Risk, Freedom, and Development in India by Robert Gibbons

The Republic of India celebrates August 15, the anniversary of independence from Britain in 1947, as Independence Day, but future generations of Indians should celebrate October 23 as well. As of that day one billion people have a new kind of freedom: a choice in providers of insurance products. While this freedom may seem less important than the freedom to choose their own government, it too promises a better life for the people of India.


बीमा विनियामक और विकास प्राधिकरण
INSURANCE REGULATORY AND DEVELOPMENT AUTHORITY

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SUB : REGISTRATION OF NEW INSURERS BY INSURANCE REGULATORY AND DEVELOPMENT AUTHORITY.

At the meeting of the Insurance Regulatory and Development Authority today, the Authority decided to grant registration under section 3 of the Insurance Act, 1938 to the following companies newly set up:

Since 1972 in the case of general insurance, and 1956 in the case of life insurance, they could buy insurance only from the state-owned companies. That monopoly ended on October 23 when the Insurance Regulatory and Development Authority authorized six new insurance ventures in India. The number of authorized insurers now exceeds 12, and it continues to grow.

Since insurance constitutes only a tiny fraction of the economy, the overall significance of this one reform might seem slight. That assessment, however, misses a profound truth. Advances in economic development should not be measured according to what is, but according to what can be.

India is a land of enormous potential. Of the nations of the world, it ranks second in population, seventh in land mass, and at its current growth rate it will soon rank in the top ten in GDP. It is also a leader in information processing and technology.

Possibilities are one thing; reality is another. India's gap between the two is staggering. India is the world's pre-eminent example of a developing country. Its successes and failures in seeking a better life for its citizens send messages around the globe. Economists of many generations have recommended policies to promote development and alleviate poverty in India. They have at various times advocated centralized economic planning, import substitution, increased food production, meeting basic human needs, better education, family planning, improvements in the status of women, and a host of other measures. Only recently, however, have they come to understand development as an integrated process.

According to Amartya Sen, the 1998 Nobel laureate in economics, poverty cannot be adequately measured merely as insufficient income. Poverty is the deprivation of freedom. More important than how much money people have is what they can do with it. People are impoverished when they cannot do what they might wish. As they gain capabilities, their lives necessarily become better. Thus Sen describes development "as a process of expanding substantive freedoms that people have."

This focus on freedom facilitates an integrated view of development. In Sen's words:

> A variety of social institutions—related to the operation of markets, administrations, legislatures, political parties, nongovernmental organizations, the judiciary, the media and the community in general—contribute to the process of development through their effects on enhancing and sustaining individual freedoms....Values and ... social ethics are also part of the process of development..., along with the working of markets and other institutions.[1]

The new freedom in the insurance sector provides a clear illustration. People buy insurance to protect their families and assets from accidental losses. More than a hundred insurers operated in British India, but the overwhelming majority of the people could not buy insurance and perhaps did not even know of its existence. After independence the

[1] Amartya Sen, *Development as Freedom* (New York, 1999), p. 297.

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government nationalized the insurance industry to channel its services toward the entire population. The state companies effectively organized to serve the whole country, but only with a limited array of products offered at arbitrary prices. Now begins a new era, in which people will have the capability of managing their risks in a variety of ways.

To understand the importance of this new freedom, one should compare the risk management practices of other countries. Risk management is a structured process of rational decision making through a sequence of steps: identifying exposures to accidental loss, evaluating alternative techniques for treating each loss exposure, choosing the best alternative, implementing it, and monitoring the results to refine or improve the program. For most businesses, and even some individuals, it is standard procedure. The risk management process enables them to weigh the costs and benefits of higher insurance deductibles, sprinklers, safety training, or any imaginable combination of loss prevention and loss financing techniques. The freedom to allocate their resources to the most efficient ways of mitigating risk allows them to capture more of their potential.

One reason that economies fall short of their potential is the inevitable, but random occurrence of natural disasters, such as the Gujarat earthquake on January 26, 2001. Property losses exceeded $4 billion, but only about 5 percent were insured. The other 95 percent must now be financed with resources originally intended for other purposes, undermining the country's economic plan. Had insurance been more widespread in India, the earthquake would have caused less disruption of the economy.

The benefit of loss financing is, however, only half of the story. For developing countries in particular, loss prevention effects can be still greater, especially as the benefits compound over time. Investments in better buildings, for example, might have prevented a substantial portion of the earthquake damage. A vibrant insurance market provides information regarding costs and benefits that helps property owners calculate which prevention techniques are worthwhile. In the absence of such price signals from the insurance market, they resist making investments for the sake of unknown benefits. The resulting loss is unseen and too often forgotten: it is the cost of the damage that could have been prevented.

Under India's insurance monopoly, earthquake insurance could be added to a standard fire policy offered by one of the state companies. The additional premium for property valued at one lakh [100,000 rupees] is 10, 20, 50, or 100 rupees, depending on the zone in which the property is located. There is little data by which to judge whether these prices are appropriate, but since the state companies are cautious about the risks they assume, both the rates and the zones probably allow them some margin. As a result, many potential insureds forgo earthquake cover because they perceive it to be too expensive.

In a competitive market, one insurer or another will discover that it can profitably accept risks from some portions of the highest-rated zone for 60 or 70 rupees per lakh, inducing more people to purchase this protection against future earthquake losses. Some will be rejected, however, because they have not properly reinforced their structures or have not complied with building codes. Thus the competitive insurance market will also encourage more investment in loss prevention measures that will minimize losses—and save lives—in future earthquakes. Moreover, the accumulation of data used to support these decisions will enable greater precision as time goes by. Systematic risk management, supported by a flexible and efficient insurance market, focuses on what can be rather than what is. The freedom to make efficient decisions about risk will carry India a long way toward achieving its potential.

Full enjoyment of this opportunity, however, will depend on other capabilities. The Insurance Regulatory and Development Authority will need resources to supervise the solvency and performance of insurers effectively. Insurers will need competent and dedicated employees to meet rising consumer expectations. An increasingly educated populace must learn to manage risks efficiently, and they will require greater transparency to obtain the relevant decision-making information. These interdependent capabilities will reinforce each other, bringing new freedoms.

The possibilities exceed any one person's imagination. Suffice it to say that a free India can be a safe India, and a model of development for all.