A NOTE ON THE CHANGING COMPETITIVE LANDSCAPE IN PACIFIC RIM INSURANCE MARKETS

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Abstract

Insurance markets in the Asia/Pacific Rim region span the spectrum from traditionally stable major markets (*e.g.*, Japan, Korea) to vastly underdeveloped emerging markets (*e.g.*, India, China) in terms of relative market penetration and sophistication. The opening of formerly closed markets in the region through re-regulation, and reduction and elimination of barriers to trade in financial services has changed the competitive landscape in the region, producing potentially significant opportunities for market entry and expansion for both domestic and foreign insurers. This paper will briefly introduce competitive advantage and market entry issues within a framework of dynamic competition. An understanding of key environmental influences (*e.g.*, regulation, consumer confidence) is fundamental to developing long-term strategies for sustainable competitive advantage in the region.

Introduction

The past decade has been economically tumultuous across the Pacific Rim for most industries, yet few faced - and likely will continue to face - as many issues as the financial sector, particularly insurers. Anticipated profitability, spurred by widely held potential investment and growth opportunities in the sector and region, have been slow to materialize or have been negatively affected, and many firms continue to struggle to meet even modest expectations. Even larger insurers in what formerly were considered exceptionally stable major markets (*e.g.*, Japan, Korea) have been adversely affected in recent years by increased insolvency risk. Evidence of sustainable recovery continues to emerge slowly, sometimes in fits and starts, and remains uneven in many markets across the region. An understanding of recent events, as well as anticipated future developments, among factors that affect this competitive landscape is crucial to identifying nascent opportunities and the timely allocation of scarce resources. Such information is immensely important to evaluating the likely success (or failure) of current and future growth opportunities in developed markets, as well as promising emerging markets. The fundamental, future-oriented role that insurance plays in supporting and enhancing economic activity and stability, for both individuals and businesses alike, undoubtedly will prove to be a highly positive factor in maintaining momentum during any recovery, and help ensure future economic health and competitiveness in the Pacific Rim region.

The Business of Insurance and the Pacific Rim

While 2001 was a troubling year for many insurers around the world, the business of insurance remains substantial and is expected to post a moderate increase over the 7.8% relative penetration (defined as total premium as percentage of gross domestic product [GDP]) indicated for the year 2000 on a worldwide basis (SwissRe, 2001). Stage of national economic development appears to influence significantly future industry growth prospects, especially in emerging markets, with highly developed countries and regions generally exhibiting higher total insurance penetration (life plus non-life business). SwissRe reports total insurance penetration in the year 2000 stood at approximately 7.7% in Asia, versus 8.2% in Europe and 8.6% in North America. Well-established, developed Pacific Rim markets exhibited relatively high penetration (*e.g.*, 13.0% in South Korea [ranking #3 in the world] and10.9% in Japan [#5]), while emerging markets in the region exhibited much lower rates of penetration (*e.g.*, 2.3% in India [#52], 1.8% in the Peoples Republic of China [#61], 0.53% in Vietnam [#84]). In general, recent sales of insurance products have outpaced GDP growth rates in many developed markets, with excellent potential for faster developing emerging markets (Hess, 2002). While there appears to be substantial market entry and growth opportunities across Pacific Rim economies, the most prudent path through each rapidly changing competitive environment is less clear.

Insurance industry growth potential, coupled with a general trend toward liberalization of Pacific Rim markets, has generated much discussion at both macro and micro levels as to how to strategically proceed with market entry and development. At the macro level, most would agree that liberalization of insurance markets may bring many substantial benefits to economies, such as: 1) improving the function of capital markets through facilitating economic activities, 2) providing a social function of protection to individuals against potential financial losses due to adverse events, and 3) supporting the allocation function through actuarial activities (Hess, 2002). However, those in emerging markets have some level of hesitancy in immediately opening markets for several reasons, including: 1) limitations to domestic subsidization across product lines if foreign firms are allowed to "cherry pick" and only offer the most profitable products, 2) potential for foreign firms to leave during times of financial crisis, fueling fear of perhaps further exacerbating difficulties in fragile, recovering economies in the region, 3) limited ability of countries to protect their infant domestic insurance industry during transition toward open insurance markets, especially for those involving international trade agreements, and 4) appropriate experience and funding of regulatory oversight (Hess, 2002). While these situations are possible, decision makers in general seem to understand the implications and appear to be carefully proceeding with market development so as to minimize negative impacts on individual markets, as well as to their stakeholders.

At the micro level, insurers must be aware of the increasing complexity of the competitive landscape in order to take advantage of Pacific Rim market entry and development opportunities. Pacific Rim insurance markets continue to experience significant changes in regulation, economic condition, organizational culture, leadership and other key environmental influences. Such changes undoubtedly will provide many opportunities to develop substantial competitive advantage. For example, the greater certainty of process offered through recently adopted World Trade Organization (WTO) fair-trade rules and dispute resolution mechanisms is expected to offer insurers in both developed and emerging economies in the Pacific Rim greater opportunities for growth and market penetration, as well as increased efficiency and effectiveness of service delivery. The effects of such changes on the competitive landscape may be especially pertinent for particular market sectors. Life insurers in potentially huge, yet vastly underdeveloped, markets (*e.g.*, China, India) may continue to see opportunities for new entry and/or expansion. Additionally, pent-up demand in response to slowly recovering private individual and corporate asset values, and continued improvement in economic conditions in both developed and emerging markets would be expected to create significant opportunities for non-life insurers. The resurgent potential for economic stability and recovery among Asian/Pacific Rim economies is widely anticipated, based on sound economic fundamentals such as traditionally high individual savings rates, good educational standards, and various improvements in corporate and public governance, and regulatory transparency, brought about by recent adverse economic events. We present a brief overview of market entry issues relevant to the changing competitive landscape in established and emerging Asian/Pacific Rim insurance markets.

Competitive Advantage and Market Entry in a Dynamic Environment

Competition in global markets always requires a complex set of capabilities (Madhok, 1997). These capabilities may be rooted at the firm, industry or country level (Porter, 1991). MNEs presumably already possess an internationalization perspective, and may thus possess greater advantage over firms that do not. This may be because greater diversity in market experience produces a superior knowledge base that is likely to be a key asset of the MNE that contributes heavily to its success (Goshal, 1987). While the variance in legitimacy requirements an MNE faces increases with the number of countries in which the MNE operates (*i.e.*, every environment is different), those MNEs that do operate in multiple environments have likely developed greater skill sets and abilities to develop relationships within different institutional environments (Kostova and Zaheer, 1999). However, greater diversity in markets may impede the speed of learning within any new environment, thus new entrants may trade-off speed of entry with breadth and depth of learning (Zahra, Ireland and Hitt, 2000). Some high control modes of entry, such as acquisition, are positively associated with depth of learning; while greenfield start-ups are not necessarily related to depth of learning, likely due to the greater time frame required for such learning to be realized.

Lack of experience in new markets creates greater information acquisition, interpretation and absorption costs (Hisey and Caves, 1985), with firms already operating in particular environments having greater advantage because they are farther up the "learning curve." Thus, working with firms that already know the domestic business of insurance model first hand should be beneficial. This may be particularly true when considering the marketing and regulatory environments. From the marketing point of view, an equity based relationship with an established, going concern may keep a "domestic face" on the organization, a potentially critical aspect given the consumer preference for national insurers within most markets, making branding, name recognition and reputation primary concerns. Furthermore, distribution channels may become less of an issue when working with an established domestic firm.

In general, no competitor can achieve first mover or long term sustainable competitive advantage unless their competencies are valuable, rare, costly to imitate and with few substitutes (Barney, 1991). The life span of any first mover advantage is generally short (Lieberman and Montgomery, 1998), with sustainability based primarily on limiting imitability (Dierickx and Cool, 1989) and learning curve effects (Lieberman, 1989). Organizations that are innovative relative to new products may be able to stay ahead of competitors, limiting the ability of rivals to imitate (Nehrt, 1998). Competition solely on price may require excessively large reserves, and is likely to result in increased scrutiny in the face of heightened regulatory attenuation regarding insolvency risk. The awareness of rivals and their ability to readily imitate any product innovation or match cost reductions compromises potential competitive advantages (Karshenas and Stoneman, 1993). A closer look at the competitive environment in one market, Japan, illustrates a number of competitive (dis)advantages of various market entry strategies.

The Japanese Insurance Markets

The trials and tribulations of the Japanese economy over the past decade are well documented. Increased unemployment, decreasing real estate values, problem bank loans, GDP stagnation, deflation, and generationally low stock market values, among other adverse factors and events, all have taken their toll on Japanese consumer (including investor) confidence. However, the business of insurance in Japan remains a US$600+ billion industry, with roughly 25% of Japanese personal savings directly tied to its products. Despite severe economic problems, the Japanese insurance market consistently has been the second largest in the world by premium volume, accounting for over 25% of global life (ranking #1 or #2 in various years) and over 10% of global non-life premiums (a solid #2), respectively (SwissRe, 2000). These markets are still widely thought to offer many significant potential growth opportunities, if only due to their size. Historically, domestic markets were completely closed to non-Japanese insurers prior to 1972 and very limited branch operations and joint ventures by foreign firms were undertaken prior to 1996 (Skipper, 1998). In general, most Japanese insurers were tied to keiretsus and structured as mutuals, and it is only recently that demutualization has been actively considered by insurers (Takenaka, 2002).

Three primary sectors generally have been recognized in the Japanese insurance industry: life, property/casualty and a third specialty sector (*e.g.*, including dread disease, long-term care, medical and disability accident insurance). Ninety-five percent (95%) of total premiums have been in the life and property/casualty sectors, almost exclusively controlled by Japanese firms (Kochaniec, 1999). Only the third sector, somewhat ignored by Japanese insurers over time in part due to regulatory constraints, has seen significant foreign penetration (Steiner, 1996). On-going financial difficulties following the general economic bubble burst, as well as the obligation to honor then newly adopted World Trade Organization (WTO) financial service and other trade commitments, spurred significant interest in restructuring domestic insurance markets.

The entire Japanese industry was re-regulated in 1996 with passage of the new Insurance Business Law (IBL) - dubbed the "Big Bang" - the first major insurance regulatory restructuring since 1939 [Law #41 of 1939]. Prior to the 1996 reregulation, Japanese markets were very consolidated. For example, only 54 insurers wrote US$606 billion in total premium in 1994 compared to US$594 billion written in the U.S. by approximately 4,000 firms (Amano, 1997); and the Japanese Post Office and the agricultural cooperative association Zenkyoren accounted for over 30% of that total. The markets remain very consolidated, even within sectors, as evidenced by estimates of the market share of the top five non-life companies growing from 57% to 86% on a pro-forma basis over the period 2000-2002 (Toyoda, 2001).

The former chief insurance regulator, the Ministry of Finance, exercised rigid control over virtually every meaningful competitive aspect of the market (*e.g.*, prior approval requirements regarding new product introduction, rates, producer commissions), with input from entrenched domestic trade associations. The review process for new products could take many months, or even years, to complete. This protectionist philosophy resulted in the so-called "convoy system" that insulated even the most inefficient domestic insurers from market discipline (Toyoda, 2001).

The "Big Bang", and other financial service regulatory changes enacted since 1996, have dramatically altered the competitive landscape facing insurers in Japan, still the largest economy in the region despite continuing economic problems. The Ministry of Finance itself was restructured, ceding primary responsibility to a newly created Financial Services Agency (FSA), where fundamental regulatory control over the 'business of insurance' remains of highest priority (*e.g.*, solvency oversight, licensing, policyholder protection, preservation of the public trust). Just a few of the many landmark changes affecting insurance regulation include: replacing prior approval with a "notification system" for new products, liberalization of policy conditions and rating processes, introduction of an independent brokerage system and emphasis on alternative distribution methods (*e.g.*, direct sales by phone, mail, internet, bancassurance), allowing cross-selling by agents, and permitting entry by foreign life and non-life firms via subsidiaries (SwissRe, 2000; Toyoda, 2001).

In addition to "Big Bang"-related changes, doors to Japanese insurance markets also were opened to both domestic and foreign competitors due to the unprecedented collapse of a handful of domestic insurers, and the potential need to rescue others. The Nissan Mutual Life Insurance Company failed in April 1997, the first Japanese insurer to become insolvent since World War II (SwissRe, 2000). Several other failures or FSA-imposed business suspensions followed, including Toho Mutual Life, Daiichi Mutual Fire & Marine, Daihyaku Mutual Life, Taisho Life, Tokyo Mutual Life and Chiyodn Life. Non-Japanese firms have been able to step in (*e.g.*, GE Capital assumed the existing policies of Toho Mutual; Manulife assumed part of Daihyaku Mutual), taking advantage of opportunities to re-brand and re-energize their target firms, acquiring formerly inaccessible channels of distribution in the process (SwissRe, 2000). Despite the rash of financial troubles, many surviving Japanese insurers are still viewed as relatively stable due to exceptionally strong reserves from years of protected profitability, and some may yet prove to be a strong economic force in the Pacific Rim region. However, elimination of the prior protectionist philosophy and increased competition has forced newfound recognition of, and attention to, formerly inconceivable insolvency risk.

To avoid potential difficulties and/or to acquire new skills, some Japanese insurers have acquiesced, becoming the target of significant investment by non-Japanese insurers and hastening the pace of overall market entry (*e.g.*, AXA acquired control of Nippon Dantai Life; AIG acquired a 22% stake in Fuji Fire & Marine; Prudential acquired a 20% interest in Kyoei Life). Domestic financial service firms and non-service firms have not stood idly by, stepping in to take advantage of opportunities by participating in mergers, acquisitions and other "tie-up" arrangements, also increasing market consolidation. Additionally, new approaches to risk transfer and financing (*e.g.*, securitization) are gaining interest, having begun to be employed by Japanese insurers and corporations primarily in light of catastrophe exposures (SwissRe, 2000). Greater consolidation might also reasonably be expected should the nascent "export-led recovery" of the first two quarters of 2002 falter or economic difficulties persist.

Another potentially key area of change in Japan involves fundamental shifts in demographics and socio-cultural factors. For example, aging of an already long-lived Japanese population, coupled with elimination of life-long employment guarantees and changes in family structure, has created opportunities for new insurance products such as pension services and long-term care coverage - both niche products many foreign firms already have significant expertise in. Conversely, the westernization of younger Japanese generations may create difficulties for all financial services firms in that the spending/saving patterns of new and upcoming buyers may not reflect former levels (Skipper, 1998). Insurers, whether domestic or foreign, may be forced to incur greater future effort and expense in advertising, obtaining and educating customers than in the past, including increased costs of producer education and training. Such costs may well be significant over the near term given the widespread uncertainty and shaken domestic consumer confidence that has dogged the Japanese economy in recent years. Importantly, foreign insurers finally may have pierced a formerly costly barrier to entry in accessing those customers through recent merger/acquisition activities and re-branded distribution channels. However, the effect and on-going success of other financial services reforms on many potential customers (*e.g.*, the implementation and restructuring of deposit insurance incentives planned for April 2003) remains to be seen.

In sum, the re-regulation of the business of insurance in Japan has produced many *potential* market opportunities for both Japanese and non-Japanese firms. Yet successful market entry still is likely to be limited to the extent new entrants and first movers understand and have the capacity to respond to simultaneous changes in regulatory, economic and socio-cultural factors. Greater competition, which now effectively encompasses both price and product dimensions, undoubtedly will increase pressure on financially weaker firms, and may lead to greater market consolidation. The competitive environment in Japan is such that the benefits of re-regulation and liberalization may indeed accrue primarily to already well-established insurers, banks and other financial service firms, including niche players. Financial difficulties in either host or home economy may dampen the relative enthusiasm and staying power of some foreign participants in the near term, yet we believe successful foreign penetration will occur long term. Conversely, we anticipate even continued difficulties in domestic markets will not prevent many Japanese insurers from seeking long term strategic growth opportunities in other areas of Asia and the Pacific Rim.

Conclusion

This paper has briefly introduced competitive advantage and market entry issues within a framework of changing competitive factors in the Asia/Pacific Rim region using Japan as an example. Future analyses should include a closer look at competitive environments in specific countries, which would further reveal (dis)advantages of various market entry strategies. The growth potential of significant emerging markets (*e.g.,* China, India), coupled with opportunities for greater penetration of already substantial established markets (*e.g.,* Japan, Korea), contributes to the attraction of firms seeking new market entry or expansion in the region. Careful analysis of environmental factors (*e.g.,* regulation, consumer confidence, cultural factors) will be essential to understanding options available to firms as they develop strategic intent, missions and actions designed to create sustainable competitive advantage.

Endnote

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