INSURANCE LIBERALIZATION IN EMERGING MARKETS[1]

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Abstract

Insurance internationally has grown at a rate of over 10 percent annually since 1950 and, in general, this rate has far exceeded the growth rate of economic development globally. The more developed and efficient a country's insurance market, the greater will be its contribution to economic prosperity. The insurance industry is thus of interest and significance to emerging economies.

Insurance markets worldwide continue to undertake pro-competitive reform. This reform is predicated on the notion that competitive markets are better at allocating resources and at enhancing consumer choice and value than are rigidly regulated, insular markets. Consequently, dozens of countries have liberalized their insurance markets.

Although the pace of market opening is far from even as there are still concerns over the potential pitfalls of more foreign insurer involvement, the benefits emerging markets stand to reap from opening up their insurance markets to foreign participation should more than offset any negative considerations. In addition to many motives driving foreign insurers to expand their insurance businesses internationally, considerable incentives support emerging market in favoring greater foreign participation.

Liberalized markets allow a greater geographic range of heightened competition, thereby creating a stronger, more competitive emerging insurance industry. With more competition, the emerging markets need greater – not lesser – emphasis on solvency oversight and supervision, disclosure and consumer information, and market monitoring. Government that deny their citizens and businesses such markets lessen consumer choice and value and needlessly hinder national economic development.

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Introduction

Almost a decade of economic liberalization — privatization and structural adjustment — has turned emerging markets into promising prospects. Developing countries, having had what amounts to a revolution in economic policies, have attracted capital investments. Emerging markets have voracious appetites for improved telecommunications, automobiles, banking services and insurance. Rapidly growing outputs, combined with improved living standards for a large percentage of the world population, have made emerging markets extremely attractive to foreign insurance corporations (Boardman, 1995). These emerging markets consist of six main geographical groups of countries: the South Asian countries; the East Asian countries; the Southeast Asian countries; the South American countries; and finally, some of the countries of Central and Eastern Europe (Avasthi, 1994).

The outlook today for emerging markets seems to have brightened. While overall the emerging markets account for only 9 percent of the world's insurance premiums, they present rapid growth opportunities for insurers and other industries. Most of the global insurers generate between 3 percent and 5 percent of their premium income from these markets, with a few having already passed the 10 percent mark (Swiss Re, 2000). The emerging markets enjoy a swift growth due to high rates of saving and investment. Investments increase national income directly during the development phase and contribute to higher production during the urbanization phase (Swiss Re, 1996).

Although insurance is one of the most important categories of service produced and consumed domestically, it has always been international in scope. Insurance is a major service industry in every UN member state. Premium income world-wide amounted to approximately $1.5 trillion (Swiss Re, 1996), an amount roughly equal to the world stock of foreign direct investment. Insurance internationally has grown at a rate of over 10 percent annually since 1950 and, in general, this rate has far exceeded the growth rate of economic development globally (Skipper, 1987; Swiss Re, 1999 and UNCTAD, 1982). Whereas global insurance premium payments should grow by approximately 4 percent per annum in real terms through the year 2000, 10 percent growth rate is expected in Asia. As a result, by the year 2000 Asia will boost its world share of GDP by 1.3 percent of non-life premiums and by 1.9 percent of life insurance premiums (Swiss Re, 2000). The more developed and efficient a country's insurance market, the greater will be its contribution to economic prosperity (see Outreville, 1990 and Outreville, 1996). The insurance industry thus is growing rapidly in emerging markets.

Insurance markets worldwide continue to undertake pro-competitive reform. This reform is predicated on the notion that competitive markets are better at allocating resources and at enhancing consumer choice and value than are rigidly regulated, insular markets. Consequently, dozens of countries have liberalized their insurance

markets. Insurance reforms were reinforced by the successful completion in December 1997 of Financial Services Negotiations under the General Agreement Trade in Services (GATS).

The GATS framework agreement establishes rules and disciplines on policies affecting access to service markets, greatly extending the coverage of the multilateral trading system (Hoekman, 1995). The demand for multilateral disciplines is driven by the growing globalization of economic activities and by the recognition that domestic policies are becoming increasingly important in determining international competitiveness (Hoekman and Primo Baraga, 1996). The GATS stands as a monument to those dedicated to the proposition that services not only could be beneficially subject to international trade rules akin to those for goods, but that such inclusion was essential in a world economy increasingly reliant on services (Skipper, 1999). It is for the reason that emerging markets have recently liberalized their insurance industries.

Driving Forces of the Insurance Industry's Liberalization

Foreign Insurers' Motives for International Expansion

Foreign insurer involvement in emerging insurance markets can occur through (1) cross-border insurance trade or (2) establishment insurance trade (see Skipper, 1997). The globalisation of insurance markets was exclusively made possible by the liberalization and deregulation of what had hitherto been a strongly protected insurance industry. In the early nineties, radical reforms were introduced in Latin America and Central and Eastern Europe. In Asian countries the liberalization process has clearly gained momentum following the Asian crisis (Swiss Re, 2000).

The liberalization process generally comprises various stages, which are often undertaken in a different sequence in individual countries (Dickinson, 1999). The first step in liberalization involves the lifting of insurance and reinsurance monopolies. A step-by-step removal of capital restrictions for foreign investors and the acknowledgement of subsidiaries of foreign insurers as equal to domestic insurers should then follow. The granting of operation rights to foreign agents and branch offices generally comes later as this involves no (or at most a very small) flow of capital.

Many reasons encourage insurance companies go outside their home borders. First, increased competition from an array of financial services firms and a low domestic insurance growth rate are combining to push a number of US and international insurers to look abroad for opportunities to introduce their products and services to a new group of customers (Douglas, 1996 and Golden, 1995). In addition, the double-digit growth rates of emerging markets cannot be ignored. In recent years demand for insurance in the emerging markets has strongly increased. The average annual growth rate in the emerging markets has, since 1990, been twice as high as in indus-

trialized countries in both life and non-life insurance (Swiss Re, 2000). The strong growth markets of Asia, Latin America and Central and Eastern Europe thus offer global insurers a welcome opportunity to conquer new markets to ensure future potential profits with the aim of enhancing and mobilizing corporate value.

A further reason for foreign insurers to expand into emerging markets can be found in heightened competition and the ensuing pressure on costs. The process of globalization offers new and favorable opportunities for risk diversification and reducing costs (Swiss Re, 2000). Most executives cite the importance of long-term strategic diversification as a prime consideration. The theory is that if the economy at home gets tough, perhaps it will not be so bad in another country or countries at the same time (Boardman, 1995). Consequently, expanding globally allows foreign insurers to diversify their risks, thus achieving efficient and optimal portfolios and offering more competitive insurance prices.

One advantage of global non-life insurers – particularly in commercial business – is their huge financial strength. International insurers are able to take on risks, which exceed the financial capital capacities of local insurers. As the former have lower capital costs owing to their diversification they are able to raise the efficiency of risk transfer and offer lower prices or greater capacities. Furthermore, the global insurers often have superior knowhow relating to products, rating, underwriting and risk management. Foreign insurers are able to fall back on the experience gained in other countries. They are also able to profit from their reputation as sound, financially strong companies.

Another reason might be to expand a marketplace. Companies that have almost reached saturation in their own countries find it is essential to their growth to expand beyond their borders. Furthermore, specialty companies that serve a specific and narrow niche in their home markets may find that their expertise serves them well in similar niches in other countries. In addition, some companies want to use their excess capacity and also see international expansion as a way to learn about new methods of distribution, new products and new technology.

Emerging Markets' Motives for Insurance Liberalization

Efforts to achieve international economic liberalization have often been justified with the classical theory of free trade, developed for product markets by Adam Smith, David Ricardo and John Stuart Mill (Ellsworth and Leith, 1984). This free trade theory states that the opening-up of product markets increases and improves the division of labor and the exploitation and exchange of economic resources and hence also improves employment and economic welfare. The improvements stem partly from comparative economic advantages and partly from economies of scale, which generally reduce unit costs and prices and thereby stimulates demand (Dinnig, 1992). In theory, if countries have a comparative advantage, they should center their economic activities around those industries. This logic is also applicable to insurance. As a result, protected domestic services may fail to become developed as much as in liberal countries.

It is wrong to view insurers as simply pass-through mechanisms for diversifying risk under which the unfortunate few who suffer losses are indemnified from the funds collected from many policyholders. Laudable though it is, this function masks other fundamental contributions that insurance makes to prosperity (Skipper, 1999). Countries that are best at harnessing these contributions offer their citizens and businesses greater economic progress. Insurance provides many categories of services material to economic growth.

In many countries, the insurance intermediary has been instrumental in raising the consciousness of the public to the need for financial protection through the insurance mechanism. It is believed that an insurance industry can assist in the achievement and maintenance of external financial stability and can be a powerful vehicle for accumulating savings (Siwatibau, 1984 and Skipper, 1997). Economists generally agree as to the positive relationship between saving rates and growth rates. Therefore, emerging markets could benefit from the rapid economic growth which could stem from increased saving rates (see IMF, 1995).

From a macro-economic perspective, liberalizing the insurance market could mobilize national savings and narrow the investment gap of not completely developed economies. In emerging markets, domestic savings have not been fully mobilized despite huge funding needs arising from infrastructure projects, for example. Insurance companies as important long-term institutional investors, thereby functioning as financial intermediaries, contribute to bringing together savers and borrowers. The benefit would be most sizeable with participation of foreign insurers possessing superior financial skills; e.g., asset-liability management and risk management. Enhancing domestic financial intermediation would further render emerging economies less dependent on short-term and highly volatile foreign capital inflows (Swiss Re, 2000).

An open, world-wide insurance market would drive economic growth by spreading insurance risks across many markets. In aggregating many individual risk exposures, insurers can make reasonably accurate estimates as to the pool's overall losses. The larger the number of insureds, the more stable and predictable is the insurer's experience. This fact leads to a reduction in volatility and, by that, permits the insurer to charge a smaller risk premium for uncertainty and maintain more stable premiums (Skipper, 1999). Insurers also benefit from pooling through their investment activities. In providing funds to a broad range of enterprises, individuals, and others, insurers diversify their investment portfolios. The default of a few borrowers is likely to be offset by the many sound investments. The more stable and predictable an insurer's investment experience, the less it can charge for loans. Needless to say, investment in emerging markets is stimulated and resources are allocated more efficiently – to the benefit of consumers.

Due to their greater financial strength and risk diversification capabilities, foreign insurers are often characterized by superior claims paying ability, which would also help to enhance the financial condition of individuals, households and corporations in emerging markets. Not only is foreign participation significant in underpinning financial security, it is also imperative to facilitating trade and commerce of developing economies (see Skipper, 1997).

The economic rationale for liberalization derives from the resulting efficiency gains that are predicted to flow to the world economy and to such countries from a more efficient allocation and use of world and natural resources (Skipper, 1987). Any deviation from cost minimizing or profit maximizing strategies will force firms out of the market, in the long run. Efficiency of operations requires firms to (1) select an output mix that fully exploits economies of scale and (2) select an input outlay that minimizes usage (technical efficiency) and uses the best combination (allocative efficiency).

The participation of foreign insurers could improve the capital allocation efficiency of emerging economies. Underwriting investment decisions made by foreign insurers based on their international experience and best practice considerations could send beneficial signals for efficient resource allocation (Swiss Re, 2000). The availability of these signals, especially in markets where credit allocations are not completely based on economic considerations, is crucial in improving capital productivity.

Specific advantages claimed for a more open international insurance market include possible benefits flowing to a domestic insurance industry from the advanced technological and managerial knowhow and expertise that foreign insurers could bring to emerging markets (Skipper, 1997). Most international insurers, unlike multinational manufacturing firms, cannot easily split their production process between their home countries and their emerging-market hosts to take advantage of differences in wage rate, labor availability and skill level. Consequently, international insurers tend to transfer managerial knowhow and technology from headquarters to the host-country market (see Carter and Dickinson, 1992 and UNCTAD, 1994).

Furthermore, a foreign market presence could bring stronger market competition. Liberalized markets allow a greater geographic range of heightened competition, thereby creating a stronger, more competitive emerging insurance industry. Insurance companies will compete over prices and underwriting criteria. Especially in markets, where price regulation has so far been in force, the current tendency for companies to cooperate via cartel-like agreements will be replaced by more rivalry and competition. Insurance companies will structure their prices in an attempt to grab market shares from other suppliers (Swiss Re, 1997).

Last but not least, growing competition as a result of expanding markets often also increases the propensity to generate new and innovative products. With increased competition, insurers have greater motivation to be more responsive to customer needs and desires, to offer better and broader range of quality goods and services, and to seek less costly means of marketing to and servicing customers. Liberalization will likely enhance the overall efficiency and productivity of the insurance industry. As a result, consumers in emerging markets could benefit from better choice and value in insurance products and services.

Adverse Effects on Restrictions of Foreign Insurer Involvement

Technological and other developments create demands for new types of risk management tools requiring highly specialized knowledge and skill, which are available only in sophisticated markets. Consequently, barriers to access of international insurance can reduce available choice and value for large industrial and commercial buyers of insurance. Such barriers can similarly reduce consumer welfare. Restrictions on the establishment of foreign insurers or on the freedom of licensed companies to provide the insurance they are willing to supply may impair the range of insurance provision to all consumers.

Economists routinely argue that restrictions reduce industrial sector efficiency. The presence of a large number of firms, low market concentration and no entry and exit barriers are necessary conditions for the existence of a perfectly competitive market structure (Truth and Truett, 1984).[3] In contrast to a competitive business, in a market characterized by entry barriers, the absence of foreign competition can allow domestic producers to enjoy monopoly power. Therefore, these firms may fail to produce at the minimum efficient scale (scale efficiency) and/or to secure the maximum possible output from their input bundles or to achieve the minimum input usage from a given output (technical efficiency).

Limits on foreign ownership, capital requirements, restrictions on reinsurance and product approval procedure, taxes and price controls have all been used to protect the locals, usually to the detriment of an efficient, competitive market (Morien, 1996). To the extent that local businesses pay higher-than-world prices for insurance or receive inferior services, their goods and services are less competitive (Skipper, 1997). Keeping foreign investors out of the banking and securities business in the international economy can inhibit needed foreign investment. The insurance potential as a source of capital and an aid to local business is thus less appreciated.

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[3] Given a large number of firms in an industry, low market concentration and few entry and exit barriers, one can conclude that an industry is not a natural monopoly.

Concerns about Insurance Liberalization

The positive considerations have underpinned the liberalization drive of emerging markets. However, the pace of market opening is far from even as there are still concerns over the potential pitfalls of greater foreign participation (Skipper, 1997).

Risk in the emerging market economies may be less manifest. Many old constraints such as the deeply rooted fear of privatization among quasi-governmental management teams still exist within these markets. Other constraints still prevalent are the differences involved in evaluating an investment in terms of asset values and performance due to imperfect stock markets, local accounting methodology and a daunting different legal system (Avasthi, 1994).

To expand its operation, a foreign insurer should, of course, consider many issues in tapping into emerging markets. Market size and potential success are logical starting points when assessing which country to enter. Issues of timing, form of entry and product line must be also considered. Significant currency fluctuations cause difficulty in measuring growth rates. High levels of inflation, endemic to many Latin American countries, also distort measurements (Avasthi, 1994). Therefore, these elements should be taken into account. In addition, since total market statistics can be misleading, market concentration needs to be looked at in terms of the specific segments.

The emerging markets' continuing integration into the global economy and sound economic growth has fuelled the demand for insurance cover. A shift in regulatory controls towards solvency controls and the opening up of new business areas have raised the capital and know-how requirements. Regulatory environment is, of course, one of the critical factors in evaluating markets (Morien, 1996). Regulatory and cultural differences cause further costs, which can have a detrimental effect on the use of economies of scale[4]. Whereas consumer protection is a consideration, the principal basis for price controls is to avoid destructive competition and ensure insurers' solvency. However, solvency requirements have generally taken the form of higher minimum capital requirements and stricter accounting standards (Morien, 1996).

Adopting joint venture insurance partners offers the advantage of familiarity with the business and an established market position. The downside is however the difficulty of finding a cultural fit. The foreign partner may have to deal with the challenge of changing established practices and relationships. The alignment of

[4] Economies of scale exist if premium volumes from international expansion increase at a rate faster than production costs.

products, services and distribution channels to the needs of the local markets is not without additional costs. It is questionable whether economies of scale can be achieved with expansion in an emerging market, since the complexity of the organization increases with international expansion and, as a consequence, the demands made on management.

A set of policy arguments urging caution in granting greater foreign insurer market access falls under the theme that foreign insurers could service emerging markets only selectively thereby resulting in the neglect of some customer groups. Foreign insurers, which are generally more focused on high-value clients, could fail to provide insurance covers to certain customer sectors, particularly to lower-groups. An additional argument is that foreign insurers, lacking in-depth understanding of local market needs, will market products similar to those marketed in their home countries and ill-suited to local needs (Skipper, 1997).

Perhaps more disturbing to policy makers in emerging markets is the prospect of over-reliance on foreign insurance financial capacity. There are worries that a sudden withdrawal of foreign insurers and capacity in times of conflicts could cripple local trade and commerce. Although this could easily be overcome by appropriate diversification strategies, this argument has resurfaced from time to time to justify more stringent regulations over foreign participation. Regardless of the economic benefits, political concerns over national independence might prompt governments to restrict foreign participation.

Conclusion

The benefits emerging markets stand to reap from opening up their insurance markets to foreign participation should more than offset any negative considerations. Provided that liberalization is being pursued against the backdrop of a solid set of prudent supervision, consumer protection and competition regulations as well as disclosure of information of the companies, the opening up of insurance markets should facilitate long-term benefits to developing economies.

Insurance is not merely a "characteristic of economic growth." It is a necessity for the great majority of today's economies (Skipper, 1997). The importance of a strong and efficient insurance industry stems not merely from its role as an essential intermediate service but also from its impact on the national economy as a whole (Kim, 1988). Indeed, at its first session in 1964 the United Nations Conference on the Trade and Development (UNCTAD) pronounced that "a sound national insurance and reinsurance market is an essential characteristic of economic growth" (UNCTAD, 1964) which grossly understates the role of insurance in economic development.

Emerging markets liberalizing their insurance industries to attract sound foreign insurers are likely to enjoy economic development and overall social welfare and face few unreasonable negative outcomes. Countries that maintain unjustifiable market access barriers and that fail to extend national treatment to foreign-owned insurers likely are doing their citizens, businesses and national economy a disservice (Skipper, 1997).

As a consequence, the appropriate role of foreign insurers in emerging insurance markets continues to be a great concern and interest to policy makers (Skipper, 1997). If the evidence suggests that foreign insurance suppliers deliver benefits in trades generally and services in particular to host countries, regulators in emerging markets structuring insurance industries that better serve each country's interest should facilitate regulatory reform built on a set of pro-competitive principles. The pro-competitive regulation should be designed to ensure competitive, solvent, and fair markets (Skipper, 1999).

The more competitive a market, the more important is prudential oversight and supervision (see Skipper 1997 and Skipper 1999). The pro-competitive regulation, in fact, requires a greater – not lesser – emphasis on solvency oversight, disclosure and consumer information, and market monitoring (Skipper and Klein, 1999). Meaningful competition and market conduct regulation similarly should assume prominent places in revamping laws and regulation to be more attuned to the new realities. Emerging market-economy countries may need to enhance prudential supervision, competition regulation and market conduct regulation as they deregulate and liberalize their insurance markets (Skipper, 1997). Competitive insurance markets serve each country's interest. Governments that deny their citizens and businesses such markets lessen consumer choice and value and needlessly hinder national economic development.

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