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CONTENTS

| Sr. No. | TITLE & NAME OF THE AUTHOR (S) | Page No. |
|---------|---|----------|
| 1. | EDUCATIONAL LEADERSHIP, MANAGEMENT AND PAKISTAN IN 2050 <i>TAIMOOR BASHARAT & DR. MUHAMMAD RAMZAN</i> | 1 |
| 2. | RESEARCH IN DEVELOPMENT ARENAS <i>ROMAZA KHANUM</i> | 6 |
| 3. | COMPARATIVE EVALUATION OF THE RELATIONSHIP BETWEEN STOCK RETURNS FIRM WITH PRICE COEFFICIENTS: CEMENT LISTED ON STOCK EXCHANGE <i>MOHAMMAD REZA ASGARI, SHAHIN SAHRAEI & AHMAD GHASEMI</i> | 10 |
| 4. | IMPACT OF STOCK MARKET DEVELOPMENT ON ECONOMIC GROWTH: AN EVIDENCE FROM SAARC COUNTRIES <i>MUHAMMAD ENAMUL HAQUE</i> | 15 |
| 5. | PREDICTING SUKUK DEFAULT PROBABILITY AND ITS RELATIONSHIP WITH SYSTEMATIC AND UNSYSTEMATIC RISKS: CASE STUDY OF SUKUK IN INDONESIA <i>MISNEN ARDIANSYAH, IBNU QIZAM, RAZALIHARON & ABDUL QOYUM</i> | 21 |
| 6. | POVERTY ALLEVIATION IN THE INFORMAL SECTOR AS A CATALYST FOR NIGERIA'S ECONOMIC GROWTH <i>MARTINS IYOBOYI</i> | 28 |
| 7. | THE MACROECONOMIC IMPACT OF TRADE ON ECONOMIC GROWTH OF NIGERIA <i>ANTHONIA T. ODELEYE</i> | 36 |
| 8. | A STUDY OF OPERATIONAL EFFICIENCY OF SELECTED PUBLIC SECTOR BANKS IN INDIA – ISSUES AND CHALLENGES <i>DR. BHAVET, PRIYA JINDAL & DR. SAMBHAV GARG</i> | 42 |
| 9. | SETTING UP LOCAL REINSURANCE COMPANY IN ETHIOPIA: ANALYTICAL REVIEW <i>ASNAKE MINWYELET ABEBE</i> | 49 |
| 10. | PROBLEMS OF SUGAR COOPERATIVES IN MAHARASHTRA <i>DR. DANGAT NILESH R.</i> | 55 |
| 11. | ANALYSIS OF ASSET QUALITY OF PRIVATE SECTOR INDIAN BANKS <i>SULTAN SINGH, MOHINA & SAHILA CHOUDHRY</i> | 58 |
| 12. | ORGANIZATIONAL COMMITMENT OF MANAGERS OF PUBLIC SECTOR BANKS IN INDIA: AN EMPIRICAL STUDY <i>DR. KANWALDEEP KAUR</i> | 61 |
| 13. | A PENTAGON PERFORMANCE SCENARIO OF SUGAR SECTOR IN INDIA <i>DR. GAJANAN MADIWAL</i> | 68 |
| 14. | JOB SATISFACTION OF EMPLOYEES – AN EMPIRICAL ANALYSIS <i>DR. UJERINABI & S. KAVITHA</i> | 72 |
| 15. | COTTONSEED UTILIZATION PATTERN AND AVAILABILITY OF COTTONSEED FOR PROCESSING <i>DR. T. SREE LATHA & SAVANAM CHANDRA SEKHAR</i> | 77 |
| 16. | NATURE AND EXTENT OF AGRICULTURAL TENANCY IN ANDHRA PRADESH - A CASE STUDY IN TWO VILLAGES <i>DR. S. RADHA KRISHNA</i> | 80 |
| 17. | A STUDY ON SELF HELP GROUPS – BANK LINKAGE PROGRAMME IN INDIA <i>DR. A. JEBAMALAI RAJA & M. SUVAKKIN</i> | 86 |
| 18. | FACTORS INFLUENCING ATTRITION <i>RISHU ROY & ARPITA SHRIVASTAVA</i> | 89 |
| 19. | REGULATORY FRAMEWORK FOR MANAGING THE MICRO FINANCE IN INDIA PARTICULARLY IN MEGHALAYA <i>MUSHTAQ MOHMAD SOFI & DR. HARSH VARDHAN JHAMB</i> | 95 |
| 20. | EFFICIENCY MEASUREMENT OF INDIAN PUBLIC AND PRIVATE SECTOR BANKS IN THE CONTEXT OF DOWNGRADED RATINGS <i>DR. KULDIP S. CHHIKARA & SURAKSHA</i> | 99 |
| 21. | COGNITIVE STYLES AND MULTI-MEDIA LEARNING: A QUASI-EXPERIMENTAL APPROACH <i>DR. RANJIT KAUR & SAROJ BALA</i> | 107 |
| 22. | ROLE OF CREATIVE MANAGEMENT AND LEADERSHIP IN ENTREPRENEURSHIP DEVELOPMENT <i>VIKAS BEHAL & PUJA BANSAL</i> | 112 |
| 23. | POSITIONING INDIA IN THE GLOBAL ECONOMY: AN OVERVIEW <i>DR. JAYA PALIWAL</i> | 116 |
| 24. | AGRICULTURE FARMERS AND FINANCIAL INCLUSION WITH SPECIAL REFERENCE TO BAGALKOT DCC BANK IN KARNATAKA STATE <i>DR. H H BHARADI</i> | 121 |
| 25. | MINREGA AND RURAL POVERTY: A CASE STUDY OF NILOKHERI BLOCK IN HARYANA PROVINCE <i>PARDEEP CHAUHAN</i> | 125 |
| 26. | EXTERNAL DEBT OF MALDIVES: GROWTH AND ECONOMIC GROWTH <i>DR. G. JAYACHANDRAN</i> | 129 |
| 27. | CORPORATE GOVERNANCE DISCLOSURE PRACTICES IN G N F C LTD. <i>DIVYANGKUMAR VINODBHAI BRAHMBHATT</i> | 139 |
| 28. | NRM POLICY OF NABARD AND SUSTAINABLE DEVELOPMENT BIRDS-EYE VIEW ON AURANGABAD DISTRICT <i>DR. ANIL BABURAO JADHAV</i> | 142 |
| 29. | MANAGEMENT OF NON-PERFORMING ASSETS: A COMPARATIVE STUDY OF PUBLIC AND PRIVATE SECTOR BANKS <i>DR. SAMBHAV GARG, PRIYA JINDAL & DR. BHAVET</i> | 146 |
| 30. | PORTFOLIO SIZE AND PORTFOLIO RISK: EVIDENCE FROM THE INDIAN STOCK MARKET <i>MEENAKSHI RANI</i> | 152 |
| | REQUEST FOR FEEDBACK | 156 |

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SETTING UP LOCAL REINSURANCE COMPANY IN ETHIOPIA: ANALYTICAL REVIEW

ASNAKE MINWYELET ABEBE
RESEARCH SCHOLAR
DEPARTMENT OF COMMERCE & MANAGEMENT
ANDHRA UNIVERSITY
VISAKHAPATNAM

ABSTRACT

This paper is an analytical review of the prospects, challenges and potential for setting up local reinsurance company in Ethiopia. Modern insurance has been practiced in Ethiopia for more than a century. However, the Ethiopian insurance sector is said to be one of the less developed in the world and African countries. The insurance sector in Ethiopia has long been in the reinsurance business arranged with foreign reinsurers. Recognizing the role of local reinsurer, a number of African countries have set up national reinsurance companies. Ethiopia is not one of them. The issue has remained unresolved for years. The literature exhibits contrasting views on the relative merits and demerits of reinsurance business arranged locally and cross border. In this respect there is little research that focused on reinsurance in Ethiopian context. This study, thus, helps to that effort. It also provides the policy makers and governmental officials with insight information that they can see and consider the possibility of setting up local reinsurance company in Ethiopia. The paper concludes, abstaining from taking positions, by recommending on the measures to take before and after establishing the company if Ethiopia would have any.

KEYWORDS

Local reinsurance, Reinsurance, Reinsurance in Ethiopia, Analytical Review.

1. INTRODUCTION

The economic, social and political significance of insurance has been documented in the literature. As a key pillar of the financial sector, insurance plays a crucial role in economic development (UNCTAD, 2007). According to UNCTAD (1980, 2007), a sound insurance market is an essential characteristic of economic growth.

Reinsurance, one operation in the insurance market, plays a vital role in the proper functioning and development of insurance industry and risk management (Holland, 2009; David Cummins et.al 2007; You Lei and Joan Schmit, 2008). Primary insurers use reinsurance for both financial and operational purposes (James R. Garren and Joan Lamm Tenant, 2003; Rodolfo, 2009; Chen, Hamwi and Hudson, 2001). The reinsurance service can be arranged either locally or abroad. The need to diversify risks may call for the need to use foreign reinsurance. This need, however, does not preclude the necessity of increasing the amount of risk retained locally (UNCTAD, 2007). Hailu Zeleke (2007) stated that from risk management point of view foreign reinsurance cannot be eliminated altogether. Hence, the question that would rather left is whether optimum risk retention is obtained.

According to UNCTAD (2007), developing countries, which Ethiopia is not an exception, are highly dependent on foreign reinsurance. The literature exhibits contradicting views on the extent and dependency of developing countries on foreign reinsurance. Some (including Outreville, 2002; Wang, 2003) argue in favor of it while others are against as it would affect the domestic insurance in these countries (UNCTAD, 2007, 1987, 1980; Irukwa, 1987).

One mechanism that developing countries would use to increase the amount of risk retained locally and decrease foreign dependency is local reinsurance. A number of African countries have set up national reinsurance companies. However, Ethiopia is not one of them despite its long experience in reinsurance business arranged abroad (Hailu Zeleke, 2007; Zafu, 2006). Different stakeholders have been proposing to set up local reinsurance company in Ethiopia. However, the issue has remained unresolved for years and so far there is nothing despite all the efforts made to produce one.

The benefits of setting up a local reinsurance company do not come without costs. Before pushing ahead, analyzing the prospects, challenges and potential for setting up the company enables to proactively see the potential costs, risks, requirements and to push ahead with policies and strategies to avail the country with the benefits.

Hailu Zeleke (2007) indicated that a detail and rigorous study should be made to identify the merits and demerits of establishing national reinsurance company in Ethiopia. He also noted on the need to identify the experience of African countries and the benefits they derived by establishing a national reinsurance company. Mezgebe (2010) has also noted that despite its importance and unlike the wealth of literature in respect of the reinsurance business outside Ethiopia, there is little research in Ethiopian context.

Motivated by the literature review and the gap in there, this study analytically reviews the potential for setting up local reinsurance company and how to do it should Ethiopia have one. Drawing on the existing literature and reports, the paper analyzes and reports on the prospects, challenges and requirements for setting up local reinsurance company in Ethiopia.

The study has tried to answer four specific questions. These are:

- 1) What does the reinsurance business environment in Ethiopia look like?
- 2) What lessons would Ethiopia draw from the experience of African countries on establishing a local reinsurance company?
- 3) What are the prospects and challenges of setting up local reinsurance company in Ethiopia?
- 4) What are the measures to take in setting up local reinsurance company & its proper functioning if Ethiopia would have any?

The specific purposes of the study include:

- i) Describing the reinsurance business environment in Ethiopia.
- ii) Exploring the experience of African countries and the benefits they derived by establishing a reinsurance company & identifying lessons to Ethiopia.
- iii) Identifying and analyzing the prospects and challenges of setting up local reinsurance company and its proper functioning in Ethiopia.
- iv) Recommending on the specific measures to take for setting up and proper functioning of local reinsurance company in Ethiopia.

The significance of the study can be justified from two perspectives. The first perspective is the importance that it contributes to the literature on reinsurance business in Ethiopia. The second is the policy implications in that the study provides policy makers and governmental officials with insight information and recommendations by which they can see and consider the possibility of setting up local reinsurance company in Ethiopia.

The study is conducted through the following:

- Review of relevant reports, unpublished records of National Bank of Ethiopia (NBE) and the limited related studies in Ethiopia
- Assessment of policy, law & practice of Ethiopian reinsurance business.
- Discussion with employees of some insurance companies in Ethiopia.
- Assessment of African reinsurance experience and review of international organizations' recommendations.

The remaining sections of the paper are organized as follows. Section two provides basics of reinsurance and review of related literature on local and foreign reinsurance – developing countries perspective and African reinsurance. Section three presents the requirements for setting up and proper operation of local reinsurance company. Section four deals with the current condition in Ethiopia vis-à-vis the requirements for establishing local reinsurance Company. Finally, conclusion and recommendations are included in section five.

2. REINSURANCE-BASICS, DEVELOPING COUNTRIES AND AFRICAN PERSPECTIVE

2.1. BASICS OF REINSURANCE

Reinsurance is one of the important operations of insurance companies (George E. Rejida, 2008) that involves the shifting of part or all of the insurance originally written by one insurer (cedant) to another insurer (reinsurer). Scholars, including Garry S. Patric, Peter Falush, Peter Liebwein and Keith Purvis, James Allen Park, Robert Kiln, Rodolfo Wehrhan, Mike Adams, Holland D.M., Edwin W. Kopf, and others have defined reinsurance in a number of careful ways. Summarizing the definitions available, reinsurance can be understood as insurance for insurance companies. The reinsurer, in return of a premium paid to it, indemnifies an insurer for a portion or all of the liabilities taken up by the latter due to a policy of insurance that it has issued. Percolation No. 86/1994, licensing and supervision of insurance in Ethiopia, defines "Reinsurance" as an agreement whereby an insurer guarantees to share in the benefits and liabilities of another insurer".

The nature of reinsurance, either facultative or treaty which again may be proportional or non proportional, is like insurance except the parties involved, specification of the contract, and size and complexity of the transactions. Based on contractual relationships, reinsurance is to be differentiated from coinsurance, where the risk is shared and not transferred among insurance companies each of them having a direct contractual relationship with the insured. Thus, reinsurance involves legal entities and not individuals. The reinsurer can also transfer risks to other entities called retrocessionaires by means of a financial transaction called retrocession (Rodolfo Wehrhahn, 2009).

The most important reasons for an insurance company to use reinsurance include increasing underwriting capacity, risk capital improvement and diversification, surplus relief, catastrophic protection, expertise transfer, financing new business and reducing volatility of underwriting (Rodolfo Wehrhahn, 2009; Peter Liebwein and Keith Purvis, 2005). The ultimate goal of reinsurance is to reduce insurers' exposure to loss. This goal enables to reduce the financial cost to insurance companies from the potential occurrence of insurance claims, and thus enhancing innovation, competition and efficiency in the market place and an economy.

How much businesses an insurer will reinsure depends on the insurer's business model, its capital strength, risk appetite and prevailing market conditions. In particular, insurers whose profitability are heavily exposed to catastrophic events, small local players, specialized insurers, insurers with small number or risks with large exposures, insurers with a greater proportion of businesses containing a mortality or disability risk elements, insurers expanding into new products & insurers exiting markets or lines of business often need and use more reinsurance (Patrizia Baur and Antoinette Breutel-O'Donoghue, 2004). Regulatory conditions also significantly influence the demand for reinsurance.

In general, reinsurance makes insurance markets more stable and attractive and results in less expensive products, higher profitability, enhanced insurability, lower cost of capital, secure industry, and growth and development of the insurance companies, the insurance sector and overall economy.

2.2. LOCAL VS FOREIGN REINSURANCE – DEVELOPING COUNTRIES PERSPECTIVE

Almost all insurance companies have a reinsurance program arranged locally or abroad; the cession of shares of liability spreads risks further and enables to achieve the ultimate goal of reducing exposure to loss. By passing the exposure to loss to a reinsurer or a group of reinsurers, insurance companies can transfer some of the risks to the reinsurer.

The insurance markets of the developing countries are characterized by low levels of growth and sophistication. The markets are also characterized by lack of local regulations governing the practice of insurance (UNCTAD, 2007).

Dependence on foreign reinsurance is much more persistent than dependence on foreign insurance. Even in countries where the insurance sector has been totally nationalized, dependence on foreign reinsurance cannot be eliminated altogether. This is particularly the case in developing countries, where the premium income is relatively small and where large risks cannot be covered by the premium receipts generated there. According to Cassandra R. Cole et al., 2008, between 1996 and 2004, two of the top six countries, in terms of total volume of reinsurance, are developing nations. Though, the demand for foreign reinsurance by developing countries varies across developing countries depending on structure of the insurance market, degree of development and the type and size of risks covered (UNCTAD, 1980), the volume of reinsurance service which these countries purchase abroad in order to balance their portfolios has increased significantly (Skipper, 1987; Outreville, 1995, 1990; Wang, 2003).

The nature and size of the market and lack of adequate diversification of risk on the business written by domestic insurers in the developing countries creates a need for a substantial transfer of their portfolio to the reinsurers. In addition, as the economies in these countries continue to grow, the domestic markets may no longer be able to meet the excessive demand in the countries (Outreville, 1990, 1995). According to UNCTAD (1980, 2007), inadequate market structure, under capitalization and insufficient know-how are among the factors that contribute for the dependency. Hence, developing countries often find themselves in the position of being net buyers of reinsurance. Cassandra R. Cole et al. (2008) find strong support for the importance of developing countries in the reinsurance marketplace and existence of higher demand for foreign reinsurance by developing countries due to the fact that their domestic markets may not be able to serve the domestic demand.

In relation to the extent and dependency of developing countries on foreign reinsurance, contradicting views are observed. Those arguing in favor of local reinsurance suggest that strengthening domestic reinsurance companies of developing countries improves the risk retention capacity locally, technical capacity of the primary insurers, and even can attract foreign market and generate hard currency. This helps minimize the outflow that may result from being completely dependent on cross border reinsures. The companies can create foreign currency earnings through dividends and earnings by making cross boarder investment using their skills, capabilities and competencies in emerging market opportunities (Zafu, 2006). According to UNCTAD (1980), UN considers the creation of strong and efficient domestic reinsurance institutions to save outflow of foreign exchange and growth, adequate legislation and supervision of reinsurance and professional training for efficient and sound national reinsurance institutions as objectives and strategy in developing countries. They also claim that dependency on foreign reinsurance has negative consequence to developing countries in terms of foreign currency outflow and deterioration of balance of payment. Excessive dependency affects the domestic insurance in developing countries resulting in low contribution to the national economy (UNCTAD, 2007, 1987, 1980; Irukwu, 1987).

Also, the dependence of developing countries, both financially and technically on foreign reinsurance, has implications to their development. These implications can be understood on the basis of the cost in foreign currency and the negative impact that excessive dependence has on the growth and development of the domestic insurance sector. According to UNCTAD (1980), heavy dependence on foreign reinsurance and the continuation of this dependence for a number of years prevents developing countries from building up their surpluses to enable them to retain a tangible volume of their premiums. This in turn affects their insurance companies' viability and development, and places them more in the position of brokerage firms than of genuine risk carriers.

On the other hand, some arguing in favor of foreign reinsurance to developing countries suggest that foreign reinsurer provides insurers with professional management expertise, financial leverage and foreign exchange inflows in times of claims (Outreville, 2002; Wang, 2003).

Despite all the existing views, the need to distribute risks as widely as possible does not preclude the necessity of increasing the amount of risks retained locally up to a sound maximum commensurate with the capacities of the local market and the companies of which it is composed. Measures at the individual and market levels can be adopted to attain this goal, supplemented by measures at the regional level (UNCTAD, 1964). Hailu Zeleke (2007) noted that from the risk management point of view, reinsurance cover from foreign reinsurance is unavoidable.

This indicates that an optimum retention of risk locally requires balancing between the two extremes. One mechanism that developing countries would use to increase the amount of risk retained locally and decrease foreign dependency is local reinsurance.

In practice, reinsurance placements for large risks in developing countries is mainly in the form of facultative cessions i.e., case-by-case reinsurance. This condition has resulted for small companies' disadvantage of virtually allowing the reinsurer to impose its terms and conditions on the direct writing company, not only as regards the terms of reinsurance but also as regards the terms of the original cover. The failure to find placement promptly for a given risk obliges the insurer to comply with the reinsurer's requirements. It is also true that facultative reinsurance allows the ceding company a much lower level of reinsurance commission and no profit commission is payable. Reciprocal exchange in reinsurance, allows to boost the level of premium income, stabilize the portfolio results, and enable the extend operations to other markets without the need to establish foreign representative abroad. Though, because of these advantages,

reciprocal exchange in reinsurance has become an internationally recognized practice, in developing countries, however, most domestic insurers are not yet making extensive use of this practice due to lack of underwriting expertise. This caused the developing countries rely upon stable commission terms rather than venturing to carry foreign risks.

As Policy considerations, plans aimed at reducing the cost of foreign reinsurance and optimize the retention of risk locally, without losing sight of the need to satisfy the requirements of the market and of the companies, may be focused on at the individual company, market or regional level; and regularly measures need to be considered. However, the actions would be affected by the market's susceptibility to the risk of catastrophes and the ceding companies' interest to use reinsurance costs under better control. To retain risks locally at reasonable levels, establishment of central reinsurance companies is recommended by UNCTAD (1980).

The expansion of the reinsurance requirements of developing countries, coupled with a desire to save foreign exchange, has prompted many governments of these countries to set up central reinsurance companies normally with public participation in their share capital. These companies are endowed with compulsory or agreed cessions from all direct writing companies operating in the market. Moreover, compulsory cessions are often accorded to these companies against low commission terms in order to favor their quick growth.

2.3. CURRENT CONFIGURATION AND EXPERIENCE OF AFRICAN REINSURANCE – LESSONS TO ETHIOPIA

2.3.1. EVOLUTION OF AFRICAN REINSURANCE COMPANIES

According to UNCTAD (2007), the insurance industry in Africa is a phenomenon of the twentieth century, following independence in the 1950's. South Africa has a longer insurance history followed by Egypt. The insurance companies are most small and medium sized. The establishment of local reinsurance companies in Africa is a more recent practice and related to the development of insurance after independence. The aim for establishing local reinsurance companies was to conserve profitable reinsurance premium ceded out of their countries and indirectly control the operations of the primary insurers.

Foreign reinsurers – Swiss Re, Munich Re, SCOR and Hannover Re have been operating in Africa for several decades. In the continent, state/regional reinsurers were the first on the scene, followed later by privately owned local players (Elizabeth Amadiume, 2011). The Egyptian reinsurance corporation formed in 1957 and Merged with Misr insurance company in 2008, was the first African reinsurer. The Moroccan state owned societe central de reinsurance, followed in 1960. Ghana Re was created in 1972. Between 1972 and 1990, a number of national and regional companies, along with a few privately owned ones, were set up. Tan Re (2011) and Uganda Re (2011) joined in the 21st century.

Elizabeth (2011) identified that the common motivating factors for the emergence and establishment of regional reinsurance companies are the desire to address capacity shortage, provide services specific to the needs of the local markets, and the development of requisite skills through training and exposure. These factors are laudable objectives which are being achieved by the regional reinsurers.

State and regional reinsurers in Africa are now competing outside their geographical spheres of influence, with generally good financial results. These achievements are partially attributed to the steadily improving capital base of the companies. These impressive performances of state and regional companies gave local entrepreneurs the impetus to create private reinsurance companies. The first privately owned company was Best Re (1985) which started in Tunisia from where it moved to Malaysia in 2011. The Nigerian based continental Re (1987), and in 1995, Main Stream Re (Ghana) and FBC Re (Zimbabwe) were formed. From 2003 to 2010 a number of privately owned companies were set up in Cote D'Ivoire, Burkina Faso, Zambia and Zimbabwe (8 private non-life reinsurers). At the helm of affairs of the private companies are a good number of experienced, successful and responsible practitioners who had worked in the national and regional insurance and reinsurance companies.

Currently, though there are more than 600 local insurance companies in Africa, the number of reinsurance companies in the continent is not much more than 30. The growth in the number of African reinsurers has been generally slow. Regional reinsurers - African Re (1976), CICA Re (1982), PTA /Zep Re (1990) and WAICA Re (2011) are the largest local reinsurers which Africa Re is the first and market leader in the continent.

The modest economic activities in the early years, huge capital requirements, low investment returns, scarcity of hard currency, limited local capacity, outward flow of premiums and paucity of skilled local man power are identified to be the reasons for the slow growth of local reinsurers in African markets (Elizabeth, 2011). Legal and regulatory requirements are also not sound in African countries.

The share of foreign reinsurers, which for many decades dominated the African reinsurance market, is now reducing. There is, however, renewed interest from Europe, Bermuda, the Middle East and Asia. Based on ownership structure, of the 33 local reinsurers in Africa, 10 are state owned, 20 are privately owned and 3 are state /privately owned. Region wise, 6 are found in North Africa, 4 in East Africa, 8 in West Africa and 15 in Southern Africa.

2.3.2. THE PERFORMANCE OF THE AFRICAN REINSURANCE MARKET

a. PREMIUM INCOME

The premium income of the African reinsurance market has been controlled by limited number of countries. In 2009, for instance, the South African Market contributes 47.2% of the African Reinsurance market; South Africa, Egypt, Angola, Morocco, Nigeria, Algeria and Kenya together made up 78.4% of the continents reinsurance premium in 2009.

In 2009, the reinsurance premium as a percentage of insurance premium on regional basis was 26.6% (Anglophone West Africa) , 21.4% (Franco phone West & Central Africa), 23.0% (North Africa,) 21.4% (African Indian Ocean Islands). 32.9% (East Africa), 24.7% (South Africa non-life reinsurance) and 2.2% (South Africa life reinsurance). The total amount of insurance premium in Africa amounts US \$51,474,772,561 of which 12.1% (US \$6,247,149,896) represents reinsurance cession in 2009 (computed from national insurance commissions and associations).

b. PROFITABILITY

There is a sustained profitability of Africa's insurance market makers. 60% of the insurance premium income is from the life branch which reinsures about 2.2% of its business. On the non-life side, Africa is essentially a proportional reinsurance market making up 90% of the continent's non-life treaty reinsurance business. The non-life treaty reinsurance premium is high, estimated on average at 25 – 28%. Performance indicators of locally domiciled reinsurers reveal that the regional players and the other reinsurers posted profits. For instance in Tanzania, Ghana and Kenya, the ratio of underwriting profits to net earned premium in (2008, 2009) were (13.18, 11.51), (7.6, 2.10) and (3.54, 7.34) respectively. The ratios for Senegal and Nigeria were (2.79, 2.51) and (8.08, 6.17 (loss)). For the regional reinsurance companies, the ratios were (9.59, 8.35) and (3.37, 6.56) for Zep Re and Africa Re respectively; for CICA Re, in 2008 and 2009, were 13.82 and 10.8 respectively.

In general, UNCTAD (2007) find out that a number of African reinsurance companies performed well in conserving resources , reducing outgoing reinsurance premiums and at different times providing reinsurance cover to small respective countries' insurance companies. However, the performance of Africa's reinsurance companies has been hampered and challenged by a number of factors including: lack of adequate capitalization, shortage of qualified or professional staff, outdated legislation , non existence of information system and national insurance statistics, and lack of confidence in their security by the majority of insurance that they try to serve ,both within and outside.

2.3.3. REINSURANCE INDUSTRY CHALLENGES IN AFRICA

The insurance industry itself in Africa which form the major source of business for the reinsurance industry has major challenges, and on top of these, there are also specific ones affecting the reinsurance industry in Africa. These are:

- i) Anti – selection – discrimination in their dealings with companies in the developed countries and to the business they secure in the local markets.
- ii) Limited underwriting capacity as the companies have small capital which is continuously being eroded in hand currency terms due to currency devaluation.
- iii) Foreign currency constraints as most insurance business is transacted in local currencies, reinsurance business by its very nature requires foreign currency, and its shortage is a challenge.
- iv) Poor skills development / shortage of skills and brain drain to developed countries.
- v) Poor Research & development capacity to meet the requirements of African situations.
- vi) Information and communication technology (ICT) –insufficient investment in ICT and the training of its people to match the challenges of technological advances and take of its opportunities.

vii) Industry supervision –lack strong and effective regulations in most Africa markets mainly due to lack of resources.

viii) Infrastructure (physical and institutional) - lacking proper infrastructure which militates against the effective operation of reinsurance companies in Africa.

3. REQUIREMENTS FOR SETTING UP LOCAL REINSURANCE COMPANY AND ITS PROPER FUNCTIONING/OPERATION

A considerable part of the strength of local reinsurance companies derives from their ability to offer a fairly large amount of business with a reasonable degree of spread. This gives them bargaining power when seeking retrocession in the international markets, thus enabling them to obtain terms more favorable than those obtained by individual insurers. Moreover, local reinsurers have a better chance of obtaining more favorable reciprocal business. The companies, by monitoring terms and conditions offered by direct insurers, and by insisting on strict tariff rates, contribute to the reinsurance terms obtained by such markets as a whole. Finally, an important aspect of activities of these companies is their ability to function on a world-wide scale. Having a broad home base with a wide spread of capacity and know-how which they develop through their contacts with the ceding companies and their retrocessionaires, they can contribute to expansion.

The proper functioning of a central reinsurance company requires a sufficiently large market. If insurance market in a country is very small, a local reinsurer is less able to meet the needs of the national economy. Such markets need to bank their efforts together at a regional or sub regional level to create common reinsurance units. The creation of such regional units allows these markets to overcome the constraints and difficulties arising from their exiguity, the scarcity of their financial resources and the lack of the technical expertise necessary for the good running of a reinsurance company.

In addition to the aforementioned points, the potential benefits of local reinsurance company and its proper functioning requires enabling environmental, institutional and regulatory requirements which are inherent in setting up the company and its operation. Also, the reinsurance business hinges on successful partnership. The advantages of reinsurance service can be increased by realizing the reinsurer as a partner rather than as a means of risk deduction only. Achieving these advantages would demand strategic partnerships, efficient operating platforms, a better understanding and management of risks and transparency at all levels.

The most important requirements for setting up local reinsurance company and its proper operation as discussed in the literature include:

➤ Proactive regulatory framework and industry supervision

The general objectives of reinsurance laws are to protect customers, standardize the conduct of reinsurance and establish a sound system. Regulatory frameworks and the laws relating to the conduct of reinsurance must be proactive, timely, relevant comprehensive, adequate and unambiguous. Strong supervisory authority armed with adequate financial and human resource must be available. The regulator/supervisor must liaise with the legislative arm of government, industry players and other entities that could play a role in the market so as to ensure that the industry is proactive and effectively regulated thereby contributing its quota to the economy.

➤ Effective enterprise risk management and corporate governance

Every reinsurance company should have a chief risk officer who reports directly to the management. If effectively handled, the function, allows the company to have a better understanding of the different types of risk it is exposed to. Both internal and external auditors must be allowed to carry out their duties in line with stipulated guidelines approved by the board. Similarly, there must be segregation of the responsibilities between management and board. The directors are also increasingly expected to demonstrate that the board is indeed adding value through its functions and that its committees focus on good governance.

➤ Improved ICT platforms, actuarial /statistical capabilities and R&D

Up-to-date ICT platform in line with cutting edge technologies would enable the reinsurer to automate most processes, thereby reducing response time and the cost of doing business. Furthermore, the reinsurer to compete with the best from around the world must employ actuarial and statistical capabilities to better understand and manage risks. Research and development is pivotal to the success of the company. It is therefore necessary for local reinsurer to recruit staff with the requisite skills to support in this regard.

➤ Strong industry bodies

A heavy burden skill lies on the shoulders of the industry bodies to lead the way forward in a proactive way that would steer the industry in the right direction. The role of well organized industry associations such as insurers, brokers etc cannot be underestimated in shaping policies and serving as a united voice for lobbying and negotiating with government through the regulatory body, consumers and other relevant sectors.

➤ Consumer awareness

Although the reinsurer has no direct link to the policy holder who is the ultimate customer, it is still a stakeholder. In that sense, all stakeholders and the regulatory authorities should work together for the interest of consumer. It is also in the best interest of the reinsurance company and the market that the public is informed and knowledgeable so as to make decisions on risk protection, investments and retirement provisions.

➤ Reinsurance education and training, Professional standards and competence

It is an acknowledged fact that the dearth of skills, knowledge and understanding in many industries need to be addressed. Education is vital tool in raising awareness. The work force is the most valuable asset. The benefits of an educated, trained and up-to-date work force are many– improved performance and quality of service, innovation, adaptation and foresightedness, competitiveness, self-confidence, cost effectiveness/value for money, improved claims management.

➤ Stability of the operating environment and adequate capital

There is a real need for stability in the general economy, legal, political and policy issues. It is also necessary to ensure a reliable, secure and adequate infrastructure, capital and foreign currency.

4. ENVIRONMENT FOR SETTING UP LOCAL REINSURANCE COMPANY IN ETHIOPIA

4.1. REINSURANCE BUSINESS IN ETHIOPIA

All insurance companies in Ethiopia cede reinsurance business to foreign insurance and reinsurance companies, such as Munich Re, Africa Re and PTA Re on proportional and non-proportional reinsurance methods (Hailu Zeleke, 2007). The proportional reinsurance plan includes facultative and treaty (quota and surplus). The same author indicated that Ethiopia has been long in reinsurance business arranged abroad and the reinsurers have the upper hand in the reinsurance arrangements. The state owned insurer, EIC transacts in reinsurance business in similar policies on a reciprocal basis with insurance companies and regional reinsurers operating in Afro Asian Countries.

With regard to the regulation of the reinsurance business in Ethiopia, though proclamation no. 86/1994 states that directive addressing the issues on reinsurance business in the country shall be issued by NBE, no such directive has been issued so far. In this respect, Workneh (2006) recommended on the regulatory requirement for the reinsurance business in Ethiopia. Hailu Zeleke (2007) also noted on the regulatory gap that it makes the challenge more difficult for the insurance industry competitiveness in the country.

The premium cession rates of the Ethiopian insurance sector for the non-life insurance business has ranged between 24%(in 2000) and 36%(in 2002) over the period 2000 to 2011. For the life insurance it is between 9%(in 2004) and 20%(in 2002) over the same period (Computed from NBE unpublished report). Zafu (2006) indicated that reinsurance business classes with least loss ratios have experienced the highest cession rates. The Ethiopian insurance industry has been a potential reinsurance market over a number of years in terms of profitability and easy access to remittance (Alamirew, 2006).

4.2. PROSPECTS (OPPORTUNITIES) AND CHALLENGES FOR SETTING UP LOCAL REINSURANCE COMPANY IN ETHIOPIA

The literature shows that developing countries like Ethiopia can derive a number of advantages by setting up and operating local reinsurance company. These, among others, include:

i. To increase risk retained locally and to reduce dependency on foreign reinsurance that would otherwise have negative consequence in terms of foreign currency outflow, deterioration of balance of payment and affects the domestic insurance industry that prevents it from building up surpluses to enable retain a

tangible volume of premiums; this in turn affects the insurance companies' viability and development, and places them more in the position of brokerage firms than of genuine risk carriers.

- ii. To serve the insurance companies with immediate effect, faster the development of the insurance industry and the economy, promote the growth of underwriting capacity. It can also assist the business development of primary insurers and provide direct insurers with essential technical knowledge.
- iii. Beyond using the local reinsurer as a risk transfer mechanism, setting up local reinsurer would create awareness for the local business people, facilitate information exchange, create job opportunities and participate in various investments.
- iv. Provide reinsurance cover to small insurance companies that would have been in difficult position to get adequate and affordable reinsurance cover internationally.
- v. To help in setting up new insurance companies, property development and mobilizing of financial resources, active participation in financial markets and preservation of foreign currency by providing local insurance capacity and to underwrite some risks that would be shunned by foreign reinsurers.
- vi. To generate foreign currency by possibly selling reinsurance for inward business.

vii. To create collaborations with regional and reinsurers, in addition to minimization of foreign exchange, to strengthen reciprocal trade and strongly negotiation for improved retention, reinsurance terms and conditions for the market.

In Ethiopian context, there are prospective conditions (opportunities) which place the country at a competitive advantage and create motivation and possibility for setting up and operating local reinsurance in the country. Parallel to this, however, are challenges that require due attention from the government and other stakeholders. These prospects (opportunities) and challenges are outlined as follows:

a. Opportunities:

- i. The long experience of the Ethiopian insurance industry arranged with foreign reinsurers
- ii. The economic growth and market oriented economic system, emphasis given to import substitution strategies aimed at strengthening foreign exchange holdings.
- iii. Existence of profitable insurance companies and potential growing domestic insurance market and higher demand for reinsurance by the insurance companies, improving condition in investing public and the private sector.
- iv. Potential support from regional and international organizations
- v. Availability and increasing number of higher educational institutions for skilled and trained man power

b. Challenges

- i. Low level of public awareness on reinsurance
- ii. Lack of attention given to the reinsurance industry
- iii. Non existence of reinsurance law and outdated insurance law
- iv. Lack of skilled man power with adequate technical expertise
- v. Lack of strong supervisory and other industry bodies
- vi. Less developed financial market

5. CONCLUSION AND RECOMMENDATION

5.1. CONCLUSION

Reinsurance plays a vital role in the proper functioning and development of insurance market. Insurance companies use reinsurance, arranged locally or abroad, for both financial and operational purposes. The need to diversify risks may call for the need to use foreign reinsurance. This need, however, does not preclude the necessity of increasing the amount of risk retained locally. Then, the question that would rather left is whether optimum risk retention is obtained.

In the literature, contradicting views are observed in relation to the relative merits and demerits of foreign reinsurance for developing countries. While some argue in favor of it, others are against as it would affect the domestic insurance in these countries. The latter group, emphasizing on the advantages of local reinsurer, have been recommending on establishment and strengthening of local reinsurance companies. In response to this, many countries have set up the company in their economy. However Ethiopia is not one of them despite the long experience in reinsurance business and efforts to set up local reinsurance company in Ethiopia.

This study motivated by the literature review and the gap in there, analytically reviews and reports on the potential for setting up local reinsurance company in Ethiopia and how to do it should Ethiopia have one. In this, context, the following points are observed.

- i. Reinsurance business in Ethiopia has been practiced for a long period of time without legal frame work. It is highly dependent on cross boarder arrangement which makes the country a net importer of the service with limited transactions in similar policies exchanged on a reciprocal basis. The reinsurers have the upper hand in the reinsurance arrangements. The reinsurance business classes with least loss ratios have the highest cession rates. The cession rates are high particularly in the non-life insurance which indicates that the insurance industry would be a potential market for reinsurance.
- ii. The insurance market in Africa is controlled by a limited number of countries and most of the insurance companies are small and medium sized. The establishment of local reinsurance companies in Africa is a more recent practice with the aim to conserve profitable reinsurance premium ceded out and indirectly control the operations of the primary insurers. This has resulted in decline in the number of foreign reinsurers. In the continent, state/regional reinsurers were the first on the scene, followed later by privately owned local players. Currently there are around 33 local reinsurance companies with good financial performance that is partially attributed to their increasing capital base, successful and responsible practitioners. However, the growth in the number of African reinsurance is slow due to modest economic activity, huge capital requirements, scarcity of hard currency, low investment returns, limited local capacity, outward flow of premises, and shortage of skilled local man power. The legal and regularly requirements are also not sound in many African countries.
- iii. Developing countries like Ethiopia can derive a number of advantages by setting up local reinsurance companies. This includes:
 - Increasing risk retention locally and reducing foreign dependency thereby saving foreign currency outflow and improve the balance of payment.
 - Promoting growth of underwriting capacity and development of the local insurance markets.
 - Providing essential technical knowledge to the insurers.
 - Creating awareness and facilities information exchange.
 - Creating job opportunities.
 - Participating in various investment and financial markets.
 - Providing adequate and affordable reinsurance cover to local insurance companies and helping in setting up new insurance companies.
 - Contributing to the proper development and mobilizing of financial resources.

In order to gain the potential benefits, setting up and proper operation of local reinsurance companies require- proactive regularly frame work and strong supervisory body, effective enterprise risk management and corporate governance, improved ICT, actuarial/statistical capabilities and R &D, strong industry bodies, customer awareness, skilled man power and stability of the operating environment and adequate capital.

Reviewing the existing conditions in Ethiopia via-a-vis the requirements, both opportunities and challenges are there in setting up and operating local reinsurance company in the country.

5.2. RECOMMENDATIONS

If Ethiopia is to set up and operate local reinsurance company, the following recommendations are suggested.

- i. Arrange /organize forums where the stakeholders can discuss on the issue. This can help to digest the potential benefits and costs, understand their positions and improves awareness.
- ii. Improve the legal environment in relation to reinsurance. Specifically, addressing issues such as the requirements for reinsurance arrangements, roles of the industry players, compulsory reinsurance, licensing, capital adequacy, corporate governance and human resource requisites.

- iii. Clearly identify the national objectives for setting local reinsurance company and continuously evaluate its performance.
- iv. Use the local reinsurance company as a sole reinsurance provider for the local insurance companies and sole agent through which to conduct retrocession transaction abroad.
- v. Strengthen the capacity of the supervisory body with finance and skilled man power.
- vi. Use joint state-private ownership structure to facilitate the availability of capital and participation of the private sector.
- vii. Demand support from international organizations and regional reinsurance companies.
- viii. Create partnership and collaboration with other countries and learn from their experience.
- ix. Enhance ICT and better flow and exchange of information and develop database.
- x. Promote leadership, managerial and technical skills for developing the human resource requirement. This can be achieved through:
 - Creating link with higher educational institutions
 - Developing corporate universities
 - Attracting skilled man power from abroad

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ABOUT THE JOURNAL

In this age of Commerce, Economics, Computer, I.T. & Management and cut throat competition, a group of intellectuals felt the need to have some platform, where young and budding managers and academicians could express their views and discuss the problems among their peers. This journal was conceived with this noble intention in view. This journal has been introduced to give an opportunity for expressing refined and innovative ideas in this field. It is our humble endeavour to provide a springboard to the upcoming specialists and give a chance to know about the latest in the sphere of research and knowledge. We have taken a small step and we hope that with the active co-operation of like-minded scholars, we shall be able to serve the society with our humble efforts.

Our Other Journals

