# IMPACT OF THE ECONOMIC CRISIS ON THE THAI INSURANCE[1]

**THANODOM LOKAPHADHANA[2]**
Faculty of Risk Management,
Assumption University, Thailand

## INTRODUCTION

In the early 1990s, Thailand enjoyed a high growth rate in the economy with real GDP of over 8%. The poor fundamentals of the country combining with the accumulated current account deficit turned the Thai economy into recession in 1997 with a considerably weakened Thai Baht and a weakened financial position in the international money market. These situations forced the government to devalue the Thai Baht and to entreat the International Monetary Fund (IMF) for financial assistance on July 2, 1997.

The real GDP growth reached the level of –8.0% in 1998 while consumption and investment fell to –8.3% and –29.2% in that year.[3] These were due to:

1) <u>Tight monetary policy</u> by raising the level of interest rate in mid1997 – 1998 to protect the value of the currency and to attract more foreign investors. However, the investors decided to hold off their investment because the cost of funding was so high and not attractive for them;

2) <u>Tight fiscal policy</u> by maneuvering the Value Added Tax (VAT) from7% to 10% in 1997 and decrease in government spending. The rise in VAT reduced consumption because it increased the price of goods and services.

The general price level increased to 8.1% in 1998 which was very high when compared to the past. At the same time, the price of imported goods also increased substantially due to the level of the Thai Baht which devalued by 50% on July 2, 1997 The volume of international trade also dropped to the record level of –6.8%, and -33.8% for export and import in 1998.

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[1] This is a version of a dissertation presented to the UK Chartered Insurance Institute in 1999. The original contained 24 statistical appendices which have had to be omitted because of space.

[2] Thanodom Lokaphadhana, MBA, B.Com, CPCU, FCII, FINZ, ARM, is an Assistant Dean at Assumption University. He is also 1st Senior Vice President of Muang Thai Life Insurance Co. Ltd.

This economic recession, which has spread to other countries worldwide, is a major issue in Thailand and affects not only the Thai economy, but also the Thai insurance industry and the international reinsurance market.

The objectives of this paper are:-

1) To give an overview of the Thai economy and the Thai insurance industry;
2) To identify the major problems which the Thai insurance industry is facing;
3) To suggest feasible strategies which the insurers should implement in the short run and the long run;
4) To suggest the appropriate role of the government in assisting the insurance industry;
5) To summarize the main points of which insurers should be aware.

This paper could serve as a scenario for insurers in other countries to study should there be a similar situation in their own economy.

## IMPACT OF THE ECONOMIC CRISIS

There are eight impacts on the insurance industry in Thailand as follows:-

1. Decrease in premium income
2. Lack of liquidity
3. Devaluation
4. Intense competition
5. Decrease in investment return
6. Underinsurance
7. Moral hazard
8. Lower quality of risk

**Decrease in premium income**

After Thailand was hit by the economic turbulence, many companies went bankrupt, and faced negative income or being taken over by financially stronger companies. Some companies went on intense cost cutting programs, including salary reduction and employees' lay off. The unemployment rate in Thailand shot up to 4.4% in 1998 compared to 1.9% in 1997. This resulted in lower income, less purchasing power and forced people to reduce their spending.

With limited income, people had to cut any unnecessary expense including insurance. Many people decided to cancel or discontinue their policies to save some money. Potential customers changed or postponed their decision to buy new insurance while existing policyholders cancelled or reduced their cover. As a result, demand for insurance has significantly decreased for both life and non-life insurance.

The life insurance industry has been affected since 1997. First year premium dropped by –12.36% and –21.10% in 1997 and 1998. Total premium for life insurance dropped for the first time in its history by 3.42% in 1998 to THB 56.768 Billion.

The number of new policies also decreased, with a growth rate of –14.92% and –18.03% in 1997 and 1998. This corresponds with growth rates of sums insured of new policies –2.91% and –20.62% in 1997 and 1998. Renewal premiums were also affected by a lower persistency rate of total premium which decreased from 84.61% in 1996 to 78.20% in 1998.

The Non-life insurance industry has been affected with a growth rate of -5.77% and -14.06% in 1997 and 1998, after 25 years of continuous growth. The total premium was THB 49.552 Billion in 1998. Motor Insurance, which accounts for 60% of the entire premium, was affected most with a growth rate of –10.75% and –18.50% in 1997 and 1998.

Before the crisis began, the number of new cars kept on increasing because almost everybody could easily buy new cars through the finance companies, who required these people to buy Motor Insurance through specified insurers. Therefore, finance companies were the major producers for most of the motor insurers. Following the crisis, a lot of cars were repossessed and very few new loans were provided by these financial institutions because of Non-Performing Loans (NPLs). The growth rate for new car sales in 1997 and 1998 dropped by 39.03% and 61.36%.

Other reasons for the reduction in motor insurance premium were

a) Some of the existing insureds changed their cover to a less expensive one, for example, from Full Comprehensive to Third Party Liability only or from Third Party Liability to Compulsory Motor only;
b) The government reduced the premium rate of Compulsory Motor Insurance by 10% in 1997;
c) Many vehicle owners do not comply with the law which requires them to buy Compulsory Motor Insurance. Currently, there are only 60 – 65% of the number of cars which actually have this cover.

For Fire Insurance, the premium income dropped by 8.42% in 1998, which was due to:-

a) Many businesses ceased their operations and stopped purchasing insurance;
b) Major corporate accounts changed from Fire Insurance to Industrial All Risks Insurance which the insurers offer at lower rates;

c) Very few new loans were provided by the financial institutions for houses or factories due to the problem of Non-Performing Loans (NPLs);

d) Some of the insureds decreased their sum insured;

e) The government decreased fire insurance rates for several risk categories to reflect overall good loss experience.

For Marine Cargo Insurance, the premium income dropped by 9.63% in 1998 due to slumping imports which dropped 13.4% and 33.8% in 1997 and 1998, while exports dropped by 6.8% in 1998.

For Miscellaneous Accident Insurance, which includes Engineering Insurance, the premium income dropped by 3.77% in 1998, due to the reduction in investment, with virtually no new major construction projects and the suspension of incomplete projects, along with price cutting to attract the remaining business.

<u>Lack of liquidity</u>

This was due to :

a) <u>Funds trapped in 56 finance companies closed by the government after the economic crisis began</u>. The amount which the insurers had deposited with these finance companies was around THB 13 Billion. These insurers could not withdraw their money for 5 years and their cash flow was stuck. Some insurers have had to borrow from somewhere else to pay claims and operating costs. Facing liquidity problem, some companies, especially the major motor insurers, delay their claims payments.

b) <u>Bad debts from the closed finance companies</u>. Before the economic crisis, finance companies were the major producers for the insurance industry. They usually held the premium which they collected for 3 - 6 months before remitting to the insurers. When the economy slowed down, they also faced liquidity problems themselves and had problems with financing. They could not afford to pay the outstanding premiums owed to the insurers following the closure by the government.

c) <u>Delay in premium payment by the policyholders and the producers</u>. Once the Insured has financial difficulty, he or she is likely to delay or avoid premium payment. The policyholders are paying their premiums much slower than before because they face cash flow problems themselves, while the producers also try to hold the premium longer in order to earn more interest on these monies. This reduces the premium that should have been collected and invested and creates cash flow problems for the insurers because they have less cash inflow while they still have to pay claims and operating costs.

*d)* <u>Increase in surrenders by life policyholders</u>. Since the crisis began, all of the life insurers are facing the problem of surrenders by their policyholders who could not continue to pay their premiums and desperately needed some money. The amount of surrender value increased by 66.37% and 65.53% in 1997 and 1998. The amount of surrender value was THB 5.08 Billion in 1998 as compared to THB 1.833 Billion in 1996 representing an increase of 177.04% while the number of surrendered policies increased by 106.71% from 1996 to 1998.

e) Lack of liquidity causes many insurers to delay their payment to overseas reinsurers, the average being 3 - 6 months after the end of the quarter.

**<u>Devaluation</u>**

Devaluation has the following impact on insurers:-

a) Increase in prices for imported spare parts;

b) Increase in prices for spare parts manufactured locally;

c) Increase in medical expense charged by the hospitals for imported medical equipment and medicines;

d) Insurers' rating downgraded. The asset values of the insurers converting to major foreign currencies decreased significantly following the devaluation. As a result, the rating of certain Thai insurers as reviewed by the rating agencies, such as Standard & Poor's (S & P), had been downgraded to reflect their view of the impact of reduced asset values on the Thai insurers' financial position.

Devaluation also increases the claims cost for Motor, Personal Accident and Health Insurances. However, due to intense competition, most of the insurers cannot increase their premiums. This means that the loss ratio for these classes increase in the short run.

Devaluation also caused problems to overseas reinsurers as their reinsurance premium income, after converting to Pound Sterling or U.S. Dollar, decreased by 30% (on average) in 1997 as a result of the devaluation.

## Intense competition

This was due to:-

a) Premium withering. Strong insurers tried to write more business in order to maintain their premium income while weak insurers desperately sought cash to survive. As a result, it led to rampant price competition which further destabilized the insurance industry. As demand for insurance decreased, the insurers have tried very hard to attract more business. Currently, the competition in the non-life insurance industry is very intense especially on the major corporate accounts with 40 – 70% premium reduction. In order to compete with other insurers that lowered their premium, the existing insurer has to lower its premium further in order to retain that account.

b) Increase in insurers. The government decided to licence 12 new life and 13 new non-life companies in 1997 as the first step to open the market for local investors. It was the time when the crisis had just begun. This resulted in reduction of market share by each company.

c) Soft international reinsurance market with huge reinsurance capacity available. Some major reinsurers try to write more business to compensate their premium reduction by accepting almost every risk offered to them.

The fierce competition brought in by some major insurers causes the following problems:-

a) Additional burden to many insurers who already faced the liquidity problems. Their bottom line will get worse if the premium volume from additional insureds cannot generate sufficient income to cover the potential claim cost. These insurers may write more business but get less income due to significant rate reductions. The insured is the one who enjoys these benefits.

b) Exaggerated commission level demanded by some producers who have a lot of business. This increases the operating cost and reduces the profit margin further.

c) Increase in turnover of the agents, especially the life insurers, who were forced out because they could not meet their companies' target.

**Decrease in investment return**

The investment yield for the insurance industry is decreasing with an average yield of 8% for the life insurance industry and 9.23% for the non-life insurance industry in 1998.

There are five factors which contribute to the decrease in investment returns :-

a) Change in monetary policy. Between July 1997 – June 1998, the government used a high interest rates policy to attract more foreign investors. The insurance industry had enjoyed high interest rates on deposits. However, since July 1998, the government decided to use the low interest rate policy in order to boost the economy. This has significantly reduced the investment return of insurers on deposits.

b) Capital loss in the stock market. Many insurers who invested in the stock market in recent years have suffered capital loss as the price of shares decreased significantly due to the poor performance of those companies;

c) Lower dividend received. Most of the stocks which the insurers have invested in do not give any dividend at all because of their poor performance;

d) Less investment assets available. Due to the delay in premium payment by the policyholders and the producers, the insurers have less money to invest;

e) Non-Performing Loan (NPL) The life insurers who lent money to the real estate sector before the economic crisis also suffered NPL. Due to tight investment control by the government which does not allow the insurers to lend money to this sector more than 20% of their investment assets, the percentage of NPL to the life insurers is around 50% of their lending in this sector or the equivalent of 10% of the life insurers' total assets. This is not so serious because they may be able to reduce the loss by selling these properties in the long run.

The life insurance industry has increased its proportion in long term investment, such as government bonds, debentures, from 29.49% in 1997 to 33.87% in 1998 and reduced the proportion of deposits and lending from 70.51% in 1997 to 66.13%.

The non-life insurance industry, on the other hand, has decreased its proportion of long term investment from 27.20% in 1997 to 23.68% in 1998 and significantly increased the proportion of bank deposits from 41.95% in 1997 to 55.75% in 1998, in order to increase the high liquidity level and earn more interest, while reducing the deposits with finance companies and maintaining the proportion of lending.

**Underinsurance**

Due to the recession, the market prices of properties such as land, houses and buildings, have decreased by 20 – 60%. However, the cost to rebuild these buildings or to replace certain spare parts of the machines has increased significantly due to inflation and devaluation.

The impact to the non-life insurers is:-

a) Premium reduction – For those who insured their properties on actual cash value basis, as the market price of their insured properties decreased, there is the tendency for them to reduce their sums insured;

b) Underinsurance – For those who insured their properties on the replacement cost basis, they tend to be reluctant to adjust their sums insured upward in order to save premium. This means that most of the insureds are underinsured. In order to maintain the account, some insurers may decide to waive the average provision or to give more ex-gratia payments.

**Moral hazard**

The problem of moral hazard which the insurers may experience are

a) Increase in numbers of arson. This is not serious because most of the property owners who mortgaged their properties know that their claims proceeds will go to the bank if there is any fire damage to their properties;

b) Increase in fraudulent claims for medical expense. There is an increasing trend for fraudulent claims by the insured or certain hospitals to exaggerate the amount of claims;

c) Increase in theft losses for motor vehicles. This is due to more poor or unemployed people, or gangs of thieves who sell the insured vehicles to neighbouring countries and claim that they were stolen.

**Lower quality of risk**

With the recession, most people will try to save their money by reducing any unnecessary expense or postponing certain expense. For example, reduction of the number of security guards in the premises will increase the chance for theft loss, while delaying periodic maintenance for machines will increase the chance for accident or machinery breakdown.

## STRATEGIES FOR THE INSURERS' SURVIVAL

Insurers should consider the following strategies :-

1) Short term strategies – if the crisis lasts between 1-3 years ;
2) Long term strategies – if the crisis lasts longer than 3 years.

**Short Term Strategies**

**1) Reduce operating costs**

These strategies can be implemented immediately by

1.1 Reducing any unnecessary operating expense, for example, to use electricity and water wisely, to use paper on both sides, to lower outgoing phone calls;
1.2 No increase in salary and no bonus for the employees;
1.3 No new recruitment to replace people who resign;
1.4 Closure of unprofitable branches.

**2) No growth**

Under the current economic climate, it is better to maintain the existing market share with no growth in premium income at all. Otherwise, they have to go into a price war to get more business.

**3) Develop the company**

These strategies can be implemented immediately without incurring a lot of expense by

3.1 Developing operational processes, by shortening them, making them more organized or eliminating any unnecessary work;
3.2 Training and developing the staff to work faster and have higher efficiency;
3.3 Training and developing the executive to be more competent and make faster decisions.

**4) Increase customer's satisfaction**

Customer's satisfaction is the key to long-term profitability. Under the current situation, insurers must try to retain the existing policyholders by :-

4.1 Providing faster service such as arriving at the scene of the accident much sooner than before;

4.2 Providing value added services such as a loss prevention engineering service for the major accounts;

4.3 Developing customer relationships, meeting face-to-face with each client and showing them long term commitment by understanding what they want and trying to meet their needs.

**5) Modify existing products**

The insurers may try to increase the premium income by

5.1 Producing a package which meet the customers' needs

5.2 Offering cheaper packages by cutting any unnecessary cover and lowering the premium.

**6) Change the marketing policy**

In order to increase the premium income, the insurers may

6.1 Use direct marketing to target a larger market, for example by selling compulsory motor insurance in the branch offices of a bank, convenience stores, gas stations or cooperatives, by contacting their head office first;

6.2 Penetrate into an unoccupied market such as life insurance where the Thai people have only 12.23 policies per 100 population, or compulsory motor insurance of which only 60 - 65% of the vehicle owners actually have this cover.

**7) Improve the company's liquidity**

Liquidity is one of the key factors for the insurers' survival. This may be improved by

7.1 Giving longer credit terms to existing policyholders who have financial difficulty. Instead of having a huge bad debt allowance, the insurer will be able to collect the premium even though it is slower than before;

7.2 Encouraging the producers to remit premium faster by giving additional commission which should be commensurate with additional investment return;

7.3 Arranging a loan with a bank / finance company for the policyholders to pay their premiums on an installment basis;

7.4 Allow the life policyholders to change from annual to half yearly, quarterly or monthly premium payment without additional charge;

**8) Improve the company's investment**

The insurers may improve their investment policy by

8.1 Having a bigger proportion of high liquidity assets with reliable financial institutions;

8.2 Having a more conservative investment strategy by not investing in risky assets;

8.3 Saving money for the future, and being prudent in spending decisions.

**9) Prevent and minimize loss**

The insurers may deal with moral hazard by

9.1 Having more cooperation among the local insurers to share information on fraudulent claims in various classes of insurance through the creation of a "Black List";

9.2 Being more careful in risk selection especially on new business;

9.3 Having periodic risk surveys for loss prevention on major accounts.

**Long Term Strategies**

**1) Develop the company**

The government is liberalizing the insurance industry by allow foreigners to gradually hold more shares in Thai companies, i.e. from the current level of 25% to 35%, 45%, 49% and up to 100% in the next 5 years.

Foreign insurers will usually have more experience, advanced technology and more capital funds. This will make the insurance market highly competitive in the near future. The insurers have to continue to

1.1 Develop the company by reducing the work process, increasing the work efficiency and upgrading the information technology systems. Even though they have to invest a lot of money now, in the long run they can substantially reduce operating costs;

1.2 Develop the staff to be more efficient and up to international standards from both intellectual and technological aspects to comply with new technology in the globalization era and be capable to compete with foreign insurers;

1.3 Improve the quality of management up to international standards, as the leading positions in the insurance industry requires modern managers with good vision.

**2) Develop the product**

The insurers must develop new products to meet the consumers' needs with emphasis on the middle class people who still have purchasing power. For example, life insurance with long term saving which earns more than interest on deposits with the bank

**3) Control operating costs**

The insurers have to evaluate productivity by comparing the premium income with the operating costs. If the premium income does not cover the operating costs, they have to downsize the company by laying off redundant staff.

**4) Merger / Joint Venture**

The current capital fund, as required by the government, is THB 30 Million for non-life insurers and THB 50 Million for life insurers. This amount is considered very low and they need more capital to write more business. The government is considering increasing their capital funds to be THB 300 Million for non-life insurers and THB 500 Million for life insurers.

However, it is very difficult to have additional capital funds during the recession. The potential solutions would be

4.1 Merger among local insurers. As competition in the insurance industry becomes fierce, mergers would reduce the overall competitive risk in the market. By merging, the companies can gain synergistic competitive advantages, provide a larger customer base, and, given the right complementary characteristics of each merging company, increase their financial stability;

4.2 Joint Venture with foreign partner. This will strengthen the local companies with fresh capital, technology, product development, marketing and training as well as boosting the overseas network for the local companies;

4.3 Sell the company to an interested party if the insurer cannot find any partner or increase the capital fund by itself;

4.4 Close the company if they cannot do anything else.

# GOVERNMENT'S ASSISTANCE

The government can assist the insurance industry by

**1) Increased tax deductible**

1.1 Increase tax deductible level for life insurance premium from THB 10,000 per person per year to THB 20,000 – 30,000 per person per year. This will give more advantage to the policyholders and encourage them to buy more insurance;

1.2 Enable the non-life insurance premiums paid by private insureds such as fire, motor, and personal accident insurance to be tax deductible;

1.3 Double tax deduction for marine cargo insurance premium if insured locally. Without this incentive, a lot of importers and exporters are insuring overseas.

2) **Monitoring the financial strength**
   It is very important for the government to monitor the liquidity and stability position of insurers to ensure that they are still healthy and can pay claims to the policyholders within a reasonable period of time.

3) **Promoting the insurance industry**
   The government can educate the public about the benefits of insurance, assist in training the professional agents, create confidence among the public and act as an information center for the foreigners who are interested in joint venture with local insurers.

4) **Lessening government control**
   The insurance industry is highly regulated by the government. There should be more flexibility for the industry to regulate themselves through the concept of "self-regulation", for example, the decision to issue certain rules or regulations for the industry, the new products and the rates to be used. The government should have less interference in the insurance industry at this moment, especially on the policy to reduce premium rates as this will make the situation worse.

# CONCLUSION

## Continuing impact

The four most important impacts on the Thai insurance industry, which continue are

1) Decrease in premium income Although the Thai economy is improving, it will take at least 3 more years before it will fully recover from the recession. The insurance industry is not likely to recover before because:

   1.1 Thai people still have less purchasing power as most of them do not have any increase in their salaries, those unemployed still look for jobs and there is more unemployment. At the same time, the government implements the easing of monetary policy by lowering interest rate on deposits to a very low level which significantly reduces the income of the depositors.

   1.2 The timing in which the government implemented some economic stimulus packages to boost the economy by easing fiscal policy, such as reducing VAT and personal income tax, was too late and too low. Most people think that they have to reduce their spending and save for their future. No measures to stimulate more insurance purchase through the increase in the tax deductible level for the life policyholders was given in these packages;

1.3 The government implemented the easing of monetary policy by lowering the interest rates on lending to encourage more investment, but the banks are still afraid of Non-Performing Loans, and set very high criteria so that very few people will successfully be granted loans.

2) Lack of liquidity - from the funds trapped in the closed finance companies and delay in premium payment by the policyholders and producers. Fortunately, the stability of the insurers, which is considered as the key factor of the insurance industry, has not been damaged. As the result, the trust from public has not been affected;

3) Intense competition among the insurers - in order to maintain their own premium level which resulted in more severe price cutting than in 1998. The situation is improving with the latest directive from the Insurance Commissioner on June 1, 1999 to ease the intense competition and to put some stability in the market;

4) Decrease in investment return - as the result of the easing of monetary policy which decreases the interest rate on deposits with the banks to a much lower rate than in early 1998, insurers will have much less investment income. This will have more impact on the non-life insurers due to the high proportion in the bank deposits. The life insurers will also suffer if they actually earn less interest than what they assumed in their premium calculation formula at 6% per year.

It is likely that the impact from economic crisis on the Thai insurance industry will continue because the insurance industry lags other financial industries by about six months to one year although it has less direct impact from the crisis.

**Key strategies for insurers' survival**

The insurers derive profits from underwriting and investment. As the investment income has an unfavorable outlook, in the short run they should focus on underwriting – either by increasing the premium income or decreasing the operating cost – in order to maintain liquidity, stability and ability to pay claims within a reasonable timeframe. There are several unoccupied markets for the insurers to penetrate. They should not use price cutting to maintain or increase the number of customers as they will write more business, have more liability but less premium.

In the long run, if the crisis continues to persist, the insurers must use the survival mode by

1) Forecasting the situation;
2) Anticipating the potential problems;
3) Having proper planning;
4) Simulating the situation.

**Role of the government**

The role of the government on supervision of the insurance industry should be changed from a strict monitor to

1. Overseeing the operation and supporting the potential advancement of the industry.
2. Developing better rules and regulations as well as cancelling the obsolete ones.
3. Increasing the role of the insurance industry through the concept of "self regulation" among themselves.
4. Providing knowledge to the public, private sector and government itself.
5. Adopting high technology to perform in a more flexible and improved manner.
6. Ensuring that the insurance industry operates in the best manner for the maximum benefits of the policyholders.

**Insurance industry outlook**

Following the economic crisis, it is likely that there will be the following changes in the Thai insurance industry:-

1. More company improvement in
   - 1.1 Controlling the operating costs;
   - 1.2 Developing operational processes - to be shorter and more organized;
   - 1.3 Increasing operational efficiency;
   - 1.4 Staff & agency development - to be capable of handling more complicated work on the "one stop service" concept;
   - 1.5 Management development – to have competent managers who know how to manage the company, have good vision, make the right decisions and right strategy at the right time and have awareness of the changing environment. These capabilities can be proved during this period if they can save the company;
   - 1.6 Information technology – there must be good systems which support the management's fast and accurate decision making and help to improve the business;

2. More customer orientation – to serve the need of different groups of customers with specific products that have higher quality and benefits. The insurers have to train their staff and agents to be capable of providing one-stop customer service;

3. More joint ventures between foreign shareholders and Thai insurers because of the need for additional capital funds and to receive new technological support. With the devaluation of Thai Baht by 50% and the decision of the government to open up the insurance market to the foreigners much sooner than required by the World Trade Organization (WTO), it is good timing for foreign insurers to bargain for such joint ventures;

4. It is unlikely that there will be very few mergers among the local companies as Thai people don't like to be No. 2 in the new company;

5. Tougher competition from foreign insurers - once the insurance market has been fully liberalized where foreign insurers can hold 100% share, they will operate with higher technology, more reinsurance capacity and more capital funds than the local insurers;

6. Less government control through the concept of "self regulation" by which the insurers have to agree and regulate themselves.