign direct investment (FDI) or portfolio inflows, have helped to bolster economic activities.

Strong continued premium growth

Economic growth fuels insurance demand.

In the last several years, the insurance industry has grown strongly worldwide, also benefiting from favourable economic development. In 2004, on the back of favourable economic fundamentals, emerging markets reported continued growth in insurance premiums, although there were tangible variations among countries and regions.

Figure 3
Insurance premium and economic growth in real terms, 5-year averages 1999–2004



Sources: Oxford Economic Forecasting, WIIW, national insurance authorities

Life premiums continued to increase in 2004, except for Russia and South Africa.

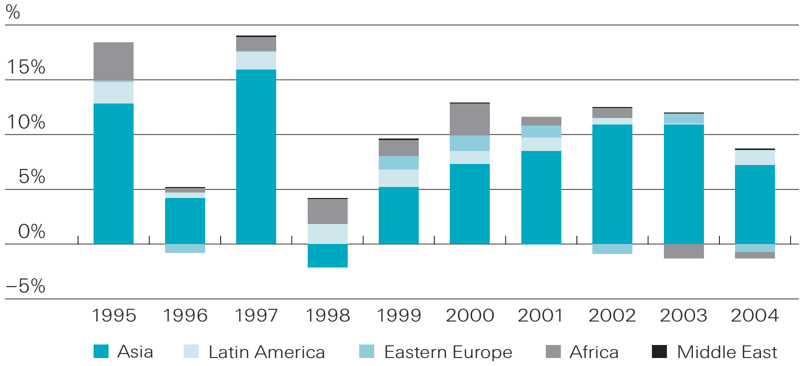
Life premium growth sustained a strong momentum
Life insurance premiums in emerging markets rose by 7.5% in real terms in 2004, after having grown by 10.8% the year before. Growth in Asia remained strong, although slightly below 10% for the first time since 1999. Latin America managed a sharp rebound of 17.1%, while the Middle East region showed healthy growth of 11%. Growth in these regions was mainly driven by their strong underlying economies, generally low interest rates and tax-related incentives in some countries.

The otherwise sanguine picture, however, was tainted by premium declines in Africa and Eastern Europe, by 4.7% and 11.5%, respectively. In the former, the decline was mainly a result of shrinkages in single-premium investment business, notably in South Africa. In the latter, the plunge was mainly due to a drop in short-term life policies aimed at tax optimisation in Russia. In the remaining Eastern European countries, life insurance premiums grew at double-digit rates for the third consecutive year. Growth was particularly strong in Poland and Slovenia as well as in the Baltic states and in southeast Europe.

Life business continues to grow robustly in Asia.

Since coming out of the financial crisis in the late 1990s, Asia's average premium growth has by far outpaced other regions and has been a major contributor to emerging market life premium growth (see Figure 4). Key ingredients that have helped underpin this performance include rising household incomes, low interest rates and the widening adoption of multi-channel distribution in many Asian markets. As illustrated below, bancassurance has generated some encouraging initial results but also exposed local authorities and insurers to key challenges.

Figure 4
Contribution to emerging market life premium growth by regions

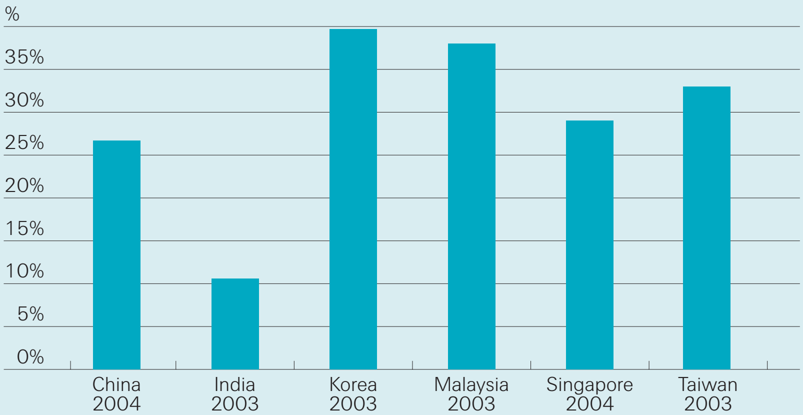


Sources: Oxford Economic Forecasting, WIIW, national insurance authorities

Bancassurance boosted top line growth of Asian life insurers

There are increasing signs that bancassurance has become an established channel for life insurance distribution in Asia. Many Asian markets reported that banks currently account for as much as 40% of new premiums, which is even more impressive considering that most bancassurance regimes are still not fully mature. This channel is currently overshadowing on-line/internet distribution, particularly in the more developed markets of Korea and Hong Kong.

Figure 5
Share of bancassurance in life insurance in selected Asian markets (*)



(*) China and Taiwan's share of total in-force business; for the rest of the countries: share of new business

Sources: National insurance authorities and industry associations, AXCO reports.

Yet, this initial success could be a mixed blessing to the industry: many domestic incumbents have found their traditional strength of having an established local sales network being eroded to the advantage of new foreign entrants who can now forge banking alliances for distribution. Pressure from sizeable agency forces in many of these markets in conjunction with political resistance resulted in postponements of regulator's schedules for further liberalisation.

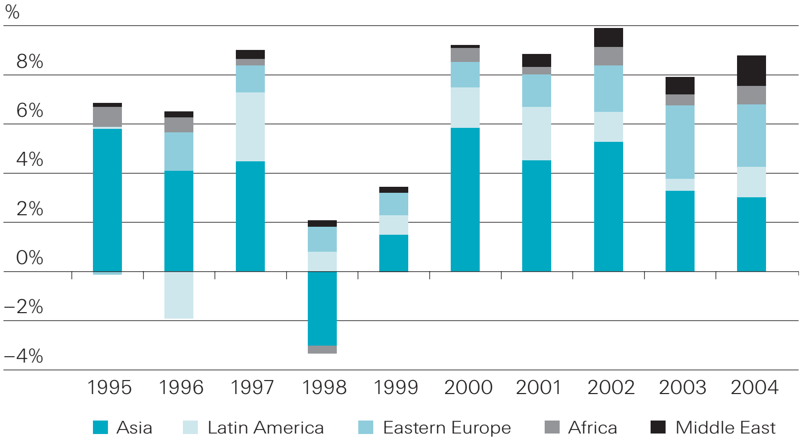
The surge in non-life premiums has stabilised.

Steady premium growth in non-life business

Real growth in non-life insurance premiums in emerging markets stabilised at 8.9% in 2004, comparable to 8.1% in 2003. Growth, ranging from 5.9% to 19.4%, was observed in all emerging regions. Asian premium volume grew in 2004 by 6.6%, at a slightly slower pace compared to the previous year (+7.0%). Premiums in Latin America gained 5.9%, up from 2.1% in 2003. At the same time, premiums in Eastern Europe, Africa and the Middle East all registered double-digit growth, of 13.8%, 10.1% and 19.4%, respectively. Even though growth in Asia was lower than in these regions, it remains the main contributor to overall growth in emerging markets (see Figure 6).

Regional developments illustrated the relative importance of different growth drivers. Growth in Eastern Europe was driven by strong increases in Russia as a consequence of the surge in compulsory motor third party liability. Middle East growth was driven by a rebound in motor lines in Turkey. Growth in Asia was led by developments in China and Indonesia: while China benefited from its recently liberalised motor premium regime and surging vehicle ownership, Indonesia saw economic growth pick up towards the second half of 2004.[2] Double-digit premium gains in Argentina and Venezuela led the growth rebound in Latin America, amid supportive economic conditions which bolstered motor business in most of the Latin American markets.

Figure 6
Contributions to emerging market non-life premium real growth, 1995–2004



Sources: National insurance authorities

Insurance penetration deepened.

Insurance penetration and spending

Insurance penetration (direct premiums as a percentage of GDP) in emerging markets remained stable in 2004 compared to the preceding year, both in the life and non-life sectors (2.3% and 1.5% respectively). This, however, is set against a backdrop of tangibly higher penetration, in both life and non-life insurance, than in 1999.

[2] For more details on China and India, readers can refer to Swiss Re, *sigma* No 5/2004, "Exploiting the growth potential of emerging markets."

The most noticeable gains in life insurance penetration occurred in Asia, where it rose from 2.8% (1999) to 3.8% (2004), whereas the Middle East suffered a slight decline. In the non-life sector, all regions recorded higher penetration in 2004, most visibly in Eastern Europe and Africa.

Table 1
Insurance penetration in emerging markets, 2004 versus 1999

Insurance penetration in % of GDP	**Life 2004**	**Non-life 2004**	**Life 1999**	**Non-life 1999**
Industrial markets	5.1%	3.9%	5.4%	3.4%
Emerging markets	2.3%	1.5%	1.8%	1.3%
Asia	3.8%	1.4%	2.8%	1.2%
Latin America	1.0%	1.5%	0.7%	1.4%
Eastern Europe	0.8%	2.2%	0.7%	1.6%
Africa	3.4%	1.5%	3.3%	1.2%
Middle East	0.5%	1.2%	0.6%	1.1%

Sources: National insurance authorities, Swiss Re Economic Research & Consulting

Strong economic performance and rising penetration sustained strong gains in emerging market spending on life and non-life insurance over the past years. Between 1999 and 2004, per capita spending on life insurance increased from USD 24.5 to USD 42.1, whereas in the non-life sector, per capita spending increased from USD 16.6 to USD 26.6.[3]

Table 2
Premium per capita in emerging market regions, 2004 versus 1999

Premium per capita in USD	**Life 2004**	**Non-life 2004**	**Life 1999**	**Non-life 1999**
Industrial markets	1 691.6	1 275.3	1 407.1	887.2
Emerging markets	42.1	26.6	24.5	16.6
Asia	49.2	18.6	26.4	11.3
Latin America	37.2	53.7	26.4	48.9
Eastern Europe	33.7	91.5	13.5	32.3
Africa	30.3	13.1	24.0	8.7
Middle East	13.7	34.6	12.7	22.3

Sources: National insurance authorities, Swiss Re Economic Research & Consulting

In terms of individual markets, South Korea continued to top the league of the largest emerging insurance markets both in life and non-life insurance, yet its growth in recent years has been undermined by already high penetration and a domestic economic downturn. In contrast, the strongest growth is coming from the Greater China region as well as other fast-expanding markets like India and Russia (in non-life insurance).

[3] The impact of exchange rate changes is relatively small over the period 1999–2004, except for Argentina, Brazil and Mexico, which depreciated tangibly against the US dollar.

Table 3
Life and non-life premiums in emerging countries: the Top 10 in 2004

Life insurance	2004 premium volume (in USD milllion)	Share of emerging markets
South Korea	48680	21.7%
China	35407	15.7%
Taiwan	33851	15.1%
South Africa	24381	10.8%
India	16919	7.5%
Hong Kong	12969	5.8%
Brazil	8199	3.6%
Singapore	6459	2.9%
Mexico	5213	2.3%
Malaysia	4208	1.9%
Top 10	**196285**	**87.3%**

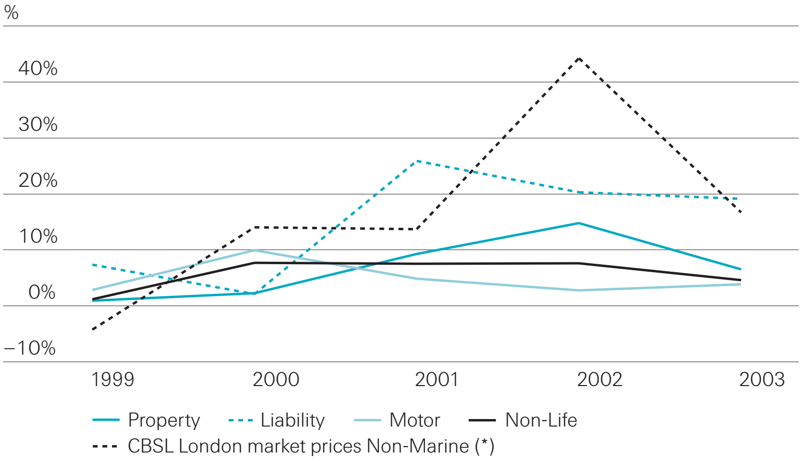
Non-life insurance	2004 premium volume (in USD milllion)	Share of emerging markets
South Korea	19944	13.8%
China	16765	11.6%
Russia	12809	8.8%
Brazil	9843	6.8%
Taiwan	9385	6.5%
Mexico	7019	4.8%
South Africa	6301	4.3%
Poland	4604	3.2%
India	4330	3.0%
Turkey	3763	2.6%
Top 10	**94760**	**65.4%**

Sources: National insurance authorities, Swiss Re Economic Research & Consulting

Motor and property remain the main lines of non-life business, though liability premiums are increasing fast.

By lines of business, non-life insurance in emerging markets is dominated by motor and property lines, which together accounted for an estimated 57% of total premiums in 2003.[4] However, during the period 1999–2003, liability premiums grew at a compound annual real rate of 12.9%, more than twice as fast as total non-life premiums (5.3%), albeit from a very low base. The underlying growth drivers differ among the various emerging regions, but the upward trend is likely to continue. The following sections of this report will take a closer look at this development and analyse the increasing importance of liability insurance in the emerging market insurance industry.

Figure 7
Real growth by line of business in emerging markets



(*) The CBSL index tracks insurance rate movements in the Lloyd's market.
Due to lack of data, Russia and Ukraine are excluded from more detailed analysis.

Sources: National insurance authorities, CBS Private Capital, Swiss Re Economic Research & Consulting

4 Line-of-business analysis is based on 2003 figures published by the national insurance authorities. Data for 2004 was not yet available for all markets at the time of compilation of this report.

Outlook: major challenges ahead, but fundamentals still strong

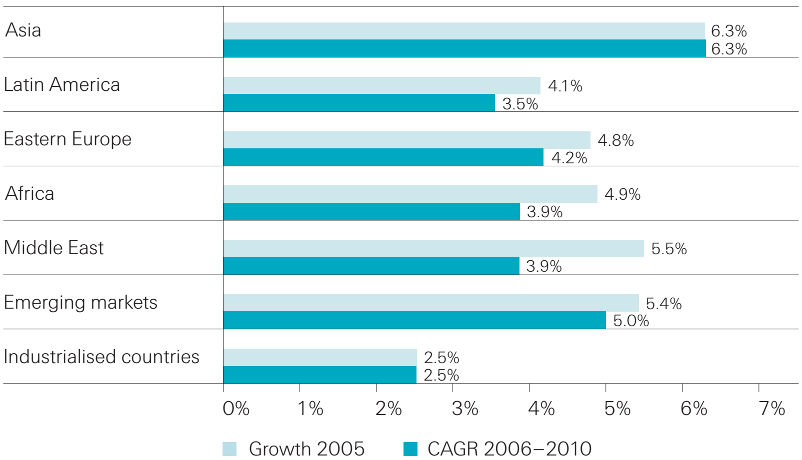
Economic outlook of emerging markets remains sanguine, notwithstanding an expected near-term slowdown.

The global economic cycle is likely to moderate as major industrialised countries start to tighten macroeconomic policies to curb inflation pressure. Domestic demand is expected to continue to underpin growth in an environment of interest rates on the rise.

Increasing resilience in Japan's recovery may provide its Asian neighbours with an additional buffer against a slowdown in the US or Europe. Eastern Europe is expected to continue to grow faster than Western Europe. However, the weakness of the EU15 economies is likely to go hand in hand with a drop in economic growth. Growth in Russia will depend on world market commodity prices and the successful implementation of structural and institutional reforms. Growth in Latin America is also expected to slow, due to the impact of the aforesaid variables. Some structural changes are needed in the region in order to accelerate growth. The Middle East is benefiting from high commodity prices and increased output of hydrocarbons.

In 2005, emerging market growth is expected to remain resilient, though slower than in 2004. Emerging market real GDP growth is expected to slow down to 5.4% in 2005 and average 5% in 2006–2010, which is significantly higher than the 2.5% increase forecasted for industrialised countries.

Figure 8
Medium-term real GDP growth of emerging markets, 2005–2010



Sources: Oxford Economic Forecasting, WIIW, Swiss Re Economic Research & Consulting

Life insurance will continue to derive support from rising income and risk awareness.

Insurance business in emerging markets will continue to benefit from the sanguine economic development. In 2005, life insurance premiums are likely to remain resilient in Asia, to revert to growth in Africa, and to continue their upward trend in Latin America (albeit at a slower pace), the Middle East and Eastern Europe (though this will depend much on developments in Russia). Demand will continue to arise from improved risk awareness, a burgeoning middle-income class, health and pension reforms in some markets and a further proliferation of alternative distribution channels, primarily in Asia. Rising interest rates will pose a grave challenge to life insurers in competition for household savings.

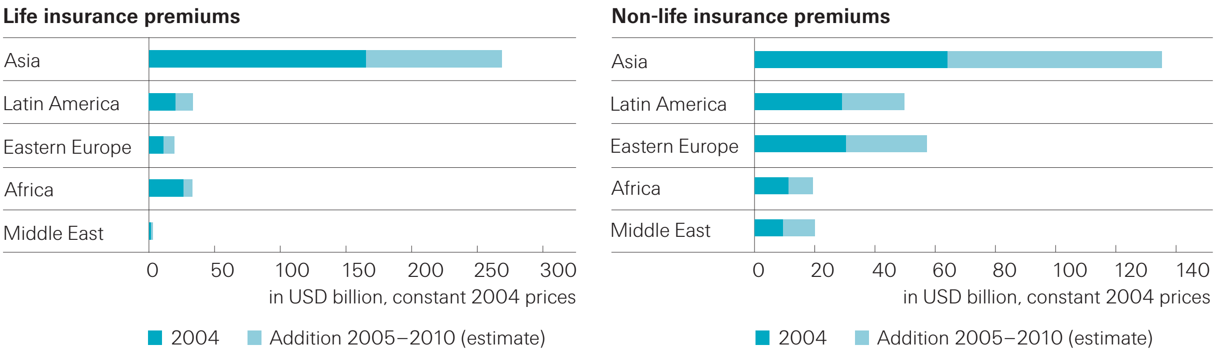
Infrastructure investment, rising asset ownership and compulsory lines will underpin demand for non-life insurance.

The non-life price cycle is seen to remain in a consolidating phase, thus putting a cap on premium growth in the near term. However, stable economic growth, increasing household assets, further large-scale infrastructure investment and the implementation of mandatory insurance in some markets will continue to support growth. In addition, international insurers appear to have recovered their appetite for overseas investments following a recuperation of their balance sheets, a development that should further help to deepen insurance penetration in emerging markets.

Last but not least, catastrophes like the December 2004 tsunami in South East Asia have prompted many emerging market governments to rethink their vulnerabilities to natural catastrophes and raised the call for better and broader use of insurance as a tool for managing these exposures – policy shifts that should encourage insurance development in these countries.

Under these circumstances, emerging markets are expected to see life and non-life insurance growth, in real terms, of 8% and 5% respectively between 2005 and 2010.

Figure 9
Real premium growth in emerging markets, 2004–2010



Sources: National insurance authorities, Swiss Re Economic Research & Consulting

South East Asia tsunami – coping with disasters

No coverage of insurance developments in emerging markets over the past year would be complete without a discussion of the Sumatra-Andaman earthquake/tsunami on 26 December 2004 that claimed more than 280 000 casualties.[5] Attention has been drawn to the stark contrast between the tremendous devastation on an economic and humanity scale versus the relatively limited insured losses, which are far lower than would otherwise be caused by an incident of such horrendous scale in an industrialised region.

This is a tragic reminder that, while all countries are exposed to natural perils, emerging markets are particularly vulnerable. Lack of fiscal resources and low insurance penetration widen the gap between actual economic losses and the financial indemnity available through public and private channels. The result is that communities suffer not only the immediate loss in lives and property but also more prolonged and draining economic adjustments afterwards, compared to industrialised economies. Although humanitarian aid from the international community can make up part of the gap, as was the case in this tragedy, this relief mainly targets the immediate needs of survivors and perhaps some restoration of public infrastructure, but does little to mitigate the destruction sustained by private properties. Unfortunately, it is in the latter that a country's more productive economic assets, and the key to its recovery, usually lie.

According to the IMF, the tsunami-affected countries face direct reconstruction costs ranging from 0.5% to nearly 24% of their GDP. These estimates do not include other indirect costs such as loss of income in the many months, even years, to come. Worse still, these adjustment costs could reach far higher levels for small countries and consume a significant part of their income in the near future. This increases the risk of further deterioration in fiscal and trade balances and of rising inflation and interest rates. From this perspective, efficient catastrophe management could play a key role in maintaining a country's macroeconomic stability and sustaining growth.

Table 4
Cost of rebuilding

	Cost of rebuilding, in % of GDP	Population in disaster year, in million persons
South East Asia tsunami 2004*:		
India	0.5	1 080.3
Indonesia	0.8	242.0
Maldives	23.8	0.3
Seychelles	5.0	0.1
Sri Lanka	4.0	20.1
Thailand	1.0	65.4
Other emerging market catastrophes:**		
Armenia, earthquake 1988	176.0	3.3
Bangladesh, flood 1998	17.0	124.8
Turkey, earthquake 1999	2.2	64.5

* Bangladesh and Malaysia were only minimally affected by the 2004 tsunami
** Figures for Armenia and Bangladesh are the cost of direct losses

Sources: IMF, World Bank, Asian Disaster Reduction Center, Gurenko (2004)

[5] See Swiss Re, *sigma* No 1/2005, "Natural catastrophes and man-made disasters in 2004."

In the aftermath of the tsunami, a number of Asian economies have moved to strengthen their response mechanisms to future natural disasters, for instance by putting in place better warning systems and evacuation plans. However, the key policy challenge for emerging markets is to strengthen their catastrophe risk management regimes by raising awareness, accessibility and affordability of insurance products. Government policies can help to ensure a minimum level of insurance provision and burden-sharing, as demonstrated by Turkey's setting up its Turkish Catastrophe Insurance Pool (TCIP) following the 1999 Marmara earthquake. Also, micro-insurance (which provides community-based coverage to low-income households through government/insurer partnerships) and the issuance of insurance-linked securities (bonds for which the payment of interest and/or principal depends on the occurrence or severity of an insured event) could be viable options before these communities can transit to more traditional insurance regimes. Last but not least, allowing foreign participation through market opening or regional institutions extends burden-sharing beyond national borders, which is of particular importance to small countries.

Determinants of liability insurance

Liability is a small but fast growing part of non-life insurance in emerging markets.

Liability insurance currently accounts for only a small part of the total non-life insurance business in emerging markets, yet its importance is rising as sustained economic development calls for more elaborate and sophisticated liability regimes. In recent years, liability insurance growth has picked up in many emerging economies.

Liability insurance until now has enjoyed far more popularity and application in developed economies. Yet in recent years attention has unduly focused on sharp escalations in judicial awards and the introduction of stricter legal standards in several jurisdictions, including the US, which inevitably led to liability regimes being viewed as costly and arbitrary. This is an unfortunate development, for this negative publicity obscures the positive role liability insurance can play in fostering economic growth.

Development of liability insurance in emerging markets

This section analyses the current situation and growth prospects of liability insurance in emerging markets, with a special focus on their links to industrialised economies. While some branches of liability insurance pertain to governments and individuals, the most common types are those purchased by businesses. For the purposes of this report, "liability insurance" comprises the following lines: commercial general liability, product liability, professional indemnity, directors and officers (D&O) liability, product recall, personal (private) liability.[6] Motor liability and social security systems are not covered, as to attempt to analyse these would go beyond the scope of this study.

The economic rationale for liability insurance

Liability facilitates economic activities...

The legal system is at the very heart of liability insurance, since it is the policyholders' legal liabilities that are insured. However, it is easy to focus too much on the legal aspects of a liability regime and overlook the market-enabling role that liability regimes play in societies. Modern economies rely heavily on private enterprises conducting their business in line with free market principles. Most of these activities generate enormous economic benefits, yet it is inevitable that they also assume various degrees of risk that could result in disputes and losses to one or more parties, whether involved in these activities or not. Without an equitable channel for loss allocation, the fear of financial ruin as a result of potentially huge third-party claims could stifle entrepreneurial incentives and become an obstacle to economic growth.

...by limiting entrepreneurs' risk of financial ruin.

A properly functioning liability regime addresses these concerns by:

- allowing a rational assessment of potential third-party risks and reflecting them ex ante in the formulation of terms and conditions, thus serving an important function in resource allocation and encouraging the adoption of risk mitigation measures;
- offering assurance of ex post financial protection to the policyholder in the event of loss, without which activities beneficial to society may not have been undertaken.

[6] The major types of liability policies are described in the Appendix.

Which factors influence developments?

Liability insurance aims to compensate for harm suffered by third parties.

Liability insurance has some distinctive characteristics compared to other non-life lines of business: firstly, unlike property insurance, which targets damage sustained by specific physical assets (vehicles and fixed structures), liability insurance covers the financial consequences arising out of the insured's obligation to pay compensation for harm caused to third parties. As a result, it can find application in a broad array of personal as well as commercial contexts, since many activities performed by an individual or organisation have potential harmful consequences for third parties.

High sensitivity to legal and regulatory changes

Secondly, as liability insurance is often purchased to insulate the insured against litigation risks, its evolution is highly sensitive to the legal/regulatory environment in the prevailing jurisdictions. At the same time, compulsory liability insurance is a common tool used by governments to address issues of broad public interest such as health and the environment.

"Long-tail" business

Thirdly, compared to other traditional lines of business, it is generally more difficult for insurers to assess their liability exposures. Liability insurance is a prime example of so-called "long-tail" business, where the claims picture will only be fully developed long after the policy has expired. Specifically, insurers are exposed to the risk of hikes in the frequency as well as in the severity of the actual claims, due to unforeseen latent factors or adverse changes in the litigation environment. Here again, the legal system plays an instrumental role in shaping the evolution of liability insurance.

These considerations suggest that the development of liability insurance should be viewed from several broad socio-economic dimensions:

Factors affecting the development of liability insurance are economic...

Economic/Financial
The impact of economic growth is manifold. Economic growth allows societies to afford more liability insurance protection. The rise of a middle-income class and greater consciousness of property rights and consumerism, while all pertinent to increasing demand for liability insurance, are directly linked to economic growth. Furthermore, new trends such as globalisation and burgeoning international trade also stimulate demand for liability insurance.

...political...

Legal/Political
New governments, new legislation/regulations and also court decisions can bring about major changes to the litigation environment and transform the context within which liability insurance works. Sometimes even developments in overseas jurisdictions can become a major factor.

... societal...

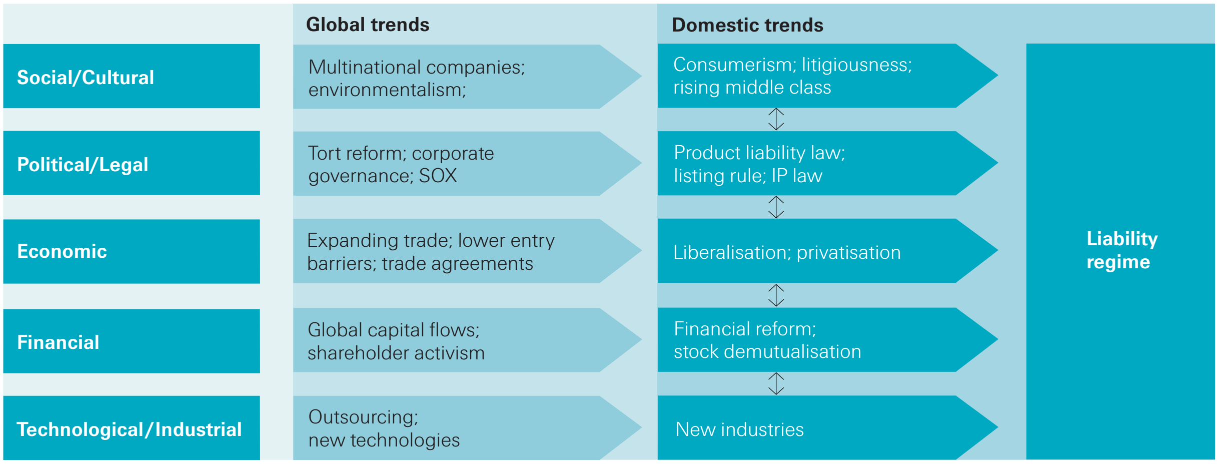
Social/Cultural
Ethical, moral, cultural, religious and social norms and standards play an important role in shaping the litigation landscape and the risk environment. Key dynamics such as demographic shifts and the influx of foreign political and cultural ideologies bring new interactions into the picture.

...and technological.

Technological/Industrial
Scientific progress and discoveries can bring new litigation risks to existing industries or even lead to the creation of new industries or products that change the legal landscape. Faster propagation of information can encourage a litigation culture, while new technologies (eg genetic engineering, nanotechnology) may carry latent risk factors that will eventually trigger new liability events. Industrial progress such as more sophisticated product standards, implementation of industrial policies and shifts in the industry's competitive structure also affect a business's exposure to litigation risks and its demand for liability protection.

Figure 10 illustrates the major channels through which global and domestic trends influence the development of an emerging markets' liability regime. While emerging markets are impacted by global trends, domestic processes can interact to weaken or strengthen the regime.

Figure 10
Factors affecting the development of liability insurance



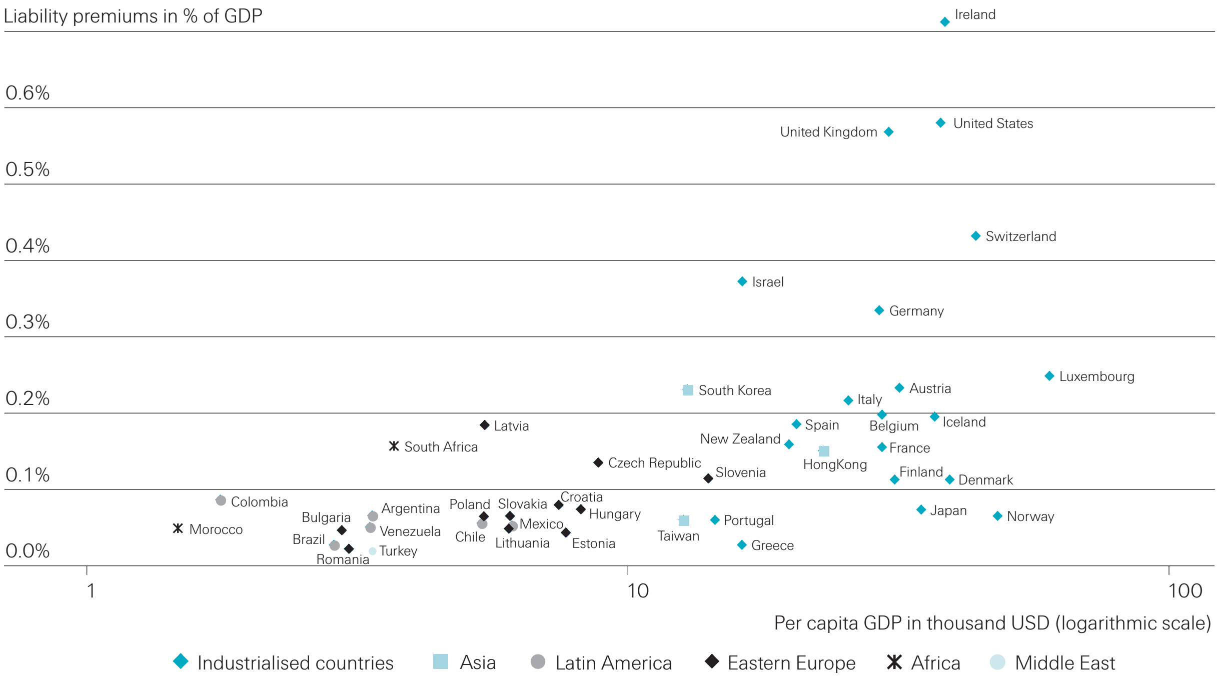
Source: Swiss Re Economic Research & Consulting

The global context

Positive correlation between liability insurance and economic growth

In general there is a positive correlation between liability insurance penetration and per capita GDP. However, liability insurance penetration varies significantly even among industrialised economies at similar stage of economic development. Japan and Iceland, for example, have similar per capita income levels to that of the US, but penetration rates that are only one-sixth. The same is true for emerging markets, although differences in penetration are less pronounced among these.

Figure 11
Per capita GDP and liability insurance penetration, 2003



Sources: National insurance statistics, Swiss Re Economic Research & Consulting

Similarities with industrialised markets justify a global view of liability insurance.

Notwithstanding the variation in penetration levels, similar trends are evolving in different emerging regions. In particular, emerging markets nowadays are more highly integrated, culturally and economically, with the industrialised economies than in the past, thanks to globalisation and the advent of technologies like the Internet. Many emerging markets also rely on exports, foreign direct investments or portfolio inflows for growth, thus giving them a strong incentive to adapt to international trends. These considerations justify examining the prospects of liability insurance in emerging markets from a global perspective.

Liability legislation in emerging markets

In most emerging markets, the civil law system applies. However, a few countries or regions, eg South Africa and Hong Kong, have legal systems based on common law. Compensation awards tend to be higher in the flexible common law systems than in civil law systems, where adjustments to the compensation limits take a long time and are subject to a complicated legislative (political) process. There are also other factors contributing to the higher compensation awards under common law, such as the remuneration system for lawyers or jury verdicts.

Distinction between civil and common law

Civil law

Developed out of the Roman law of Justinian's Corpus Juris Civilis and presently prevailing in the majority of countries of the world, especially in continental Europe, but also in Quebec (Canada), Louisiana (USA), Japan, Latin America, and most former colonies of continental European countries, civil law is based upon statutes as opposed to court decisions. It proceeds from broad legal principles that are codified and recognized as normative. The competent organ gives or enacts the law in codes and statutes, which are the primary source of law. By default, courts base their judgments on the provisions of such codes and statutes, from which solutions are to be derived in any particular case. Court decisions have to be extensively substantiated based on the code or draw analogies from statutory provisions to determine the rights of the parties to a lawsuit.

Common law

Originally based on the unwritten laws of England, it is generally derived from principles rather than rules; it does not consist of absolute, fixed, and inflexible standards, but rather of broad and comprehensive principles based on justice, reason, equity and common sense. Moreover, its principles have been determined by the social needs of the community and adapted to new conditions, interests, relations and usages as societies progress. Precedents (past cases) are the primary source of law, while statutes are seen only as incursions into common law and are thus interpreted narrowly.

Traditional liability principles apply in most emerging markets.

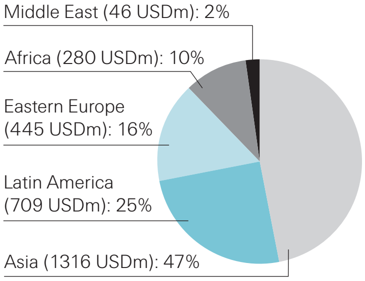
In many emerging markets, traditional principles with regard to liability insurance still apply, eg liability based on fault.[7] However, in some markets, changes in legislation in recent decades have modified the principle of liability based on fault to one that shifts the burden of proof onto the defendant. Even stricter statutory regimes are found in Asian countries in specific matters, eg product liability. Such trends, for example in the US, have significant implications in terms of escalating claims costs and rendering the outcome of litigation highly uncertain. The introduction of punitive damages and the broadening of liability targets ("deep pockets") have also worked to distort the economic functioning of liability insurance. While most emerging markets are still at an early stage of development with respect to liability insurance and do not yet show the various excesses manifest in developed markets, it is important that emerging markets avoid the pitfalls of some runaway liability regimes.

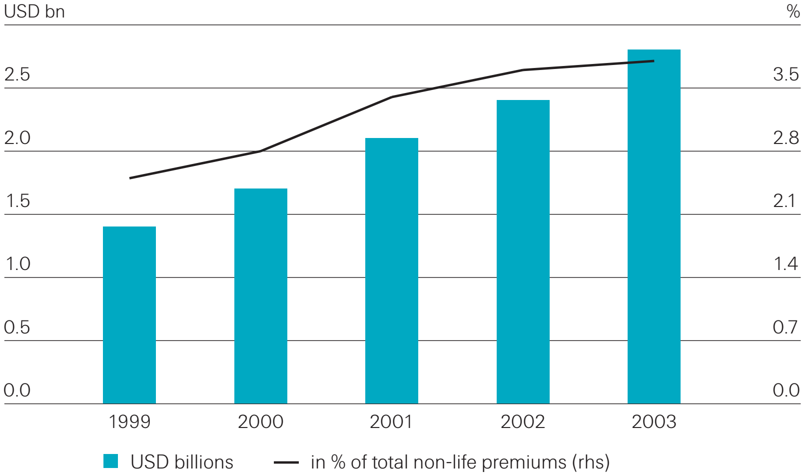
[7] Readers may refer to the Swiss Re publication: "Liability and liability insurance: Yesterday, today and tomorrow", 2001, for further details.

Strong growth from a low base

The past years have seen a strong increase in liability premiums in emerging markets.[8] Direct premiums grew from USD1.3 billion in 1999 to USD 2.8 billion in 2003. Liability premiums thus doubled in this period – albeit starting from a low level –, clearly outpacing growth in other lines of business. The share of liability premiums in total non-life increased to 3.8%, up from 2.5% in 1999, which is relatively low compared to some industrialised countries. By region, Asia accounts for almost 50% of documented liability premiums, whereas Latin America and Eastern Europe have a 25% and 16% share respectively.

Figure 12
Liability premiums in emerging markets and regional distribution, 2003





Sources: National insurance authorities, Swiss Re Economic Research & Consulting

[8] The following 26 countries covered in this report publish liability premium data: China, Hong Kong, Indonesia, South Korea, Malaysia, Taiwan, Argentina, Brazil, Chile, Colombia, Mexico, Venezuela, Czech Republic, Hungary, Poland, Slovakia, Slovenia, Bulgaria, Croatia, Estonia, Latvia, Lithuania, Romania, South Africa, Morocco and Turkey. Together they account for 80% of the 33 markets covered in this report, in terms of total insurance premiums. It should be noted that liability business underwritten by overseas entities, notably Lloyd's and the London markets, is not included. Also, some liability business is included in other lines of business. Therefore, the market size presented in this report is likely to understate the true scale of the market.

Accounting year versus underwriting year: a difference that matters

It is appropriate to note here that companies use different accounting systems to report premiums and losses:[9]

Accounting year system
Premiums and losses are entered in the accounts according to the treaty criteria for the relevant accounting year (no breakdown by year of occurrence or underwriting year). Premiums are registered according to the premium due date, sometimes also according to premiums paid, and paid losses according to the date of payment.

Year-of-occurrence system
Premiums and losses are entered in the accounts according to the treaty criteria for the relevant year of occurrence. Premiums are registered according to the premium due date, sometimes also according to premiums paid, and paid losses according to the date of loss occurrence, which must be precisely defined for each class of business.

Underwriting year system
Premiums and losses are entered in the accounts according to the treaty criteria for the relevant underwriting year, premiums and paid losses according to the date when the original policy was written.

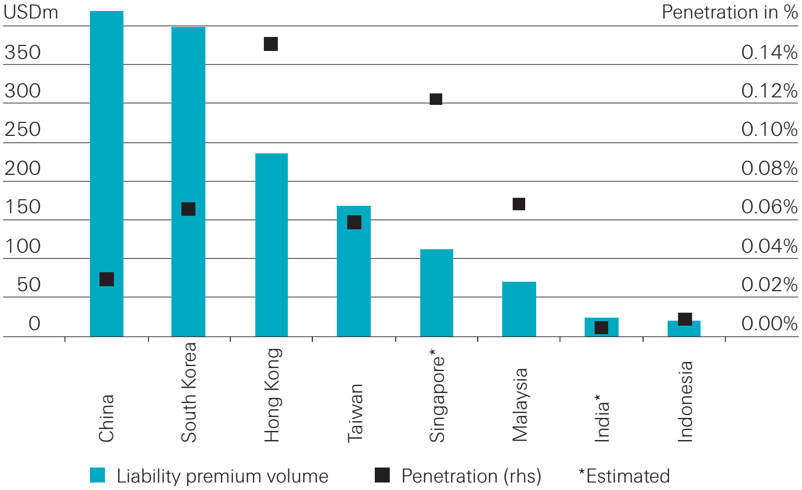
The distinction between the different systems is of particular importance in the liability business, due to its long-tail characteristic. The most accurate way to record technical results is through the underwriting-year system, which tracks the development of the business through the years. However, the figures reported by national insurance authorities are generally accounting-year figures – therefore loss ratios are calculated on this basis. This is also case for the figures shown in this report.

[9] The different accounting systems showed in the box are extracted from Swiss Re publication: "Introduction to reinsurance accounting", 1998. Readers can refer to this publication for further details on insurance and reinsurance accounting issues.

Liability premiums almost doubled between 2000 and 2003.

Growth of liability insurance in Asia has accelerated in recent years, with related premiums strongly increasing from USD 790 million in 2000 to USD 1.3 billion in 2003. The market is resiliently biased towards the three Greater China economies – mainland China, Hong Kong and Taiwan – plus South Korea. Overall penetration is low at near 0.05% of GDP but is considerably higher in the more established commercial centres of Hong Kong (0.15%) and Singapore[10] (0.12%) due to their more sophisticated legal systems.

Figure 13
Liability premiums in Asia in 2003



Sources: National insurance authorities, Swiss Re Economic Research & Consulting

General liability is the most popular product.

In most Asian markets, general liability is the most important liability product. Some markets like South Korea, Taiwan and the Philippines have mandated the purchase of public liability insurance for certain business establishments, and Thailand and China are said to be considering similar schemes. Product liability and professional indemnity policies are also becoming increasingly common (see Appendix).

Profitability has remained satisfactory.

Liability insurance has generally enjoyed lower loss ratios than the overall non-life market, thanks to both Asia's traditionally less litigious culture and its nascent growth stage. However, this could change as liability regimes in the region catch up with their western counterparts.

Globalisation drove liability business.

The region's reliance on global trade and financial flows gives its governments strong incentives to follow the trends in industrialised countries. At the same time, the financial crisis at the end of last decade has demystified the clout of its corporate sector, previously thought impervious to legal challenges, and hardened the resolve of authorities to combat commercial misbehaviour. This progressive stance is reflected in a general tightening of pertinent legislation and court rulings in the region.

[10] As the data for Singapore is an estimate, it is not included in the overall analysis of Asian liability premiums.

Among the various economies, South Korea has demonstrated the strongest expansion in its liability regime, to the extent of earning itself the name "Asia's California" in recent years. Its evolution will be explained below. Another country poised for strong liability growth is China, where both the legislature and the courts have in recent years formulated substantive rules to facilitate private lawsuits against companies, especially in areas like consumer protection and securities litigation. Going forward, continuing privatisation of previously state-owned enterprises and trade liberalisation should further reduce administrative and political resistance to taking legal recourses to settle disputes. Anticipating rising demands for liability protection, the insurance regulator, CIRC, has put forward an initiative to develop liability insurance and has begun setting up experimental liability covers for local business in selected cities.

Country- and industry-specific factors are also important drivers.

Elsewhere, demand for liability insurance is underpinned by the proliferation of specific industries with high litigation exposure, such as the health care, pharmaceutical and logistics sectors. India has reported strong growth in professional indemnity insurance, a trend that will likely continue as the country seeks to establish itself as a global technology service centre amid ongoing tightening in intellectual property protection. The region's health care industry is also facing an acceleration in liability exposure. Aside from rising medical demand from the domestic populace, many countries, especially those in South East Asia, are keen to promote their so-called "medical tourism" industry, which offers clinical and surgical services targeting patients from foreign countries. This latter vogue, in particular, could expose local medical professionals to more costly liability regimes overseas. At the same time, lawsuits filed by shareholders are becoming more common, mirroring increasing willingness of minority shareholders to challenge management decisions.

Liability regimes have also reacted to the emergence of new risk factors. Recent scares of avian flu and other food safety issues have led to a run on related liability insurance in food-exporting countries. Separately, the passage of the Sarbanes-Oxley Act (SOX) in the US has set an example for tighter financial market regulations in the region and increased the potential exposure of local companies to securities litigation both at home and abroad (see "Liability outlook" below).

As a result, demand for liability insurance in Asia is expected to accelerate in the coming years, led by commercial lines like product liability and D&O covers. Yet for all the opportunities that this development presents, insurers will also have to confront substantial risks in the context of how liability regimes in the region will eventually evolve. A perceived failure to control the cost of the system could stifle the development of this promising market. It is thus important for industry and regulators to learn from the experience of the industrial economies and to ensure a liability environment that is both sustainable and equitable.

South Korea – Asia's California?

The South Korean economy has become known in recent years for its strong comeback from the 1997 financial crisis and for its increasing dominance in the global home electronics market. However, it also offers testimony to how economic modernisation and global integration have turned this once court-shy, Confucian country into what is now called "Asia's California" by allusion to its rapidly changing litigation culture. The implication to insurers is heightened by the possibility that South Korea, as one of the more advanced emerging markets, may be only the first of many to go along the same path. In particular, its export-driven growth model, recent progress in financial and corporate reforms, and growing consumerism are features that echo what this report sets out as drivers behind growing liability awareness.

Product liability

Several legal apparatus have been added to the long-standing Consumer Protection Act in recent years, including:

- A supreme court judgement in 1997 that reversed the burden of proof from plaintiffs onto defendants in the case of medical negligence claims.
- The Product Liability Act which came into effect on 1 July 2002, establishing grounds for no-fault liability claims.
- The admission of both economic and non-economic heads of damages (pain, suffering, inconvenience and other non-monetary damages associated with liability insurance claims) in personal injury cases.

The result has been a surge in claims. The Korea Federation of Small Businesses reported that product liability lawsuits in the first half of 2004 more than doubled from the previous year to 1 215 cases and that insurers saw a double-digit jump in both the number and the average amount of claims over the same period. Much of the award inflation is related to the rapid increase in medical costs and average wages.

Until now, water filters, foodstuffs and medical equipment have been the product groups most vulnerable to claims. However, there has reportedly been an increasing number of "slip and trip" claims against shopping malls, and a number of smokers have brought actions against Korea Tobacco. This trend towards greater litigiousness over a wider range of commercial products and services may be encouraged by the government's plans to allow class action lawsuits.

As a result, demand for related insurance covers has taken off, with first-year product liability premiums tripling to KRW 51.6 billion between 1999 and 2002. Even so, it is estimated that only about 1.4% of all manufacturing and distribution companies had purchased covers in the twelve months ending June 2004, which suggests that a sizable protection gap remains.

D&O: executive liability

Korea's corporate landscape has also undergone remarkable changes in recent years that reflect the government's resolve to avoid a repeat of the "corporate cronyism" that was blamed for the 1997/98 financial crisis and to increase competition and widen foreign investment participation in domestic industries. These initiatives have been supported by the recent tightening of regulations.

Since the financial crisis, the courts have increasingly been emphasising the fiduciary duties of directors, culminating in the 2002 ruling against four former Korea First Bank directors for a KRW 270 billion loss as a result of bad loans made to Hanbo Steel Co Ltd during 1993–1997. The following year saw another landmark ruling in a lawsuit brought by a shareholder of Hwasungsa Co Ltd against the directors of one of its subsidiaries, Sungdam Co Ltd. In this case, the Seoul High Court held that the shareholders of a corporation have the right to file a double derivative action on behalf of the corporation's subsidiary against the subsidiary's directors, even if they possess no shares therein. Both cases were initiated by minority shareholders on behalf of the corporation and clearly testify to the current trend toward greater shareholder activism.

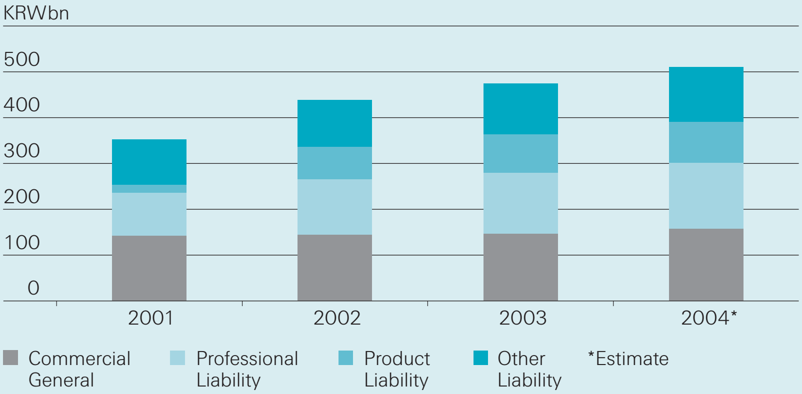
Separately, Korean financial authorities tightened governance and accounting regulations for listed companies at the end of 2002. In line with the passage of the SOX in the US, regulations were promulgated with regard to mandated certification by officers, allowable loans to officers, audit committee guidance, internal accounting management, and whistleblower protection, with offenders punishable by imprisonment for up to five years or a fine of KRW 30 million.

These developments suggest that coming years will see a continued rise in the number and diversity of lawsuits brought against managements. Demand for executive liability insurance has already responded to this trend, with premiums in the 2004 financial year rising by almost 10% to KRW 88 billion.

Liability issues for multinational companies

Economic liberalisation has provided multinational companies with more channels and opportunities in domestic industries but also exposed them to liability issues specific to the host country. In South Korea, one example is so-called successor liability, which refers to liability assumed by the acquirer of a business. In recent years, disputes in this context in South Korea have tended to focus on labour issues, due to the post-Asian financial crisis rise in acquisitions of financially distressed local enterprises and the strong clout of labour unions, but similar principles could also find application in areas such as product, environmental and contractual liabilities. Last but not least, multinationals, being foreign to local jurisdictions and practices, could also find themselves the targets of legal actions.

Figure 14
Direct premiums from liability insurance in South Korea, 2001–2004

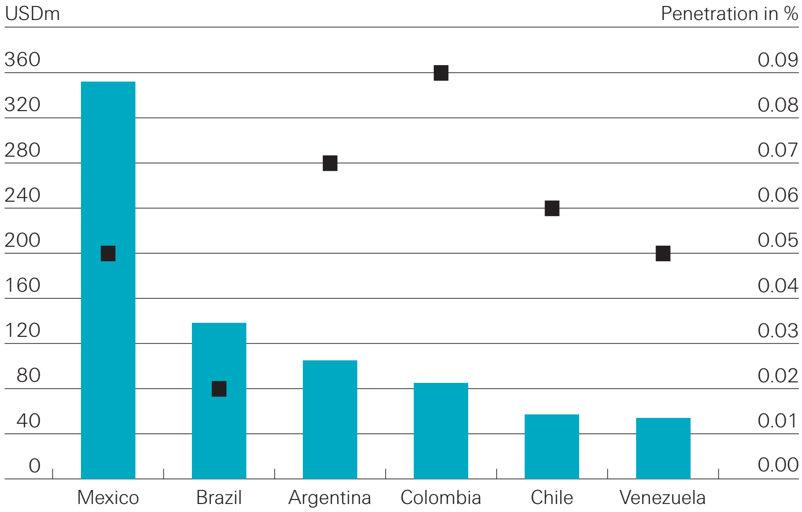


Sources: KIDI, Swiss Re Economic Research & Consulting

Liability insurance accounts for 4% of Latin American non-life premiums.

Liability premiums in the six major Latin American countries (Argentina, Brazil, Chile, Colombia, Mexico and Venezuela) amounted to USD 791 million in 2004, compared to USD 709 million a year before. This volume represents only 4% of the total non-life premium volume of the aforesaid countries. The highest volume was generated in Mexico (USD 352 m), followed by Brazil (USD 138 m), which together accounted for 62% of total liability premiums in these countries in 2004.

Figure 15
Liability insurance premiums in Latin America, 2004



Sources: National insurance authorities, Swiss Re Economic Research & Consulting

Robust growth in liability business in recent years

The long-term average growth rate in liability insurance in the period 1998–2004 was 8.8%, twice as fast as total non-life business. Brazil, Chile and Colombia recorded the highest growth rates (ranging between 13% and 15%). Due to the small size of this line of business, its impact on overall growth, however, is still minor.

Trade and foreign investment raise awareness of liability issues.

During the second half of the 1990s, Latin America was the recipient of a substantial part of the foreign direct investment in emerging markets, thanks to relative macroeconomic stability and privatisation programs. A large number of foreign companies decided to invest in the region, bringing with them a culture of being adequately protected by insurance, which benefits not only the diversity of products bought but also makes for higher insured limits. In addition, increasing trade flow has accelerated demand for liability covers, which in many cases are prerequisites for exports.

In 2003, for instance, the volume of exports was above 16% of GDP in all six countries, and the US was the main export destination (Mexico: 88.5% of total exports, Venezuela: 51% and Colombia: 44.3%). At the same time, most of the countries in the region witnessed changes in consumer law, company law and labour law – all towards more stringent liability standards and the tightening of admissible grounds for exemption – which impact directly on the development of this line of business.

Insurance penetration remains low so far.

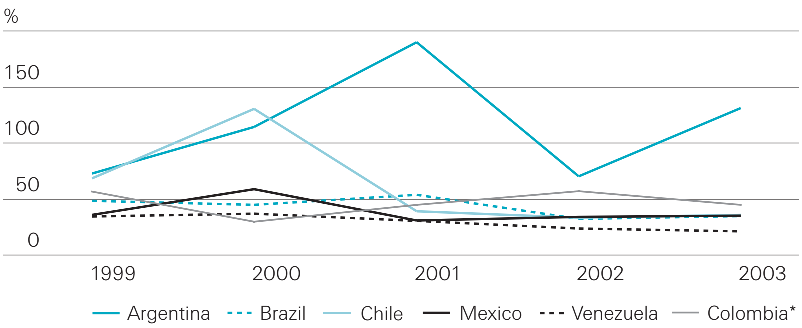
Despite sanguine growth in recent years, the penetration level in Latin America is comparatively low: only 0.05% of GDP is spent on liability insurance. Colombia and Argentina have the highest penetration levels (0.09% and 0.07%, respectively). Brazil, on the other hand, shows the lowest penetration rate of the region, at 0.02%. These low levels reflect societies that are, in general, not litigious. There is a comparatively low level of awareness of individual rights; therefore demand for insurance against third-party claims has been modest so far. In addition, in the recent past liability has been perceived as a "service line of business", offered to insured clients in a package with the more developed lines in order to confer some extra value-added to the clients. In many cases no real exposure/price analysis was performed, and consequently there are huge discrepancies with regard to terms and conditions. Due to the comparatively low volume generated in this line of business, no major efforts have been devoted to gaining a deeper knowledge.

Mandatory covers are prescribed for some economic activities, but the rules are seldom enforced, so only a small proportion of all potential insureds is actually covered. As a consequence, mass liability business is not highly developed in the region.

General liability and product liability are the most important products.

A large portion of the liability portfolio is therefore composed of commercial liability. General and product liability are the most important lines of business in the region. Among the former, covers bought as a pre-requisite for trade agreements and for protection against high-frequency risks (eg, public services) are the key drivers; whereas for the latter, highly exposed industries (eg, chemical industry) and overseas exposures are the main reasons for buying covers. In recent years, demand for professional indemnity (particularly medical malpractice covers) has been rising fast in the region, mainly due to growing litigiousness in this field. D&O is also an emerging class of business, although its importance remains low as yet. Interest in this line of business is rising, however, particularly in Brazil.

Figure 16
Loss ratios in Latin America, 1999–2003



*Colombia's figures are on a net base.

Sources: National insurance authorities, Swiss Re Economic Research & Consulting

Low litigiousness – low loss ratio

Due to the fact that litigiousness is not prevalent in Latin America, the loss ratio in the six countries analysed has remained below 50%, except in Argentina[11]. Low claims awards and long average settlement periods also contributed to sustaining loss ratios at low levels. In addition, in some countries (eg Colombia and Mexico for bodily injury), caps have been established by law. However, the number of claims has been on the rise in recent years, reflecting a shift in the public's attitude towards litigation. A trend towards awards above and beyond the actual objective damage is also to be observed in the region. Compensation for "pain and suffering" is becoming more common in some countries such as Argentina, and more recently, Mexico and Brazil.

Some markets also allow class actions: For example, Chile has recently amended its consumer law to allow collective actions under specific circumstances. A similar situation has been observed in Brazil.

Growth in liability to outstrip GDP growth in the medium term

Over the medium term, liability insurance in Latin America is set to continue its upward trend, mainly driven by corporate business. Growth in this line of business is expected to be more than double GDP growth in the period 2005–2010.

Some lines of business, such as D&O and product liability, are showing higher growth potential – albeit from a low base – following recent amendments to laws and the proliferation of new corporate governance standards that are gaining ground worldwide. Claims are also on the rise against the backdrop of spreading liability awareness.

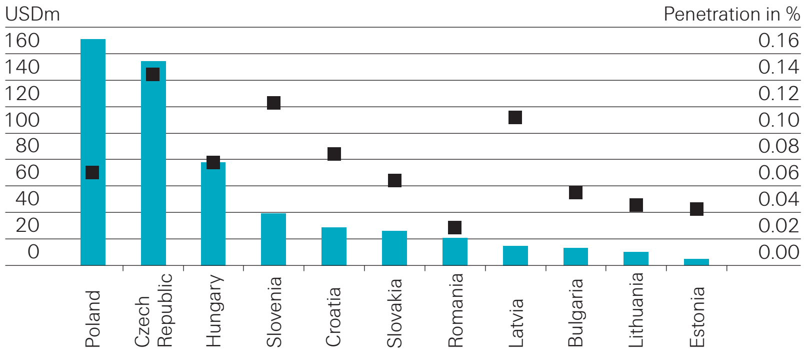
Nevertheless, to sustain growth at a faster pace, some pre-conditions need to be met: bills with implementing regulations need to be passed to clearly define the legal framework, and checks and controls need to be set up to enforce mandatory covers. Furthermore, insurers will also need more know-how and clearer strategies to further develop this line of business.

[11] In Argentina, a loss ratio of over 100% is attributable to higher claims awards and higher frequency, together with failure to adjust pricing due to strong competition.

Regional liability premiums amounted to USD 561 million in 2004.

In 2004, liability premiums in Eastern Europe[12] amounted to USD 561 million or 4% of direct non-life premiums written in this region. The Central European states – the Czech Republic, Hungary, Poland, Slovakia and Slovenia – accounted for 84% of the liability premiums written, followed by the EU candidates – Bulgaria, Romania and Croatia – with a share of 11% and the Baltic States – Estonia, Latvia and Lithuania – with a share of 5%. In terms of premiums, Poland and the Czech Republic were the most important markets with an aggregate premium volume of USD 325 million in 2004.

Figure 17
Liability insurance premiums and penetration in Eastern Europe, 2004



Sources: Supervisory Authorities, Insurance Associations, Swiss Re Economic Research & Consulting

Robust growth of liability insurance in recent years

Liability premiums grew by 12% adjusted for inflation in 2004, more than double the rate registered for the overall non-life market (+5% in 2004). Thus the trend of above-average growth in liability premiums has continued. In recent years, growth of liability insurance was mainly driven by ongoing integration into the EU and the resulting need to comply with the stricter EU liability requirements, particularly in the fields of product liability and professional indemnity.

Determinants of liability penetration: economic structure, wealth and liability know-how

While the trends in liability insurance are generally similar across Eastern Europe, the current state of development of the respective markets differs tangibly: in the Czech Republic, Slovenia and Latvia[13], liability insurance penetration lies above 0.1%, while it is as low as 0.03% in Romania. The differences in penetration can be explained by the economic structure, the country's wealth and the familiarity with liability insurance. In countries with a tradition of exporting to Western Europe, liability insurance is in general more highly developed. For example, Slovenia has played an important role as a component supplier to the German automobile industry for a long time. Slovenian suppliers have thus taken German product liability legislation into account, extending product liability and recall covers for their exported goods. A high proportion of large-scale industries, as for example in the Czech Republic and Poland, has also benefited liability insurance, as large corporations usually have a higher risk awareness and therefore buy more cover against harm to third parties. The sums insured in these countries are high in a regional comparison. Furthermore, liability penetration tends to be higher in wealthier countries and where knowledge about liability insurance is more widespread.

[12] The countries covered in this analysis are Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia. Russia and Ukraine are not covered due to a lack of data.
[13] The relatively high liability penetration in Latvia has to be interpreted with caution: liability premiums are distorted by liability cover bought for tax optimisation purposes.

Commercial general and product liability covers are most common

General and product liability covers for enterprises, together with compulsory liability covers account for the major part of liability premiums (see Table 6 in Appendix). However, small- and medium-sized commercial risks are often not covered, or only at low indemnity limits. Private liability covers are of minor significance, except in the Baltic States. Such covers are frequently part of household content insurance. D&O and recall insurance are still of low importance.

Liability products follow Western European standards.

In general, liability products offered are not tailor-made to Eastern European markets, with the exception of country-specific compulsory liability covers. This is the consequence of the predominance of Western European insurers in the region: their market share amounts to over 80% in the countries analysed, except for Poland and Slovenia.

Compulsory covers lead the development in liability insurance.

There is a broad range of compulsory liability covers. Generally, these products have had low sums insured. The last few years have witnessed a pronounced increase in compulsory liability covers. Furthermore, the adoption of EU directives is making it necessary to adjust sums insured to Western European levels. For example, in the Czech Republic minimum indemnity limits for insurance brokers were raised by a factor of six to USD 1.3 million per claim (or USD 2 million in the aggregate) between 1999 and 1 January 2005 to ensure compliance with the EU Directive on Insurance Mediation. This increase in indemnity limits is challenging the industry, as many companies do not have experience in dealing with this new exposure, whether in terms of calculating risk premiums or determining terms and conditions. A further challenge to Eastern European insurers is that the minimum limits imposed by EU directives are relatively high compared to the income level of their insureds. Another factor making it difficult to assess exposure is lack of claims experience.

Profitable liability business in general

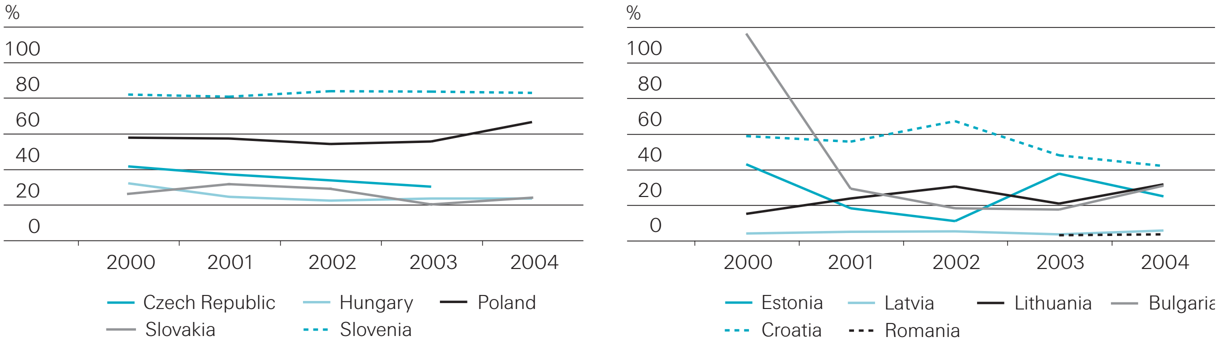
In 2004, loss ratios[14] in the countries analysed were below 50%, except in Slovenia and Poland (see Figure 18).[15] The relatively low loss ratios in liability insurance may be explained by a weak awareness of individuals' rights, which also manifests itself in the low prominence of consumer protection groups. Furthermore, slow court procedures and advance payment of court fees, as required eg in Hungary or Romania, make suing unattractive. Also, relatively low awards, absence of punitive and exemplary damages, and caps on pain and suffering awards (Slovakia) put a curb on claims payments.[16]

[14] Due to a lack of statistics, the loss ratio is calculated as direct claims paid divided by direct premiums written. Poland is the only exception, where the loss ratio corresponds to direct claims incurred divided by direct premiums earned.

[15] In Slovenia, the high loss ratio of over 80% is attributable to numerous small claims brought by employees for temporary disability arising out of accidents at work. Employees are considered third parties in relation to their employers, therefore general third party liability policies include employers' liability risks, where employees can prove negligence. About 70% of claims under third party liability policies in Slovenia are brought by employees. The surge in the Polish liability loss ratio in 2004 is mainly due to strengthening of medical malpractice reserves.

[16] Accounting systems also impact the loss ratio, see "Accounting year versus underwriting year" on page 21 of this study.

Figure 18
Sound loss ratios in Eastern Europe, 2000–2004



Loss ratios are calculated as direct claims paid divided by direct premiums written, except for Poland, where direct claims incurred are divided by direct premiums earned.

Sources: Supervisory authorities, insurance associations, Swiss Re Economic Research & Consulting

Liability premiums could double in the medium term.

Economic and societal dynamics tangibly impact liability insurance. New compulsory insurance, higher sums insured, subrogation by state institutions against liability insurers – eg to recover health costs in the case of personal injury – and ongoing integration into the EU have raised awareness and litigiousness. Furthermore, improvements in living standards, benchmarking with Western Europe and new corporate governance rules are bound to increase the frequency and severity of claims in the coming years. If liability insurance is to remain profitable, it is important to assess upcoming changes correctly today and to make adequate allowance for them in pricing. This will pose a major challenge to liability insurers in the region. Taking current penetration levels as an indicator, liability insurance still offers untapped potential and could easily double in volume over the medium term (2005–2010).

South Africa

Liability insurance: 5.4% of non-life premiums in South Africa

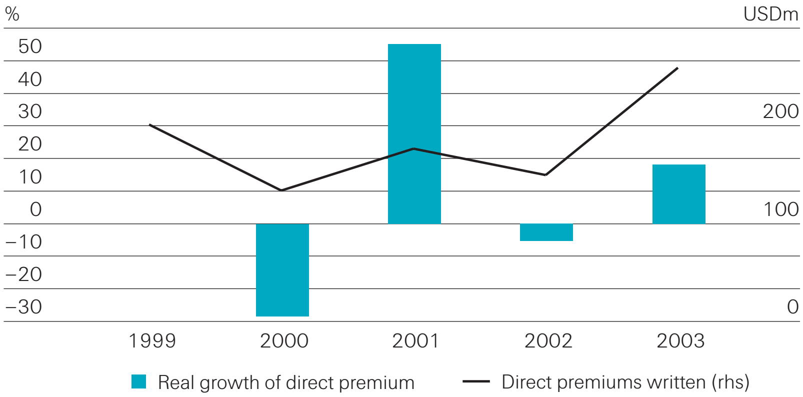
In 2003, premiums from liability lines of business in South Africa amounted to USD 259 million, or 5.4% of the total non-life premium volume. Between 1999 and 2003, the South African liability market grew at an average real rate of 5.5% per annum (see Figure 19). A milestone was reached in 1998 with reinforced stability following the second democratic national election in South Africa. This infused confidence in the country's main trading partners and a more stable socio-economic environment gained ground. With the expansion of trade, South Africa became an increasingly important recipient of foreign direct investment, a positive influence on demand for liability insurance.

The high level of liability penetration, 0.16% of GDP, rivals those found in industrialised countries. There are two main reasons for this: firstly, loss experience in the past has been towards higher awards, which has helped to enhance awareness for insurance covers, even though severe claims have not been so frequent. Secondly, South Africa retains a trace of British influence. Common law is the basis of the local legal system, and UK insurers are key players in the local market, which has helped to evolve a broad range of liability products.

Wide variety of products

Commercial general liability and product liability are highly developed in the country. Professional indemnity insurance is common, since professional associations often require coverage as a prerequisite for membership. D&O has not been extensively developed, but has been gaining ground recently. Not only commercial lines, but also private liability is well-developed in the market, often covered under umbrella schemes. This line of business has been in operation for more than ten years.

Figure 19
South African liability premium volume and real growth rate, 1999–2003



Sources: Supervisory authorities, Swiss Re Economic Research & Consulting

Loss ratio: driven mainly by high frequency of losses

The average loss ratio for the period 1999–2003 is 78%, mainly reflecting a high frequency rather than severity of losses, though peak claims are comparatively higher in South Africa than in other countries covered in this report. There is a tendency to use liability insurance as a marketing tool. This results in a large number of low-severity claims being handled by insurance companies in the role of an "arms length"[17] image protection service. That said, insurers still prefer to avoid going to court, as the legal procedure is long and costly. In the medium term (2005–2010), the line of business is expected to grow at the same pace as the GDP.

Middle East: weak development

In the Middle East, liability business is under-developed. In 2003 Turkey, the most important market in the region and accounting for 40% of total non-life premiums, reported liability premiums of only USD 46 million.

Various reasons for the lack of liability development in the Middle East

Religious factors play an important role in explaining this lack of development in the region. According to a strict interpretation of Islamic law, taking out insurance policies like in the West goes against Muslim principles. Some companies have found a way around this in the form of "takaful" (or cooperative insurance).[18] A strong religious culture that discourages people from making claims against others and the political and economic instability in some countries during the past decades are the main reasons for the restrained development of insurance in general and liability insurance in particular.

Turkey and UAE are seeing some positive developments.

But the situation is slowly changing in Turkey and the United Arab Emirates (UAE). In Turkey, increasing awareness of civil law, the influence of foreign investments and strong relations with Europe and the US (NATO member, EU candidate, customs union with the EU since 1996) are helping to promote take-up of liability insurance. As for the UAE, some growth is also to be observed, though still confined to the construction-related lines of business. In recent years, there has been a boom in construction (stronger inward investment), which has positively impacted the development of professional indemnity coverage for engineers and architects. In this context, growth in liability insurance will outpace GDP growth in the medium term (2005–2010). Liability premium volume in Turkey is expected to double over the same period.

[17] An agreement between two parties that was made freely and independently of each other without a special relationship, being relatives, or having another deal on the side or one party having complete control over the other.

[18] Takaful (Arabic for "take responsibility for one another") sets out rules for cooperative forms of insurance that resolve the three points of conflict with Islamic law – the uncertainties involved in an insurance contract, the way in which insurance resembles gambling and the way in which insurance companies earn interest on the funds available to them. Takaful insurers can be compared to mutual insurance associations.

How is liability insurance going to develop in emerging markets?

Sustained growth is expected...

The outlook for liability insurance in the emerging markets remains favourable. Recent years have witnessed a steady increase in liability growth in most emerging markets. This trend is set to continue, though the pace of development could diverge among the different regions. Economic growth is the common denominator underpinning liability business growth in the medium term. However, development of specific lines will be shaped mainly by the way legislation adapts to evolving legal practices and the economic environment in the various markets.

... though at a different pace.

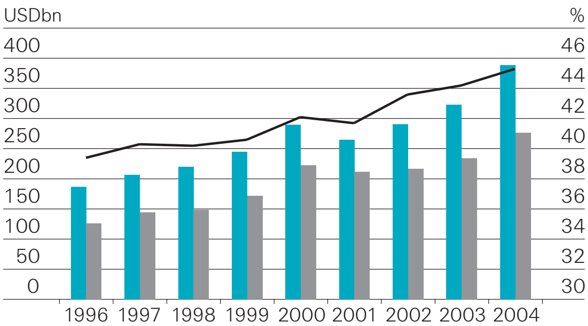
Asia will likely maintain strong growth on favourable economic fundamentals and further dynamic development on the legal side, such as the adoption of more stringent consumer protection legislation. In Eastern Europe, major growth impetus will stem from the need to comply with legal requirements imposed on EU members. Latin America and South Africa could show relatively slower growth. In Latin American countries, the lack of a clear legal framework constitutes a structural impediment to liability insurance taking off. In South Africa, liability insurance is already quite highly developed. In the Middle East, liability insurance will benefit from economic growth. But no exponential growth is expected in the medium term.

Some common denominators will impact on most emerging markets going forward:

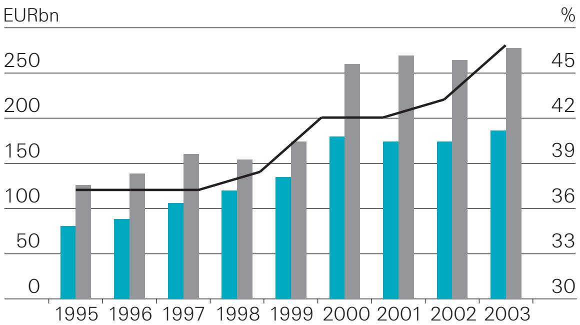
Increasing global trade integration
Emerging markets are playing an increasingly important role in the expansion of world trade. Their share of imports to both the US and EU surpassed 40% at the turn of the century and has continued to rise. Asia dominates most of these flows due to its export-driven economies. The US imports more from Latin America, and the EU from Eastern Europe, which reflects increasing regional integration, partly under the auspices of trade and economic arrangements such as NAFTA and EU enlargement.

Figure 20
Imports from emerging markets by the US and EU, 1996–2003/04

US imports from emerging markets by regions



EU 15 imports from emerging markets by regions



Asia Other emerging markets — % of total Imports (rhs)

On a customs clearance basis for US and FOB basis for EU

Sources: United States International Trade Commission, Eurostat

Exporters' liabilities go beyond product injuries.

A consequence of this trade linkage is that emerging markets are increasingly exposed to more stringent international product standards. While the nature and degree of trade penetration are far from uniform across regions, the pertinent laws and regulations are now clearly converging at an accelerating pace. Emerging market manufacturers and exporters can be held liable under the legal systems of their export destinations for injuries that their products may cause.

Exposure rising in both volume and severity

Recent developments suggest that exposures are on the rise. Firstly, specific types of product liability legislation with strict liability norms and fewer possibilities for defendants to exonerate themselves are spreading worldwide. Secondly, the cost of remedies for potential injuries is rising. Thirdly, the potential exposure to patent infringement lawsuits is equally, if not more worrisome, as this is the very area where some of the highest damages awards have been reported in a number of countries. These considerations will lead to stronger demand for liability insurance covers for emerging market corporations.

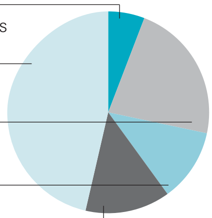
Financial market development and corporate governance

Apart from its implications for trade in goods and services, globalisation also affects the liability exposure of emerging market corporations through financial channels. According to the IMF, foreign financing to emerging markets surged to a record high in 2004, with gross direct stock and bond issuance exceeding USD 170 billion. Most of these flows are driven by corporate rather than sovereign demands. Investors providing financing expect the same standards of shareholder/stakeholder protection as they enjoy in their home countries, thus boosting demand for liability covers in emerging markets.

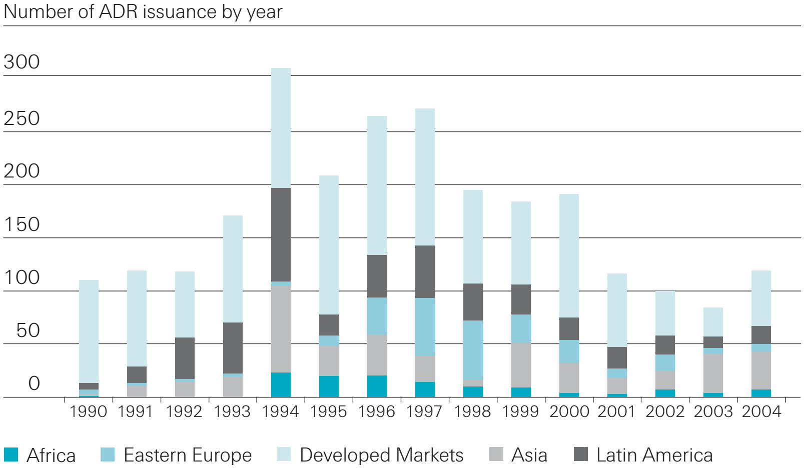
SOX as an example for emerging market corporations

Another example is the Sarbanes-Oxley Act, introduced in the US in 2002 in an attempt to clean up the corporate world and make sure that scandals like Enron would never happen again. Among other things, it sets forth more stringent responsibilities in terms of enhanced public disclosure requirements and mandatory CEO and CFO certification of financial statements and introduces new offences that previously did not exist.

Figure 21
American Depository Receipts (ADR) listings and composition



*Number of listings shown in brackets



Source: Citibank Universal Issuance Guide

Emerging market issuers face tougher scrutiny abroad.

This act affects not only US-domiciled companies but also foreign issuers and non-US-domiciled companies listed in the US, which have to be compliant with the Act by the end of 2005. The full regulatory impact will likely take years to manifest itself, but a jump in US private securities lawsuits against foreign companies in 2004 appears to confirm fears for emerging market issuers which now account for 40% of total ADR (American Depositary Receipts) programs.

Tightening of corporate governance norms in the EU

In the European Union, too, over forty corporate governance codes have been adopted at national or international level over the last decade, with the declared aim of better protecting the interests of shareholders and/or stakeholders.[19] A further catalyst comes from efforts by governments or regulators to demutualise their stock exchanges. These initiatives are usually driven by the policy goal of fostering more competitive domestic financial markets, but they also reinforce the gatekeeping role of the stock exchanges, as the latter find themselves legally exposed to misconduct by their listed companies.

As a result, more and more emerging market companies are buying liability insurance protection. These developments clearly raise the stakes for emerging market issuers in terms of additional compliance costs and litigation risks. Diverting issuance activities to other financial centres with less restrictive regimes is only a short-term and limited solution, as more regulators similarly tighten their codes to bring their own markets into line with the more advanced regimes.

[19] From the publication "The changing landscape of Liability" 2004, SustainAbility Ltd.

Impacts of industrial development

Spending more on health care and other "litigious" industries could boost demand for liability coverage.

Changes in domestic industry structures also play an important role as demand shifts to address social, demographic and economic needs. As an example, Asia and Latin America have recently seen an expansion in industries such as health care that are considered particularly vulnerable to liability litigation.

At the same time, some emerging markets are witnessing rapid development in technological fields such as information and telecommunications technology and consumer electronics, and also innovations in genetic engineering and biotechnology. While these ventures can yield enormous economic profits, their high innovation and technological content are also a source of new and untested hazards, and thus high litigation risks.

Services outsourcing is another growth area.

A related industrial development among emerging market economies is their increasing participation in the global outsourcing industry, with some countries like India having proved particularly successful thanks to their highly educated workforce and strong linguistic adaptability. Despite such competitive advantages, however, outsourcing firms in emerging markets also face greater volatility in their operation parameters due to their reliance on poor infrastructure and local supporting services. This raises concerns of a potential rise in operation risks, from simple service disruption to security breaches, that could lead to legal disputes and but also open up new demands for liability coverage.

Conclusions

Social, technological and economic developments will continue to exert their influences, whilst the legal system might eventually hold the key to defining a liability regime. New laws and regulations impose stricter responsibilities, thus influencing claims growth. As more developing countries open up their domestic markets, they face the need to bring previously protected, or even nationalised, industries to a competitive level on a par with international standards, a process further promoted by the propagation of uniform norms and standards. These developments promote liability awareness by setting up "best practice" codes of conduct for the business community and lower the legal and political defences that corporations can use to evade responsibility for violations.

While the above factors will underpin demand for liability insurance in emerging markets over the coming years, the healthy development of the sector is not a matter of course. Importantly, emerging markets will have to avoid the many pitfalls witnessed in industrialised nations, in particular the US.[20]

[20] For further details please refer to Swiss Re, *sigma* No 6/2004, "The economics of liability losses – insuring a moving target"

Worrying trends in industrialised nations

One of the key concerns today is that the gamut of parties protected by liability law is now much wider than it was in the past, comprising not just individuals and their property but also the general public as the "owner" of natural goods within the ecosystem. In addition, the deep-pocket principle is becoming a general standard, and legislators and judges are increasingly seeking to attach liability to whoever has the ability to pay, irrespective of which of the parties involved is actually responsible. Moreover, globalisation has provided opportunities for "litigation arbitrage", as plaintiffs now have more liberty to choose between multiple jurisdictions in which to file charges. This "forum shopping" almost invariably works in the plaintiffs' favour and puts the defendants at further risk.

A bad system defeats its own purpose.

These developments have certainly generated much animosity against the system as it stands. Critics claim that the negative impact of the resulting litigiousness on the economy and the society is being ignored. The ill effects of these trends on the insurance industry, and the business community as a whole, are visible. These developments could significantly push up insurers' indemnity payments and aggravate the risks associated with underwriting liability policies. The result will be either rising premium rates and/or declining capacity in the market as more insurers refuse coverage to what would otherwise be insurable projects. These consequences are clearly at odds with the economic function of liability insurance as explained earlier in this study.

Huge untapped potential in emerging market liability business

The biggest challenge emerging markets face is thus to find equilibrium in the legal field by providing fair compensation for victims while keeping the cost of the overall system within manageable dimensions in the years to come. For insurers, these new realities will require a more profound knowledge of local market developments and an understanding of how they impact on the liability regimes, and the ability to manage their exposure appropriately through careful product designs and prudent pricing. Provided that these challenges are properly addressed, this line of business offers significant potential to be exploited. Real growth in this line of business is expected to reach twice the GDP growth rate in the medium term, ie 2005–2010.

Table 5
Major liability business lines

Product liability	Covers legal liability for bodily injury, property damage and occasionally also pure financial losses incurred by consumers and innocent bystanders. Defects which cause losses may originate from improper conception, design, manufacture or storage of the product, or from improper use by the consumer. Liability is triggered by the defective nature of products, not by their hazardous characteristics.
Product recall insurance	Product liability is complemented by special statutory regulations aimed at ensuring product safety. They oblige entrepreneurs to take all measures appropriate to the specific circumstances so as to guarantee the safety of the products brought into circulation throughout their entire life cycle. One of these measures is to recall products which do not (or no longer) guarantee the required safety. Insurance for product recall and product integrity covers the expenses incurred by the liable enterprise.
Commercial liability insurance	Covers bodily injury, property damage and occasionally also pure financial losses incurred by third parties and originating from risk sources at the premises of an enterprise. The risk sources may be either static (the mere existence of the premises with the operating facility, installation and equipment) or dynamic (operating procedures such as processing of materials, manufacture of products, and administrative activities).
Professional indemnity insurance	Failure of the management and employees of services companies to exercise due care and prudence can cause substantial financial losses to third parties (clients in the accounting, auditing and consulting sectors; patients in the medical sector), for which the party responsible is required to pay compensation. Professional indemnity insurance covers claims for damages based on breaches of the duty to exercise due care and prudence, or failure to follow state-of-the-art or other generally applicable professional standards and practices. Liability insurance for directors and officers (D&O) of an entity provides cover for their personal legal liability towards shareholders, creditors, employees and others arising from wrongful acts such as errors, omissions, negligence or breach of trust during the course of their duties.
Employer's liability insurance	Employers are responsible for the health and safety of their employees in the performance of their duties, ie for the consequences of work-related accidents (which occur eg due to lack of adequate safeguards on machines, tanks and vessels, and facilities) and for occupational diseases (eg due to inadequate ergonomic conditions at the workplace). In some countries, they can also be responsible under liability law for general conduct towards employees in the context of "employment practices liability".
Environmental impairment liability insurance	Covers liability for impairment to the environment due to the activities preformed at the enterprises premises.

Source: Adapted from Swiss Re's publication "Emerging risks: a challenge for liability underwriters", 2003

Table 6
Relevance of the different liability products, per country

		Commercial General Liab.	Product Liability	Directors' & Officers'	Recall	Professional Indemnity	Private Liability
Asia	China	+	+	+	+	+	+
	South Korea	++	++	+	+	+	+
	Hong Kong	++	++	+	+	++	+
	Taiwan	+	+	+	+	+	+
	Thailand	+	+	+	+	+	+
	Singapore	++	++	+	+	+	+
	Malaysia	++	++	+	+	++	+
	India	+	+	+	+	+	+
	Indonesia	+	+	+	+	+	+
	Vietnam	+	+	+	+	+	+
Latin America	Mexico	+++	+++	+	+	+	+
	Brazil	+++	++	++	+	+	+
	Argentina	+++	+++	+	+	++	+
	Colombia	+++	++	++	+	++	+
	Venezuela	+++	++	+	+	++	+
	Chile	+++	++	+	+	++	+
Eastern Europe	Poland	+++	+++	+	+	++	+
	Czech Republic	+++	++	+	+	++	+
	Hungary	+++	++	+	+	++	+
	Slovenia	++	+++	+	++	+	+
	Croatia	+++	+++	+	+	+	+
	Slovakia	+++	+	+	+	++	+
	Latvia	++	++	–	+	+	++
	Romania	+++	+	+	–	++	+
	Bulgaria	+++	+	+	–	+	+
	Lithuania	++	+	–	–	+	++
	Estonia	++	++	–	–	+	++
Africa	South Africa	+++	+++	++	+	++	++
Middle East	Turkey	+++	++	+	++	+	+
	United Arab Emirates	++	++	+	+	+++	+

– Does not exist 0% + Low importance 0–10% ++ Medium importance +10–35% +++ High importance +35%

Source: Swiss Re Economic Research & Consulting

Table 7
Macroeconomic indicators in 2004

		Population (millions)	Gross domestic product USD billion	Real change (in %)	Inflation rate (in %)	Exchange rate local curr./USD year average
Asia	South Korea	48.1	685	4.5	3.6	1 146.20
	China	1 299.0	1 599	9.5	3.9	8.28
	Taiwan	22.7	309	5.7	1.6	33.35
	India	1 077.0	595	6.7	4.1	45.28
	Hong Kong	6.9	164	7.5	0.1	7.79
	Singapore	4.3	104	8.3	1.7	1.69
	Malaysia	25.1	117	6.9	1.4	3.80
	Thailand	62.3	162	6.2	2.7	40.23
	Indonesia	217.0	260	5.0	6.4	8 936.00
	Philippines	82.8	86	6.1	5.6	56.04
	Vietnam	82.4	45	7.7	9.5	15 741.00
Latin America	Brazil	178.5	600	5.2	6.6	2.93
	Mexico	103.8	659	4.4	4.7	11.30
	Chile	15.9	91	5.8	1.1	611.03
	Argentina	39.0	152	8.8	4.4	2.93
	Venezuela	26.0	106	17.3	21.7	1 892.80
	Colombia	44.9	93	4.0	5.9	2 635.90

		Population (millions)	Gross domestic product USD billion	Real change (in %)	Inflation rate (in %)	Exchange rate local curr./USD year average
Eastern Europe	Russia	142.9	566	7.1	11.0	28.95
	Poland	38.6	238	5.5	3.4	3.71
	Czech Republic	10.2	107	3.8	2.8	25.68
	Hungary	10.1	100	3.9	6.8	202.75
	Slovenia	2.0	32	4.2	3.6	192.42
	Slovakia	5.4	41	5.3	7.6	32.24
Africa	South Africa	43.9	213	3.7	1.4	6.44
	Morocco	30.6	51	3.7	3.1	8.87
	Egypt	68.7	73	4.4	11.3	6.20
Middle East	Turkey	71.6	302	8.9	10.6	1 431 800
	Iran	67.3	164	6.2	15.9	8 613.10
	UAE	4.3	89	5.2	3.3	3.67
	Saudi Arabia	23.3	241	5.3	0.3	3.74
	Lebanon	4.6	19	3.0	2.0	1 514.30
	Kuwait	2.4	42	3.9	1.6	0.29

Sources: Oxford Economic Forecasting, WIIW, Swiss Re Economic Research & Consulting

Table 8
Key insurance indicators

	2004	Premium volume (in million of USD) Total	Life	Non-life**	Change (in %) 2004, local currency inflation-adjusted Total	Life	Non-life**	Annual change (in %) 1999–2004, inflation-adjusted Total	Life	Non-life**
Asia	South Korea	68 623	48 680	19 944	3.1	3.4	2.3	1.2	–0.3	5.5
	China	52 171	35 407	16 765	7.1	2.9	17.0	24.1	29.4	16.0
	Taiwan	43 236	33 851	9 385	14.3	17.6	3.7	17.0	19.6	9.6
	India	21 249	16 919	4 330	10.4	10.5	10.1	15.8	17.7	10.0
	Hong Kong	15 260	12 969	2 291	24.2	30.8	–3.5	19.2	22.0	8.3
	Singapore*	9 696	6 459	3 237			1.1	12.4	10.7	12.8
	Malaysia	6 453	4 208	2 245	13.5	20.1	2.8	12.1	14.9	7.9
	Thailand	5 747	3 167	2 581	10.0	15.5	3.9	14.4	18.9	10.1
	Indonesia*	3 381	1 626	1 754				13.0	16.3	10.4
	Philippines*	1 292	783	509				7.9	11.2	3.7
	Vietnam	904	601	302	26.3	35.1	11.9	43.5	76.9	21.6
Latin America	Brazil	18 042	8 199	9 843	10.8	16.0	6.9	8.3	19.2	2.5
	Mexico	12 231	5 213	7 019	10.9	21.7	4.1	5.6	2.9	7.9
	Chile	4 026	2 617	1 410	8.1	9.9	5.0	8.7	7.1	12.3
	Argentina	4 098	1 345	2 752	19.9	40.9	11.7	4.7	3.4	5.4
	Venezuela	2 629	79	2 550	18.0	18.0	18.0	11.2	12.2	11.2
	Colombia	2 336	645	1 691	1.1	1.7	0.9	5.2	5.4	5.1
Eastern Europe	Russia	16 352	3 544	12 809	–1.7	–38.4	17.6	17.8	6.0	23.0
	Poland	7 431	2 828	4 604	7.9	11.2	6.0	3.9	7.3	2.2
	Czech Republic	4 393	1 720	2 673	3.7	4.6	3.1	9.4	14.3	6.9
	Hungary	2 887	1 179	1 708	–0.2	1.7	–1.4	6.9	7.1	6.7
	Slovenia	1 809	531	1 278	12.6	38.3	4.6	7.9	19.0	4.7
	Slovakia	1 488	603	885	6.8	6.4	7.1	7.0	9.6	5.4
Africa	South Africa	30 682	24 381	6 301	–1.7	–4.8	12.3	3.4	2.4	7.9
	Morocco	1 372	323	1 049	–3.5	–18.8	2.4	3.2	–0.1	4.4
	Egypt	612	211	400	18.8	28.8	14.1	9.3	14.5	7.1
Middle East	Turkey	4 619	857	3 763	20.0	7.5	23.3	7.2	7.8	7.0
	Iran*	1 880	153	1 727				25.8	18.8	26.5
	UAE*	1 493	254	1 239				12.0	9.2	12.6
	Saudi Arabia*	1 196	50	1 146				6.5	45.3	5.6
	Lebanon	577	180	397	9.3	27.4	2.6	2.6	15.7	–1.1
	Kuwait*	393	95	298				14.7	24.9	12.2

* Estimates for 2004, annual growth rates are calculated for the period 1999–2003
** Non-life premiums include health

Sources: Oxford Economic Forecasting, WIIW, National insurance authorities, Swiss Re Economic Research & Consulting

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