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Foreign Insurers in Emerging Markets: Issues and Concerns

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Executive Summary

The appropriate role of foreign insurers in national insurance markets continues to be a topic of great interest and concern to policy makers. Over the past few decades, perhaps the most common view has been that foreign insurers should be constrained in various ways, if not barred altogether. Thus, countries often prohibited or severely limited foreign ownership of domestic insurers.

Dozens of countries have undertaken macroeconomic reforms. Domestic microeconomic reforms have followed. Many countries have opened their markets to foreign goods and services. Foreign direct investment, formerly discouraged, is now sought. Tariff and non-tariff barriers have fallen. State-owned enterprises have been privatized. Many governments have deregulated industry, commerce, and domestic finance.

Simultaneously, concern persists that certain dimensions of this liberalization euphoria may carry unacceptable risks and drawbacks. One such concern relates to the appropriate role of foreigners in the provision of financial services generally and insurance in particular. The paper distinguishes the two possible methods of foreign insurer involvement in national markets; through cross-border and establishment trade. The analysis focuses on establishment trade within the direct insurance market, addressing the concerns and issues associated with foreign investment as they relate to the insurance markets of developing countries and economies in transition to market economies, referred to collectively as emerging markets.

Insurance in Economic Development

A well-functioning insurance market plays an important role in economic development. In 1964, the United Nations Conference on Trade and Development (UNCTAD) pronounced that "a sound national insurance and reinsurance market is an essential characteristic of economic growth." This three-decade-old quote probably is the UN's only formal acknowledgment that insurance is important, and even it fails to do justice to the role of insurance in economic development. Insurance is not merely a "characteristic of economic growth." It is a necessity for the great majority of today's economies.

Regrettably, the precise linkages between insurance and economic development are poorly understood. In-depth research on this issue is sparse and largely anecdotal, unlike the situation with banks which enjoy by comparison a substantial body of supportive research. Not surprisingly, therefore, the role and importance of insurance in economic development goes largely unappreciated by policy makers.

In thinking about the role of foreign insurers in domestic insurance markets, it is useful to examine the role of financial intermediaries generally to economic development and to inquire whether foreign insurers could contribute. If they cannot or will not contribute in some way to economic development, one may legitimately question their relevance for transition economies and developing countries. The converse also applies.

Insurance aids economic development in at least seven ways. *First,* insurance promotes financial stability and reduces anxiety. In doing so, it permits businesses to operate with less volatility and risk of failure, thus providing greater financial and social stability within national economies. Simultaneously, it reduces anxiety for individuals and business owners.

Second, private insurance can substitute for government security programs. This fact reduces the strain on taxpayers and can make for a more efficient allocation of societal resources.

Third, insurance facilitates trade and commerce. Modern economies are built on specialization and its inherent productivity improvements. Greater trade and commercial specialization demand, in turn, greater financial specialization and flexibility. Without a wide insurance product choice and without constant service and pricing innovations, insurance inadequacies can stifle both trade and commerce. International insurers often enjoy a reputation as market innovators.

Fourth, insurance mobilizes national savings. Countries that save more tend to grow faster. Of the world's 20 fastest growing economies over the preceding 10 years, 14 had savings rates greater than 25 percent of GDP, and none had a saving rate of less than 18 percent. By contrast, 14 of the 20 slowest growing countries had savings rates below 15 percent.

Insurers offer the same advantages as other financial intermediaries in channeling domestic savings into domestic investment. The nationality of the owners of domestic insurers is largely irrelevant to this channeling function. Life insurers and other contractual savings institutions can be especially important for developing countries. In contrast with commercial banks which specialize in collecting short-term deposits and extending short-term credit, contractual savings institutions take a longer-term view. Their long-term liabilities and stable cash flow are ideal sources of term finance for government and business.

Locally incorporated foreign-owned insurers could bring additional and possibly innovative marketing and product competition to the national market. This can deepen and broaden the domestic financial services marketplace. Research on the determinants of national savings suggests that such market strengthening is associated with higher saving rates and, hence, greater economic development.

Fifth, insurers enable risk to be managed more efficiently. They do this by risk pricing, risk transformation and risk pooling and reduction. A competitive market's success depends on pricing. Insurers price risk through their underwriting and investment activities. Business owners and managers, potential investors, creditors, employees, and other stakeholders can use these risk pricing signals to make better informed decisions, thus enhancing national economic efficiency. Foreign insurers often are particularly good at risk pricing.

Insurance also permits businesses and individuals to transform many of their property, liability, loss of income and other risk exposures to suit their own needs better. Moreover, life insurers help individuals and businesses transform the characteristics of their savings to the liquidity, security and other risk profiles desired. To the extent that foreign insurers bring additional capacity to a market, they facilitate this risk transformation activity.

The third risk management function performed by insurers is risk pooling and reduction. Pooling occurs in both underwriting and investment. Pooling reduces volatility. By reducing volatility, a smaller "risk premium" can be assessed insureds and borrowers. As foreign-owned insurers often are part of much larger international insurance groups, their risk pooling activities might be particularly helpful, thus offering the potential for greater pricing and investment stability.

Sixth, insurers and reinsurers have economic incentives to help insureds reduce losses. Foreign insurers sometimes can bring state-of-the-art loss mitigation services to markets.

The *seventh* benefit of insurance to economic development is that insurers foster a more efficient allocation of a country's capital. They gather substantial information to conduct their evaluations

of firms, projects and mangers both in deciding whether to issue insurance and in their roles as lenders and investors. In making such investment and insurance decisions, insurers tangibly signal the market's approval of promising, well-managed firms and projects and thereby foster a more efficient allocation of a country's scarce financial capital and insurance bearing capacity. Foreign insurers often can bring innovative and more efficient means of gathering and evaluating information, thus aiding in capital allocation.

Therefore, based on the means by which insurance underpins economic development, the conclusion is that foreign insurers have a potentially constructive role to play in the insurance markets of transition economies and developing countries.

In this study, the means by which foreign insurers might actualize their contributions to economic development are examined. Additionally, the arguments as to why countries might be wise either to go slow in market liberalization or to limit foreign involvement in their insurance markets are analyzed.

Arguments Favoring Greater Foreign Insurer Involvement

Briefly, the specific arguments favoring greater foreign insurer participation are that countries could realize one or more of the following benefits:

- improvements in customer service and value
- increased domestic savings
- transfers of technological and managerial knowhow
- additional external financial capital
- improvements in the quality of insurance regulation
- creation of beneficial domestic spillovers, including the addition of more and higher quality jobs, quality enhancing backward and forward linkages, and societal loss reductions.

Each of these arguments is examined, relying primarily on existing banking and related research and on available anecdotal evidence. Except for one argument, they were assessed as constituting reasonable expectations for emerging markets. The foreign direct investment accompanying foreign insurer establishment was assessed as being less important to development than the other items.

Concerns About Foreign Insurer Involvement

Policy makers have expressed numerous reservations about foreign insurer participation in their domestic markets. Such reservations are classified around seven common themes, five of which were found to have little or no justification or the associated issues could be addressed more adequately and with less consumer loss through alternative means. The validity and importance of a sixth theme cannot be established *a priori*. The seventh reservation theme was judged to warrant policy-maker concern.

The five classes of reservations either lacking factual justification or for which more efficient, viable alternatives exist are as follows:

- *First*, foreign insurers might dominate the domestic market and thereby precipitate adverse microeconomic (less consumer choice and value) or macroeconomic (failure to contribute adequately to economic development) effects. If a market offers great potential and if

domestic insurers are inadequate and unsophisticated, market liberalization could lead to foreign domination. In such a case, however, no rational basis exists to support a parallel belief that the nation's consumers and businesses will suffer harm or that the national economy will be harmed. On the contrary, that the market offered great potential, was unsophisticated, and had an inadequate capacity suggests that the status quo was stifling microeconomic and macroeconomic improvements.

- The *second* reservation class for which factual justification is lacking or for which more efficient means exist to address the concern than denial of market access is that foreign insurers might market insurance selectively, thereby leading to adverse microeconomic or macroeconomic effects. (This selectivity may be because of concern that foreign insurers will market insurance only to the most profitable segments, to multinational corporations or to the commercial sector, ignoring the retail market.) Governmental efforts to discourage selective marketing can be harmful. Specialization and market segmentation lead to efficiency improvements, as suggested earlier. It is true that segmentation could cause some market segments to be under served. If it does and if these under served segments are judged critical, policy makers would be wise first to examine whether repressive regulation (such as price suppression) was at fault. If not, insurers can be enticed into neglected segments through less distorting subsidies or other positive means.
- The *third* class of reservations is that foreign insurers might fail to make lasting contributions to the local economy. No reasonable factual basis to support this belief could be established.
- The *fourth* class of arguments for limiting foreign insurer market access is that the domestic market is already well-served by locally owned insurers or through reinsurance. Again, no reasonable factual basis to support this belief could be established.
- The *fifth* reservation category is that the national industry should remain locally owned for strategic reasons, such as national security concerns or because of the desire for economic diversification. To the extent that these goals are valid and not driven by special interests, less market-distorting means exist for accomplishing them than limits on foreign insurer participation.

The *sixth* reservation class is that foreign insurers may provoke a greater foreign exchange outflow. The validity of this concern cannot be ascertained *a priori*. Over the short-term, of course, foreign exchange would flow into the country. More importantly, as an UNCTAD study noted: "(any) loss of foreign exchange may not be substantial enough to justify the opportunity cost involved in running and upgrading national insurance corporations."

The *final* reservation relates to the belief that full market liberalization should await insurance and possible macroeconomic regulatory reforms so as to minimize the chances of micro- or macroeconomic disruptions. This concern is valid in certain situations, particularly regarding adequate prudential supervision, competition regulation and market conduct oversight. Reasonable insurance laws and regulation are essential. Ideally, they should exist prior to full market liberalization to avoid abuse by the unscrupulous.

The study concludes that opening insurance markets to appropriate foreign insurers is likely to aid economic development, enhance overall social welfare, and carry few unresolvable negative possibilities. 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 economies a disservice.

Introduction

The appropriate role of foreign insurers in national insurance markets continues to be a topic of great interest and concern to policy makers. Over the past three or four decades, perhaps the most common view has been that foreign insurers should be constrained in various ways, if not barred altogether. Thus, countries often prohibited or severely limited foreign ownership of domestic insurers. Many markets were oligopolistic, if not monopolistic. National treatment was often judged inappropriate, so that, if admitted, foreign insurers were disadvantaged via-a-vis local insurers.

Of course, the situation has changed for many countries. Dozens have undertaken macroeconomic reforms to reduce chronically high inflation rates and control budget deficits. They have made currencies convertible and liberalized exchange controls. Some 60 to 70 countries have no restrictions on capital movements today, compared with 20 to 30 in 1980.

Both trade-related and purely domestic microeconomic reforms have followed. Many countries have opened their markets to foreign goods and services. Foreign direct investment, formerly discouraged, is now sought. Tariff and non-tariff barriers have fallen. State-owned enterprises have been privatized. Many governments have deregulated industry, commerce and domestic finance.

Simultaneously, concern persists that certain dimensions of this liberalization euphoria may carry unacceptable risks and drawbacks. One such concern relates to the appropriate role of foreigners in the provision of financial services generally and insurance in particular. This paper focusses on the concerns and issues associated with this role as relates to the insurance markets of developing countries and economies in transition to market economies—referred to collectively herein as **emerging markets**.

The approach followed is, first, to set out the possible methods of foreign insurer involvement in national markets. There follows a general discussion about the important role that a well-functioning insurance market plays in economic development. Foreign insurers should reinforce (or at least not hinder) this role if their participation is to be viewed favorably by policy makers in emerging markets. The final sections present the arguments for and against greater foreign insurer involvement and present conclusions.

A key assumption underpinning the discussion here is that policy makers are committed to creating and supporting a competitive market. Policy makers could, for example, open a previously monopolistic or oligopolist market to foreign interests and privatize previously state-owned insurers, but without simultaneously creating the needed competitive environment and prudential oversight. The effect could be merely to substitute a privately owned monopoly or oligopoly for a state-owned one, without any substantial benefit to citizens, local businesses and the national economy.

Methods of Foreign Insurer Involvement

Foreign insurer involvement in domestic insurance markets can occur through (1) cross-border insurance trade or (2) establishment insurance trade.[1] For purposes of this study, the term **insurance trade** should be understood to encompass both types of market access. Each is discussed below.

Cross-border Insurance Trade

Definition. **Cross-border insurance trade** exists when nonresident insurance providers sell insurance to residents. From the viewpoint of the insurer's country of domicile, its **home country**, such insurance is an export. From the viewpoint of the country of residence of the insured person or object, the **host country**, the insurance is an import. Cross-border insurance trade can take several forms.

Pure cross-border insurance trade exists when an insurance contract results from solicitations by an insurer domiciled in another country. The solicitation may occur via direct response techniques (telephone, newspaper, mail, or the Internet) or through brokers. Such insurance typically involves large risks. Much reinsurance is marketed in this way.

Own-initiative cross-border insurance trade means that the insured initiated the contact with the insurer. Corporations often seek insurance abroad, in an attempt to secure more favorable terms, conditions or prices than those available locally. Individuals less frequently do so.

Consumption-abroad cross-border insurance trade occurs when an insured, temporarily residing or visiting abroad, enters into an insurance contract with a local insurer. A distinction should be noted between insurance intended to provide cover only during the length of stay and insurance intended for longer term needs.

Yet another variation of cross-border insurance trade occurs when a multinational corporation (MNC) purchases **difference-in-conditions (DIC) insurance** or **difference-in-limits (DIL) insurance** as part of its global risk management program. Such policies, usually written in the MNC's home country, may involve coinsurance with foreign or other domestic insurers. Coverage may extend to many exposures of the parent and its foreign affiliates. Affiliates often purchase underlying insurance locally, with the master contract providing excess or gap coverage.

Issues. In an ideal world, complete freedom would be extended to insurers (and reinsurers) to provide cross-border insurance services and to customers to purchase insurance from whomever they wished. The logic supporting this position stems from the very foundations of competition. The greater the competition, the greater will be customer choice and value, other things being the same. In other words, insurance consumers in this idealized, liberalized insurance world could enjoy lower premium rates for equivalent coverage and security, and product innovations otherwise unavailable from domestic insurers. In addition, domestic market capacity could be protected from undesirable risk concentrations and possible disruptions to that market as well as to the real economy. Finally, anticompetitive practices, such as local cartel behavior, would

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[1]This section draws from Skipper (forthcoming), Chapter 4.

be less likely with complete freedom of cross-border insurance trade.

The economic logic for the above position would be unassailable if insurance markets exhibited fully the traits of the perfectly competitive model. In practice, however, two sets of problems argue against the position.

First, many, especially developing, countries have argued that cross-border insurance trade has negative macroeconomic effects on the national economy. In contrast to insurance purchased from locally established insurers which then invest funds locally to back their reserve obligations, thus aiding economic development, cross-border insurance purchases usually result in little or no host-country investment. Rather, the foreign insurer or reinsurer likely invests in its home country. In addition, in contrast to establishment insurance trade by foreigners, cross-border trade creates less local insurance expertise (technology and skills transfer) and, hence, adds less human resource development to the national economy.

In isolation and with other things being the same, the above macroeconomic concerns are valid. The issue, however, is more complex than the above simple analysis suggests, as important secondary effects should be considered. If the national market fails to offer desired coverage because of insufficient local capacity or because of pricing or product availability problems, forcing customers to purchase inferior coverage locally may be self-defeating in the long term. For one thing, an inadequate local capacity or spread of risk can endanger the very foundation of the national insurance market and by that wreak havoc on individuals and industries within the economy that rely on insurance. If this danger is to be avoided, national insurers must rely on international reinsurance, thereby substituting indirect (reinsurance) cross-border insurance for direct cross-border insurance and inserting another expense component in the process.

Even if capacity and spread of risk are not problems, forcing citizens and businesses to purchase higher priced or more limited coverage locally means they would have inferior coverage or pay more for the coverage than their competitors elsewhere in the world. Citizens would purchase less insurance than they would otherwise, therefore depriving themselves of some security. With continuing liberalization and internationalization of national markets, national and international competition intensifies. In such an intensively competitive world, differences in the quality and price of production inputs (such as insurance) potentially can mean the difference between success and failure.

The *second* argument against complete freedom for cross-border insurance trade revolves around the concept that government has an obligation to protect ill-informed buyers. This argument finds concrete support in both economic theory and fact. A critical assumption in the competitive model is that buyers are well informed about the products they buy. Without substantial product knowledge, consumers can make ill-advised purchases. Because of the close tie that insurance has with the overall public interest and its quasi-fiduciary nature, governments worldwide have been reluctant to ignore the natural imbalance in positions between certain insurance buyers and sellers. Sophisticated insurance buyers, such as large businesses, have reasonable opportunity to become well informed and to avoid weak or incompetent insurers and poor policy purchase decisions. The need for government oversight is correspondingly diminished. The same logic applies when direct insurers purchase reinsurance.

A different situation exists with individual

consumers and small businesses, who are more easily misled. Lacking sufficient knowledge to make appropriate inquiries as they negotiate for insurance, they are notoriously easy prey for the unscrupulous insurance seller. Thus, there are sound reasons for restricting pure cross-border insurance trade with respect to individuals and other poorly informed buyers. An exception can occur when the host country insurance regulator is satisfied that the insurer's home country provides at least equivalent protection to the customer as that which the host country provides. The European Union's Single Market Program illustrates this *mutual recognition* approach.

The same pro-restrictive logic is less compelling with own-initiative cross-border insurance trade. Consumers who voluntarily initiate insurance purchases with unlicensed foreign insurers effectively forfeit the regulatory protection otherwise afforded by their country. Many countries' regulations, including those of the Organization for Economic Cooperation and Development (OECD), are generally consistent with this view, although cross-border purchases are discouraged in several countries through a denial of favorable tax treatment.

The other forms of cross-border insurance trade involve more sophisticated buyers. The need for government intervention into these transactions for purposes of protecting the insurance consumer is less compelling.

Establishment Insurance Trade

Definition. **Establishment insurance trade** exists when insurance is sold to residents through a locally established undertaking owned by nonresidents. The opportunity to establish a local presence is often essential to the efficient provision of insurance services. Establishment insurance trade can take several forms.

Establishment via **subsidiary** exists when nonresidents create a *de novo* domestic insurer or acquire an existing domestic insurer. The subsidiary is a legal entity separate from its parent and may be wholly owned by the parent or owned with others, such as through **joint ventures** partially owned by residents. The subsidiary is the most substantive form of establishment and is inextricably linked with capital movements and inward direct investment. Excepting ownership nationality differences, such subsidiaries legally are identical to other national insurers and, therefore, answer fully to the national insurance regulator, not to the owner's domiciliary regulator.

A **branch office** is a detached portion of a foreign insurer and, hence, is wholly owned by the firm. Unlike a subsidiary, the branch office is not a stand-alone insurer, but legally a part of an insurer. As such, the branch office is subject to home country regulatory oversight. Because it has a local presence, incurs financial obligations locally and typically bears risk locally, it is also subject to host-country regulation. This dual regulatory oversight offers the potential for conflicts of law and regulation.

An **agency** is a much less substantial form of establishment. As the legal representative of the foreign insurer, the agent's powers to represent its principal may range from narrow (for example, sales only) to broad (sales, underwriting, pricing, and claim settlement). The foreign-owned domestic agency must comply fully with all host country agent licensing and other requirements. Establishment by agency is akin to cross-border insurance trade since the actual risk is borne by a foreign insurer not subject to host-country control.

A **representative office** seeks to

promote the interests of and sometimes services the local clients of the foreign insurer. The representative office neither bears risk nor sells insurance. Within OECD countries, its establishment requires host country regulatory notification but not approval.

Issues. Establishment has long been among the most contentious insurance trade issues, although OECD code obligations, the newly adopted General Agreement on Trade in Services (GATS), and a general worldwide liberalization trend have together yielded a softening of positions. One reason for this contentiousness is that establishment can require foreign direct investment (FDI) which historically has been closely associated with the exercise of national sovereignty.

Establishment issues stem principally from market access, national treatment and transparency concerns. Thus, some countries limit foreign insurer market access via establishment because of a desire to protect the local insurance industry and because of other concerns. Even when market access is not restricted, foreign-owned establishments may be denied national treatment, thus placing them at a competitive disadvantage. Finally, in some markets, transparency problems exist in that market access and other competitive rules may be unwritten, incomplete or inconsistently enforced.

Apart from the above three issues, a matter peculiar to branch offices stems from their dual status as part of a foreign insurer and as a local establishment. Because branch offices are risk-bearing entities, host-country rules typically require local investment of assets backing local reserves. In addition, a substantial deposit or guarantee fund—often equal to the minimum capital and surplus requirements for domestic insurers—may be required. These localization requirements ensure national regulatory control over reserve funds. For the foreign insurer, such requirements fragment assets and decrease investment flexibility. In addition, the dual oversight by host and home country regulators can lead to difficulties for the regulators and insurer alike. Without direct regulatory cooperation, conflicts seem unavoidable. At the same time, however, a branch office may offer greater security to the local market than a subsidiary, as its operations are backed by the parent's financial capacity, not by local financial resources alone.

Scope of this Study

Complete freedom of cross-border insurance trade is unlikely to evolve separately from meaningful international regulatory cooperation. While important first steps have been taken in the direction of regulatory cooperation, much work remains.

Establishment insurance trade represents a larger (and growing) share of international insurance trade than cross-border insurance trade. The successful marketing and servicing of numerous forms of insurance require a substantial local presence.

Also, issues associated with establishment relate more closely to economic development and national sovereignty than those associated with cross-border trade. Finally, unlike the situation with cross-border insurance trade, a country's decision whether to allow full market access via subsidiary establishment need not await arrival of meaningful international regulatory cooperation. Establishment issues, especially those related to subsidiaries, do not require cooperation with the investor's home country regulator (although this is desirable). Domestic policy makers can comfortably make policy decisions about rights of establishment unilaterally.

For these reasons, this study focuses on

foreign insurers' involvement in emerging markets via establishment, emphasizing subsidiaries and branch offices with local investment.

The Role of Insurance in Economic Development

It is now widely agreed that financial services generally and insurance in particular are of primordial importance to economic development.[2] The United Nations Conference on Trade and Development (UNCTAD) recognized this importance when it acknowledged ". . . that a sound national insurance and reinsurance market is an essential characteristic of economic growth."[3]

Even with such support, it helps to be clear about exactly how insurance underpins economic development. The precise linkages between insurance and economic development, however, are poorly understood. In-depth research on this issue is sparse and largely anecdotal, unlike the situation with banks that enjoy by comparison a substantial body of supportive research. Unsurprisingly, therefore, the role and importance of insurance in economic development lack full appreciation by policy makers in many markets.

In thinking about the role of foreign insurer participation in a country's domestic insurance market, it is useful to examine the role of financial intermediaries in economic development generally and to inquire whether foreign insurers would more likely aid or retard this development. For if they cannot or will not contribute in some way to economic development, we may legitimately question their relevance for emerging markets. The phrase "national insurance and reinsurance market" has never been completely defined within a UN context, and, therefore, it could be read either to include or to exclude foreign insurers.

While there is wide acceptance of the view that financial development affects economic growth, there is less agreement as to the mode through which it does so. One theory holds that a country's financial system contributes to economic growth by increasing the rate of capital accumulation. Under this view, financial capital (from domestic savings or international capital inflows) is necessary to finance the many industrial, commercial and infra structural projects essential to economic development.

Another (not mutually exclusive) theory holds that financial development aids economic development by improving the efficiency of capital allocation. Under this view, improvements in productivity and economic efficiency are at least as important as capital accumulation in explaining economic development.[4]

Whatever the correct link between financial development and economic growth, studies by King and Levine (1993 a, b, c),

[2]This section draws from Skipper (forthcoming), Chapter 3, which cites the literature in support of this statement.

[3]UNCTAD (1964), p. 55.

[4]Levine (1996), pp. 232-235.

How Insurance Aids Economic Development

- Promotes financial stability and reduces anxiety
- Can substitute for government security programs
- Facilitates trade and commerce
- Mobilizes savings
- Enables risk to be managed more efficiently
- Encourages loss mitigation
- Fosters a more efficient capital allocation

using data on 80 countries over the 1960-1989 period, show that various measures of financial development are strongly associated with various measures of economic growth and efficiency. In still more recent research exclusively on developing countries, Levine (1996) finds that financial development stimulates economic growth, and policies that promote financial development stimulate economic development.

Financial markets in general and insurance markets in particular differ greatly from country to country. The more developed and efficient a country's insurance market, the greater its contribution to economic prosperity, other things being equal. It is wrong to view insurers as simple pass-through mechanisms under which the unfortunate few who suffer losses are indemnified from the funds collected from many policyholders. Laudable though it is, this strictly financial intermediation function may be no more important to economic development than other elements of insurance. We will see that

insurers are not simply balance sheets and that insurance provides “real” services critical for economic activity and long-run growth.

Insurance provides seven categories of services important to economic growth. These benefits, listed in the box above, are discussed in detail in the section that follows.[5]

[5]This section draws in part from Levine (1996).

Promotes Financial Stability and Reduces Anxiety

Insurance is designed to help stabilize the financial situation of individuals, families and organizations. It accomplishes this task by indemnifying those who suffer a loss or harm. Without insurance, individuals and families could be forced to seek assistance from relatives or friends or from the government in case of loss, both of which are considered demeaning in many cultures. Businesses that incur significant uninsured losses may suffer major financial reverses or even fail. Besides the loss in value of the owners' stake in the business occasioned by an uninsured loss, other stakeholders could suffer as well. These negative spillovers could include higher unemployment; customers being deprived on the firm's products or services; suppliers losing business; and government tax revenues decreasing and responsibilities increasing.

Insurance also can reduce anxiety. Anxiety can be constructive, as when it causes creativeness, or it can be negative, as when it causes constant worry, depression or even paralysis in decision-making. Anxiety that arises from concern about the financial consequences of loss of life, health, property, and financial assets usually falls into the negative category, but can be ameliorated partially through the purchase of insurance against the anxiety-inducing event. Insurance enhances peace of mind and provides a sense of financial security. For this reason, corporate insurance and reinsurance are often referred to fondly by executives as "sleep insurance."

Can Substitute for Government Security Programs

Insurance, especially life insurance, can benefit society in other ways. An OECD (1987) study highlighted this important point:

> The fact that so many life insurance policies are purchased undoubtedly relieves pressure on the social welfare systems in many states. To that extent, life insurance is an advantage in the context of public finance, and, as a result, is generally viewed with favor by governments. A number of governments acknowledge this in tangible form by granting tax relief to policyholders. At this point, tax incentives for life insurance contributions are widespread among OECD member countries.

A Swiss Reinsurance Company (1987) study demonstrates that privately purchased life insurance can substitute for government-provided benefits and vice versa. For a group of 10 OECD countries, the study found a significant negative relationship between social expenditures and life insurance premiums. It attributes part of the recent high growth in life insurance premiums "to the growing financial difficulties of the social old-age pension systems. . . .Life insurers thus take an increasingly important role in relieving the burden of social pension schemes."

Facilitates Trade and Commerce

Insurance underpins trade, commerce and entrepreneurial activity. Many products and services are produced and sold only if adequate liability insurance is available to cover any claims for negligence. Because of the high risk of new business failure, venture capitalists will often make funds available only if tangible assets and the entrepreneurs' lives are adequately insured. Airplanes do not fly; ships do not sail; and trucks do not haul freight without insurance coverage. International trade relies on insurance.[6]

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[6]Large corporations whose shares are widely held have less need for insurance. See Phillips (forthcoming).

Modern economies are built on specialization and its inherent productivity improvements. Greater trade and commercial specialization demand, in turn, greater financial specialization and flexibility. Without a wide insurance product choice and without constant service and pricing innovations, insurance inadequacies could stifle both trade and commerce.

Insurance also supports business activity by enhancing the creditworthiness of customers. Thus, banks and other creditors typically insist that loan collateral be insured, or they will not make the loan (or will build an additional "risk premium" into the interest rate). They may also require the purchase of life insurance on the principal wage earner's life for personal loans or on the lives of key employees with business loans. It is in these ways that insurance truly serves as "the lubricant of commerce."

Mobilizes Savings

The Importance of Savings to Economic Development. The general financial services literature emphasizes the important role of savings in economic development. Savings can be either financial or non-financial. Non-financial savings take the form of real assets such as land, jewelry and buildings. Financial savings are held in financial assets such as savings accounts, bonds, shares and life insurance policies. Generally, the more economically developed a country, the greater the proportion of its total wealth in financial savings. This result is not unexpected and is consistent with the view that financial development and overall economic development move in tandem.

Countries that save more tend to grow faster. Of the world's 20 fastest growing economies over the preceding ten years, 14 had saving rates greater than 25 percent of GDP and none had a saving rate of less than 18 percent.[7] By contrast, 14 of the 20 slowest growing countries had saving rates below 15 percent.[8] The diagram on the next page illustrates this pattern. The shaded area suggests the positive correlation between the savings rate and real per capita GDP growth.

Economists generally agree as to the positive relationship between saving rates and growth rates, but they do not all agree as to the direction of causation. While the most recent research on the direction of causation is not totally conclusive, the International Monetary Fund (IMF) concludes that:

> . . .the data suggest that there may be a virtuous circle between growth and saving. Increases in growth raise the saving rate, which in turn feeds back to increase growth. This has potentially broad ramifications.[9]

This conclusion is a happy result for emerging markets. It suggests that rapid economic growth could stem from either increased saving rates, the introduction of new technologies, or methods that increased productivity.

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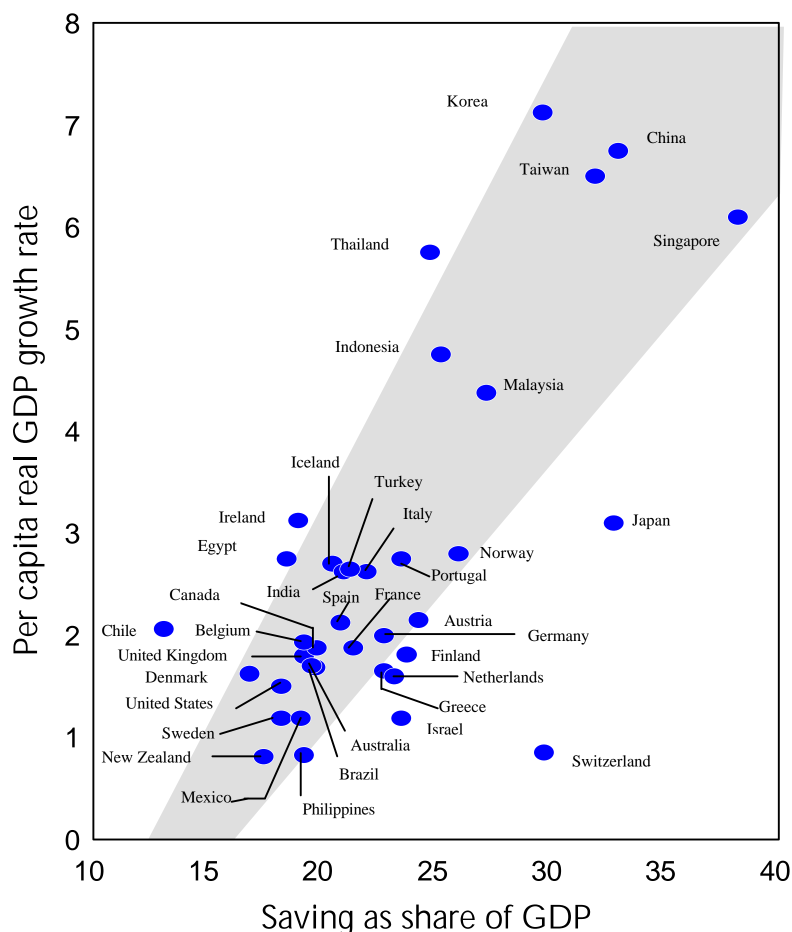
[7]IMF (1995), pp. 69-70.

[8]IMF (1995), p. 70.

[9]IMF (1995), pp. 70-71.

Saving Rate and Per Capita GDP Real Growth



Source: IMF (1995), p. 72.

Insurers Enhance Financial Intermediation. Insurers, especially life insurers, offer the same advantages as other financial intermediaries in channeling savings into domestic investment. The nationality of the owners of domestic insurers is largely irrelevant to this channeling. Financial intermediation of all types decouples the savings and investment functions. By doing so, investment is no longer confined to the sector in which the saving takes place. Funds can flow to the most productive sectors in an economy.

Insurers enhance financial system efficiency in three ways. *First*, financial intermediaries reduce transaction costs. Thousands of individuals each pay relatively small life insurance premiums. The insurers then use these amassed funds to invest in businesses and other ventures. In performing this intermediation function, direct lending and investing by individual policyholders, which would be exceptionally time consuming and costly, is avoided.

Second, insurers create liquidity. They “borrow” short term and lend long term.

"Borrowing" for insurers means that they use funds entrusted to them by their policyholders to make long-term loans and other investments. Both life and non-life insurers stand ready to provide policyholders, or beneficiaries, with instant liquidity if a covered loss occurs. The creation of liquidity allows policyholders to have immediate access to loss payments and savings while borrowers need not repay their loans immediately. If all individuals instead undertook direct lending, they would likely find their personal wealth held in long-term, illiquid assets. Insurers, thereby, reduce the illiquidity inherent in direct lending.

Third, insurers acting as financial intermediaries facilitate economies of scale in investment. Some investment projects are quite large, especially in relation to available financial capital in many emerging markets, and require correspondingly large amounts of financing. Such large projects often enjoy economies of scale, promote specialization and stimulate technological innovations and therefore can be particularly important to economic development. By amassing large sums from thousands of smaller premium payers, insurers can often meet the financing needs of such large projects, thereby helping the national economy by enlarging the set of feasible investment projects and encouraging economic efficiency. "Thus, efficiency and savings may be importantly linked; by facilitating resource mobilization, financial intermediaries increase the feasibility of large, high-return investment projects."[10]

Financial Intermediaries versus Financial Markets. The more developed (complete) a country's financial system, the greater the reliance on markets and the less the reliance on intermediaries. Indeed, if the users and providers of funds had complete information about each other, if the borrowing/lending functions were frictionless, and if monitoring were costless, financial intermediaries would not exist. In such an idealized world, all risks could be exchanged at little or no transactions costs in financial markets in which both buyers and sellers possessed all the information they needed about possible future "states of the world." The closer a financial market comes to achieving these three ideals, the more complete it is and the more important will be the financial market compared with financial intermediaries, *ceteris paribus*. (For this reason, many clever people are working diligently to lower information, transaction, and monitoring costs in insurance with the goal of utilizing the financial market to cover some insurance risks.)

Financial markets are more developed in developed market-economy countries and, therefore, are of greater importance in such countries than in emerging countries. Even so, financial intermediaries, in all countries, are far more likely to be providers of investment funds than are financial markets. Only firms of a certain minimum size typically can easily tap into securities markets. Few such firms exist in most emerging markets. Because of this fact and because financial markets are less incomplete in developed countries, one would expect financial intermediaries, such as insurers, to play a relatively greater role in investment finance in emerging markets than in developed market-economy countries. Collier and Mayer (1989, pp. 3-6), for example, provide support for this view with respect to banks.

Insurers versus Other Financial Intermediaries. A well-developed financial system will have a myriad of financial institutions and instruments. The greater the variety, *ceteris paribus*, the more efficient the

[10]Levine (1996), p. 231.

system and the greater its contribution to economic development. A recent UNCTAD study commented authoritatively about the converse: "the less developed and diversified a financial system is, the more restricted will be the access to small and risky borrowers to sources of finance."[11]

Contractual savings institutions, such as life insurers and private pension funds, can be especially important financial intermediaries in emerging markets. In contrast with commercial banks, which often specialize in collecting short-term deposits and extending short-term credit, contractual saving institutions usually take a long-term view. Their long-term liabilities and stable cash flows are ideal sources of long-term finance for government and business.[12]

Enables Risk to be Managed More Efficiently

Financial systems and intermediaries price risk and provide for risk transformation, pooling and reduction. The better a nation's financial system provides these various risk management services, the greater the saving and investment stimulation and the more efficiently are resources allocated. Each of these risk management areas is discussed below.

Risk Pricing. A competitive market's success depends on pricing, and the pricing of risk is fundamental to all financial intermediaries. Insurers price risk at two levels. *First*, through their insurance activities, insurers evaluate the loss potential (riskiness) of businesses, persons and property for which they might provide insurance. They set a price (premium) for insuring against loss based on this assessed riskiness.[13] The riskier the exposure, the higher the price. Some exposures are so risky that insurers refuse to offer insurance at any price. In pricing the risk associated with losses to businesses and others, insurers cause insureds to (1) quantify the consequences of their risk-causing and risk-reduction activities and, thus, (2) deal more rationally with risk. Investors in projects judged too risky for insurance at any price are similarly put on notice and should rationally expect returns commensurate with the risk.

Second, through their investment activities, insurers evaluate the creditworthiness (riskiness) of those to whom they extend loans and the likely business success (riskiness) of those in whom they invest. By these activities, business owners, potential investors, customers, creditors, employees and other stakeholders can be better informed about the firm's risk characteristics and thereby make better informed decisions.

To the extent that foreign insurers are more experienced and competent in refined risk pricing in the above two areas than are locally owned companies, they can bring more discipline to a national insurance market and thus contribute to economic growth of the host country.

Risk Transformation. Insurance permits businesses and individuals to transform their risk exposures to suit their own needs better. Many property, liability, loss of income and other risk exposures can be transferred to an insurer for a price and, in the process, the insured's risk profile can be

[11]UNCTAD (1995b), p. 6.

[12]Vittas and Skully (1991), p. 2.

[13]Insurance markets that rely on cartel or other tariff-setting practices are less likely to realize maximum benefit from insurers' pricing of risk in this way.

changed.[14] Moreover, by tailoring contracts to the needs of different clients, life insurers help individuals and businesses transform the characteristics of their savings to the liquidity, security and other risk profile desired. To the extent that foreign insurers bring additional capacity and technical expertise to a market, they facilitate this risk transformation activity.

Risk Pooling and Reduction. Risk pooling and reduction lie at the heart of the insurance mechanism and, as with risk pricing, occur at two levels. *First*, in aggregating many individual risk exposures, insurers rely on the law of large numbers to permit them to make reasonably accurate estimates as to the pool's overall losses. Of course, they cannot predict which insureds will have losses, but they do not require this for the scheme to function efficiently.

Overall, the larger the number of insureds, the more stable and predictable will be the insurer's loss experience. This fact leads to a reduction in expected loss volatility (risk) and, by that, permits the supplier to charge a smaller risk premium for its risk transfer services and potentially to maintain more stable premiums.

Second, 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 or bankruptcy 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.

Foreign-owned insurers are often part of much larger international insurance groups with a global customer base and investment portfolio. As such, their risk pooling activities could be particularly effective, thus offering the potential for lower premiums and greater pricing stability.

Encourages Loss Mitigation

Insurance companies worldwide have economic incentives to help insureds prevent or reduce losses. Moreover, their detailed statistical and other knowledge about loss-causing events, activities, and processes probably gives them a competitive advantage over many other firms in loss assessment and control. If pricing or availability reflects loss experience, insureds, in turn, have economic incentives to control losses.

Insurers support many loss control programs, typical of which are fire prevention; occupational health and safety; industrial loss prevention; reduction in automobile property damage, theft and injury; and literally dozens of other loss control activities and programs. These programs and activities reduce both direct and indirect losses to businesses and individuals and complement good risk management. Society as a whole benefits from the reduction of such losses.

Of course, not all losses can or should be prevented. The costs of loss mitigation activities must always be weighed against its direct and indirect benefits.

Foreign insurers often offer particularly good loss prevention and mitigation services to their insureds. For example, routine risk management audits identify ways to enhance worker and product safety and to prevent or control losses caused by fire, windstorm, flood, and other perils. Some insurers and reinsurers enjoy a reputation for great technical expertise which is available to clients from the earliest design phase through construction and operation of manufacturing

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[14]It is in this transformation process that the classical moral hazard and adverse selection problems arise for insurers.

and other facilities. Such services often are inadequate in many emerging markets. To the extent that these services are lacking, a national economy could benefit from a greater involvement by competent foreign insurers.

Fosters a More Efficient Capital Allocation

Insurers gather substantial information to conduct their evaluations of firms, projects and managers both in deciding whether (and at what price) to issue insurance and in their roles as lenders and investors. Individual savers and investors may not have time, resources or ability to gather and analyze information to this degree. As a result of this specialization by insurers, they allocate financial capital and insurance risk bearing capacity to the most attractive firms, projects and managers.

Because insurers have a continuing interest in the firms, projects, and managers to whom they provide financial capital or risk bearing capacity, they have an incentive to monitor managers and entrepreneurs to reduce the chances that they engage in unacceptable risk-increasing behavior. Insurers thus encourage managers and entrepreneurs to act in the best interests of their various stakeholders (customers, stockholders, employees, and creditors). In other words, insurers and other financial intermediaries help resolve the **principal-agent problem**—situations where one party (the agent) does not always act in the best interests of its principal. By doing so, insurers tangibly signal the market's approval of promising, well-managed firms and foster a more efficient allocation of a country's scarce financial capital and risk bearing capacity.

National financial systems that allow insurers to gather and evaluate information in this way should realize a more efficient allocation of capital and therefore stronger economic growth.[15] To the extent that foreign insurers facilitate this process, their participation in domestic insurance markets could be a welcome addition.

[15]This statement is not intended to suggest that certain limitations on insurers' information gathering and evaluation might not be appropriate. For example, government may conclude that certain types of information (e.g., religion or race) should not be collected or used because of concerns about unfair discrimination.

Arguments Favoring Greater Foreign Participation

This section examines the means by which foreign insurers might contribute to the economic development of emerging markets. The next section examines the converse.

In accordance with economic theory, liberalized markets lead to a more efficient allocation of a country's resources and, by fostering greater competition, create greater consumer choice and value. Conversely, restrictions on new entrants can be expected to lead to inefficiencies and market distortions that curtail consumer choice and decrease consumer value. The potential benefits for a country of greater foreign insurer involvement emanate directly from the role that insurance plays in economic development. Proponents of greater foreign involvement in emerging markets cite six potential benefits to national economies:

- Improvements in customer service and value
- Increased domestic savings
- Transfers of technological and managerial knowhow
- Additional external financial capital
- Improvements in the quality of domestic insurance regulation
- Creation of beneficial domestic spillovers

Improvements in Customer Service and Value

Increased involvement of foreign insurers is believed to create a stronger, more competitive local insurance industry. With increased competition, insurers have greater motivation to introduce new and innovative products, to offer more responsive and higher quality services, and to seek less costly means of marketing to and servicing customers. Insurers recognize the need to secure a competitive edge through product differentiation and market segmentation strategies, each of which renders the domestic insurance industry more responsive to consumer needs and desires.

At the same time, individuals and businesses can secure protection for a wider range of risks, possibly at lower cost, so that firms can allocate fewer resources to risk management. This enables them, in turn, to offer even lower-cost products and services to their customers, thus rendering domestic firms more competitive internationally. One noted insurance authority suggests that these types of indirect effects might be more important for a national economy than the direct effects.[16]

Anecdotal evidence also supports the view that greater foreign participation leads to improvements in customer service and value. One has but to explore the changes that have taken place within formerly restricted insurance markets that are now open, such as Poland, Mexico, Chile, and the Philippines, to obtain examples where improvements have resulted. However, published research on this assertion is scarce. This void is not surprising both because of the dearth of research on international insurance issues and because insurance market liberalization is relatively new to most emerging markets.

Fortunately, banking and insurance have many common features (such as the underwriting and pricing of risk) and both serve similar financial intermediation functions. Thus, insurance-relevant inferences

[16] Carter and Dickinson (1992), p. 82.

may be reasonably drawn from the much richer research literature on banking.

The findings of these banking studies lend consistent support to the notion that greater foreign involvement leads to improvements in customer service and value. In his most recent study on the role of foreign banks in developing countries, Levine (1996, p. 240) summarizes the findings of his own research and the research of others:

> In addition to lowering the cost of banking services, foreign banks have also introduced new and better services. . . . [E]vidence suggests that foreign banks directly improve the range and quality of financial services in countries that open to foreign banks and indirectly promote financial development by inducing domestic banks to improve their operations.

A recent report on foreign direct investment in Africa by the UNCTAD (1995a, pp. 54-55) notes the adverse consequences of FDI restrictions on foreign service providers:

> [A] number of service industries have traditionally been highly regulated; considered to be of strategic importance, they were typically closed to foreign investors. Furthermore, a number of key service industries were affected by either nationalization or indigenization programmes. . . . A few countries realized soon that indigenization policies could be harmful to sophisticated service industries and abandoned them, while others continued to restrict FDI in services for many years. The result has been not only an under developed services sector, but also diminished competitiveness of export industries relying on services input.

Increased Domestic Savings

Research on the relationship between domestic savings and economic development supports the view that both a broadening and deepening of the local financial system are important. The greater the number and variety of quality financial intermediaries within a market, other things being equal, the higher should be the national saving rate. Therefore, a greater foreign insurer involvement could contribute to this development.

However, the issue of increasing *domestic* savings might become even more important in the future. Some evidence suggests that saving rates within many developed countries may decline in the future as larger proportions of their populations retire and begin drawing down their savings.[17] The current high dependency by many emerging economies on external savings, therefore, may be put in jeopardy. The IMF (1994, p. 89) comments on this possibility:

> Many [developing countries] have enjoyed large inflows of capital over the past few years as the industrial countries posted poor economic growth. This has buffered developing countries from the growing world saving squeeze. . . . Increasing pressure on saving will reveal policy imbalances and structural economic weaknesses everywhere, and each country must put its own house in order.

The IMF goes on to relate the 1994 Mexican economic crisis to its low domestic saving rate coupled with ". . . an unsustainable dependence on foreign savings." Developing countries, therefore, are advised that they must increasingly look

[17]See, IMF (1995), chap. 5, generally.

inward for the great bulk of savings needed to finance domestic investment.

This assertion, as with the preceding one, enjoys much anecdotal but little direct empirical evidence. Even if studies existed, establishing the direction of causation would prove challenging.

Hence, we are left to rely on anecdotal evidence and economic theory in judging the possible validity of this assertion. Using these together, there seems little reason to believe that locally incorporated foreign-owned insurers would be any less capable of serving a domestic market than locally owned insurers.

Transfers of Technological and Managerial Knowhow

One of the most prevalent arguments to support greater foreign insurer participation in emerging markets is that foreign insurers will bring new and better technical (e.g., loss control and actuarial) skills, training programs, technology and managerial techniques to the domestic market.

In contrast to multinational manufacturing firms, most international insurers cannot easily split their production processes between their home countries and their emerging market hosts to take advantage of differences in wage rates, labor availability and skill level. Establishment insurance trade, especially subsidiary ownership, involves the duplication locally of most, if not all, of a foreign insurer's services. Consequently, international insurers tend to transfer managerial knowhow and technology from headquarters to the host-country operation. The recently acquired technical and managerial knowledge is then propagated throughout the industry (and economy generally) as these better trained employees seek new jobs with other firms and also seize opportunities to create their own insurance-related firms.

The large international insurers contend that they routinely serve as an unwitting training facility for competitors in the many emerging markets in which they operate, and hundreds of their former employees hold important positions with other insurers internationally. Numerous authors and insurance executives cite specific examples and build a strong case for this assertion's validity.[18]

Moreover, simple logic favors the position. The foreign insurer is anxious to maximize the likelihood of its subsidiary's success, to which well-trained, knowledgeable personnel are critical. If it cannot easily hire such personnel locally, the insurer has a financial incentive to ensure that adequate knowhow and technology are transferred from the head office. The fact that the insurance trade takes place via establishment (in contrast to cross-border) further ensures a longer-term commitment to the market; thus, reinforcing the benefits of creating a competent local presence.[19]

The earlier-referenced UNCTAD (1995a, p. 59) study on foreign direct investment in Africa confirms the distinction between insurance and manufacturing establishment: "[A] parent TNC [transnational corporation] in services (e.g., an insurance firm) establishing an affiliate in an African country has to reproduce, in distinction from manufacturing firms, factor and skill proportions used at home . . .

[18]See, e.g., Carter and Dickinson (1992), chap. 5.

[19]"For the firms concerned, this form of investment more than any other, represents a long-term commitment to a chosen country, and is not one that can be quickly or easily reversed." "A Survey of Third World Finance" (1993), p. 21.

"[parenthesis original].

Another UNCTAD (1994, p. xxiv) publication highlights the possibility of skill and knowledge transfer: " . . . TNCs often provide labour with the opportunity to acquire additional knowledge and skills, and this is particularly so in the case of affiliates operating in developing countries. . . ." The report cites support for meaningful transfers:

> [Transnational service corporations] reproduce in host countries the technologies used by their parent companies. To some extent, this is reflected in the smaller differentials between home and host country compensation levels in service TNCs as compared with those in manufacturing TNCs; this suggests that average skill levels in service affiliates are closer to those of their parent companies than is the case with skill levels in manufacturing affiliates relative to those in their parent firm. In other words, unlike in the case of manufacturing TNCs, the skills required for the production of services do not tend to be centralized in parent companies; rather, they are spread to host-country operations, primarily through training.[20]

Foreign insurer establishment in developing countries, therefore, is likely to bring technology and managerial knowhow transfers with it. Because confining the benefits of these transfers to the foreign insurer is impossible, the national economy gains. As summarized by the UNCTAD's *World Investment Report*, "The transnational structure and the large size and scope of many TNCs thus hold a distinctive potential for the development of the skills and knowledge of their employees and the further dissemination of those capabilities in an economy. . . ."[21] A caveat to this (and other observations) is the assumption that government has created and supported competitive market conditions. If, for example, government hinders meaningful competition by supporting cartel pricing, insurers have much less incentive to incur the expense of transferring technical underwriting, pricing and reserving knowledge.

Additional External Financial Capital

One advantage touted for FDI is as an additional source of financial capital. As with domestic savings, it can finance local investment. The UNCTAD's (1995a, p. 55) African FDI study repeats this theme: "The contribution of FDI to domestic investment is potentially important, especially in Africa, where the level of domestic savings is low and the general trend of gross domestic investment during the 1980s has been downward."

Developing countries have been garnering an ever larger share of FDI. Inflows to developing countries increased at an average annual rate of 25 percent between 1992 and 1994. Not counting intra-European Union flows, developing countries account for about one-half of global inflows. This large proportion is misleading, however, as more than 80 percent of developing country FDI inflows accrue to just 10 countries, with the least developed receiving only 0.7 percent.[22]

Data on insurance-related FDI flows to developing countries and their specific uses are largely nonexistent, as is relevant research. Related research suggests that such capital

[20]UNCTAD (1994), p. 232.

[21]UNCTAD (1994), p. xxv.

[22]UNCTAD (1995b), pp. 6-9.

inflows ". . . are not likely to be a major engine of economic growth in developing countries. . . ."[23] Capital inflows to most developing countries represent a small proportion of total investment finance. The overwhelming majority of local financing still comes from local savings. Moreover, the funds required to acquire or establish a *de novo* insurer typically are small in comparison with the total funds under management.

Thus, it may be true that capital inflows attendant to foreign insurers establishing operations within emerging markets can serve to finance additional projects. For countries with very low national saving rates, these inflows could be important. For other emerging markets, however, their importance relative to other financing sources could prove minimal. Consequently, this argument, in isolation, probably holds less relevance for most emerging markets than those discussed elsewhere.

Improvements in the Quality of Domestic Insurance Regulation

An interesting argument by proponents of greater foreign insurer involvement is that it can stimulate government and its regulatory authorities to regulate better. Full deregulation does not necessarily accompany liberalization. Indeed, a more liberal insurance market will require different and, usually, more detailed and effective regulation, especially as regards market conduct, competition law and prudential oversight.

We find evidence to support this regulatory improvement hypothesis. Scores of Eastern European, Asian, and Latin American countries continue to update, revise, and rationalize their insurance laws and regulation. Policy makers in these countries assert that these actions are a direct consequence of liberalization. Such actions are expected to improve financial system efficiency and by that aid economic growth.

[23]Levine (1996), p. 238.

Creation of Beneficial Domestic Spillovers

Proponents of greater foreign insurer participation often set forth the arguments that an economy will gain from beneficial domestic spillovers or what economists call positive externalities.[24] To cite but one of the most general positive externalities, consider the employment needs of a international insurer which requires well-educated individuals. If the local educational system is unable to meet its needs, pressure forms for improvements and beneficial spillovers ensue. An UNCTAD (1994, p. 235) report observes:

> The quality of human resources of service firms has become a major factor determining the rate at which new technology can be introduced and productivity increases can be achieved. This . . . increases demand for better educational preparation by institutions of formal education. . . .

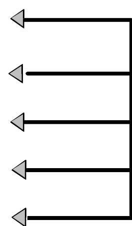
Besides such general potential spillovers, three other classes deserve mention. A greater foreign insurer presence is said to lead to additional and high quality employment, to

[24]**Positive externalities** are benefits that accrue to individuals or organizations for which they do not pay full marginal cost. The classic example is the lighthouse. Its beacon can be seen and used by all seagoing vessels, and its beneficial effects cannot be limited only to those who paid for the lighthouse. The service rendered by the lighthouse to nonpayers is an example of a positive externality.

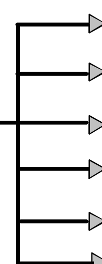
Quality Enhancing Linkages

Backward Linkages

Banks
Accounting Firms
Law Firms
Rating Agencies
Telephone Services



Insurer



Forward Linkages

Commodity Firms
Manufacturing Firms
Shipping Firms
Extractive Industries
Service Firms
Technology Suppliers

quality enhancing backward and forward linkages and to societal loss reduction.

Additional and High Quality Employment. The creation of new insurers usually creates new jobs. They provide additional employment possibilities for nationals in a non-polluting business, thus easing national unemployment.

Moreover, the local employees of most international insurers enjoy better wages, work conditions and economic security benefits than those prevailing with purely national firms.[25] As noted above, the wage differentials between home and host country multinational service firms are less than those with multinational manufacturing firms. This fact suggests that international insurers can offer particularly good wages.

Quality Enhancing Backward and Forward Linkages. Foreign-owned insurance companies rely on the services of many local firms. Insurers establish "backward linkages"—relationships with their input suppliers—when they subcontract actuarial and inspection services and when they rely on local accounting and auditing firms, credit bureaus, rating agencies, law firms, banks, and a host of other organizations. They establish "forward linkages"—relationships with firms that use insurance services in their production—when they supply marine, aviation, transportation, and other types of commercial insurance.

These linkages are said to encourage the collaborative firms to offer higher quality services and by that improve their own operations. Benefits from such improvements accrue to the foreign and local insurers.

The validity of this assertion seems logical and self-evident. Firms that expect high quality production inputs signal the market accordingly. Providers that fail to meet expectations risk losing business. The UNCTAD's *World Investment Report* both confirms and encourages more use of backward and forward linkages:

> Both types of linkages are typically associated with considerable training, in particular where foreign affiliates operate with certain quality requirements. Government policies need . . . to focus on TNCs in those industries

[25]UNCTAD (1994), p. xxiv.

> and activities that are likely to provide significant technical assistance through training and other forms of human resource development for enterprises linked through backward and forward linkages. . . .[26]

As established above, insurers have natural incentives to offer training and technical assistance, and they naturally have numerous backward and forward linkages. Insurers expecting high quality inputs and insureds expecting high quality outputs are hardly limited to the foreign owned. To the extent, however, that foreign insurers bring the possibility of improved customer service and value to a market, they can be expected to be important catalysts for service and value improvements.

Societal Loss Reduction. Insurers have strong financial incentives to reduce claims. One important means is by creating and supporting various loss prevention organizations. For example, fire prevention associations are common worldwide and insurers support most of them. Employee and product safety and crime prevention activities by insurers are also common. International insurers, reinsurers and brokers are noted for their expertise in loss reduction.

The benefits from these loss reducing activities are not limited to insurers. All of society benefits—both insureds and uninsureds—from having fewer losses.

[26]UNCTAD (1994), p. 379.

Concerns About Greater Foreign Participation

Concerns about greater foreign insurer involvement in emerging economies abound. The debate is as old as that related to international trade itself. The arguments against a greater foreign participation are presented and analyzed in this section. Although the arguments individually are numerous, we can group them into seven common themes:

- Foreign insurers will dominate the domestic market
- Foreign insurers will service the market selectively
- Foreign insurers fail to make lasting contributions to the local economy
- Market opening should await certain reforms
- The domestic market is already well-served by local insurers
- The insurance industry should remain locally owned for strategic reasons
- Foreign insurers will provoke a greater foreign exchange outflow

Foreign Insurers will Dominate the Domestic Market

Proponents of constraining foreign insurers argue that foreign insurers could dominate or destablize the domestic market. Several bases offered for this view are discussed below.

Economies of Scale and Scope. Because multinational insurance groups are large and because they conduct operations in several countries, they could enjoy substantial economies of scale (based on their large size) and of scope (based on their multi-product offerings and their multi-country operations).[27] These economies could allow foreign-owned domestic insurers to operate at lower cost and, therefore, to offer lower prices than locally owned domestic insurers. The result could be that many locally owned insurers could not compete and would cease operations. The foreign owned insurers could then dominate the market.

Fairly extensive research exists on economies of scale in insurance.[28] The studies generally find that scale economies exist for smaller and medium-sized insurers, but not for large insurers. In fact, several studies found scale *diseconomies* for large or very large insurers.[29] Evidence on the existence of product scope economies is more limited.[30] The studies are uniform in finding only limited product-based scope economies for

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[27]**Economies of scale** exist when a firm's output increases at a rate faster than attendant increases in its production costs. **Product-based economies of scope** exist when a single firm can produce multiple outputs at less cost than can multiple firms. **Geographic-based economies of scope** exist when a single firm can operate in multiple markets at less cost than can multiple firms.

[28]See, e.g., Grace and Timme (1992); Gardner and Grace (1993); Cummins and Weiss (1993); and "Economies of Scale in the Insurance Industry," (1991).

[29]See, e.g., Cummins and Weiss (1993); Harwick (1993); and Harris and Katz (1991).

[30]See, e.g., Kellner and Mathewson (1983); Fields (1988); Grace and Timme (1992); Bernstein (1992); Yuengert (1993); and Hogan, Satish and Witt (1995).

insurers.

Our existing understanding of the issue of whether international insurers could use their large size, multi-product production possibility, or their geographic diversity to realize economies sufficient to take over a country's insurance market, therefore, would suggest a negative response.

Greater Financial Resources/ Efficiency Basis. Even if international insurers do not enjoy economies of scale, their large size could permit them to exercise much greater economic clout than smaller, locally owned domestic insurers. Also, foreign insurers may use technology better and possess greater management or technical skills than locally owned insurers, thus enabling them to operate more efficiently, even lacking economies of scale.[31] Under either scenario, foreign insurers could charge lower prices than locally owned insurers, ultimately driving them out of business. Their more favorable pricing may be due to their more efficient operation or to their engaging in **dumping**—selling products at less than their cost of production to gain market share.

The rationale for dumping is to gain a dominant market position by driving competitors out of business. Once accomplished, the insurer could then safely raise prices, realizing monopolistic profits. At the first sign of any new upstart insurer, the dominant insurer could temporarily lower prices to thwart the potential competitor.

Variations on this theme are found in the literature.[32] One variation is the theory that the admission of foreign insurers could cause such incredible pressure on prices that all insurers would be forced to engage in so-called cutthroat price competition. The local insurers, assumed to be weaker financially, could not compete in the longer term, and would become insolvent. Their insureds would, thereby, suffer. The foreign insurers, having weathered the intense competition because of superior financial resources or greater efficiency, would then emerge with a dominant market position.

Another variation of this theme relates to the situation within smaller insurance markets. If a developing country's insurance market is small, the entry of only one or two large, financially strong foreign insurers could result in their easily securing a dominant position because the market cannot support many insurers. Again, the weaker local insurers would presumably fail.

The market domination concern has both political and economic dimensions. Analyzed purely as an economic issue, the concern seems largely unjustified, as discussed below. We cannot dismiss it, however, when analyzed purely as a political issue. Each nation-state has the right to organize its internal market as it wishes. If a nation wants to exclude foreigners in whole or in part, that is its affair. These types of decisions often have little concern with economics. They may flow from political ideology, a desire to protect local culture or a host of other concerns.

Of course, the government and citizens ideally should understand fully the economic consequences of their decisions, and the economic consequences of isolation generally will be depressed economic growth. Moreover, such governments and citizens ideally would have investigated fully whether vested interest groups might be using non-market arguments to support policies that enrich them at the general public's expense.

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[31]The underlying theory of and studies on economies of scale assume that no firm has a technological or managerial advantage over other firms.

[32]See, for example, UNCTAD (1993), p. 21.

Setting aside these non-market concerns for the moment, one should examine the economics of the market domination argument for limiting foreign involvement in national insurance markets. It is probably true that many international insurers enjoy sufficient financial resources and efficiencies that they could dominate some emerging insurance markets. The question is less whether they could do so and more whether they would want to engage in behavior that would allow them to do so. The logic for such actions seems to falter.

First, few insurance markets internationally are, in fact, dominated by foreign-owned insurers. Most markets that permit foreign involvement have a blend of ownership arrangements, but with local citizens controlling the majority.

Second, and what is more important, we should investigate whether those few markets in which foreign-owned insurers have substantial market shares experience adverse effects, such as lower quality services, higher prices, or other negative aspects. After all, the mere fact that foreign interests may dominate an industry is not intrinsically bad. It is bad (from an economic point of view) if and only if consumers or the national economy suffer some detriment because of their dominant role.

Neither cross-country nor individual country studies have examined this precise issue. Anecdotal evidence from markets that have or are gaining a substantial foreign presence (including Argentina, Austria, Australia, Canada, Chile, Denmark, Hong Kong, Mexico, The Netherlands, the UK, and Poland) supports the opposite point of view. Chile's market opening and resultant efficiency gains are legend. Markets with a substantial or growing foreign presence are largely those with a reputation for offering individuals and businesses high quality services at low prices.

Dumping and Insurance

Even if a foreign insurer has attempted or does attempt to gain market dominance by dumping, the effects seem more likely to be positive than negative for citizens and the economy. Selling insurance at a loss constitutes an exceptional transfer from the insurer to the insured. Economically, it amounts to a subsidy from the foreign insurer to the host country. If a market is reasonably competitive and in the absence of substantial economies of scale, such predatory pricing cannot result in market dominance and would result in lower cost insurance for consumers.

This concern may be more apparent than real for other reasons. The establishment of a new insurer is no speedy process under the best of circumstances.[33] Staff must be hired and trained; a distribution network established; policies designed, priced and approved; and a local image built. New insurers gain market share slowly. Break-even often takes six or more years. For example, after more than seven years of openness, the market shares of U.S. insurers in both Korea and Taiwan are less than 2 percent.

Further, locally owned insurers often have substantial advantages over their new rivals. They typically have many years of experience and a deep understanding of the local culture. They understand the local market and have established relationships with customers, suppliers, and other

[33]See, e.g., Schroath (1987).

stakeholders. As with Mexico, local insurers faced with efficient foreign insurers exploit these competitive advantages while improving efficiency.

Regarding concerns about insurance dumping, we have evidence that some insurers, both locally and foreign owned, sometimes price insurance at less than the actual cost of production. Often this practice is to retain market share or because of optimistic loss forecasts. Whatever the reason, we have no evidence of insurers engaging in this practice for purposes of market domination. Moreover, such underpricing has always turned around within a short time, and seems related to the underwriting cycle in non-life insurance.

The inherent slowness of creating a local insurer coupled with stockholder pressures on managers to maintain and improve short-term profitability discourage policies of deliberately selling insurance at a loss, at least for any sustained time. More importantly, it is doubtful that any single insurer has the market power successfully to carry out a plan of market domination via dumping. As the analysis in the box suggests, the greater the foreign presence within a country's insurance market, the less likely could an insurer sustain such a plan.

Finally, attempts by foreign-owned or locally owned insurers to dominate a market are best addressed through competition regulation. To the extent that policy makers have a legitimate basis for concerns about vertical or horizontal competition restraints, the first-best remedy is regulation that goes directly to the offense. Limits on market access run counter to the goal of competition regulation.

The best "insurance" against any adverse effects of any possible market dominance by foreign insurers is for government to encourage greater competition. A greater foreign presence within a market is an important means of encouraging greater competition.

Infant Industry Basis. The infant industry argument as a basis for protecting local firms from international competition is centuries old. See the box on the next page for an overview of this argument. Its efficacy remains questionable although it routinely appears in international trade debates. *First*, a competitive market would not need protection as, despite temporary disadvantages to small or inexperienced firms, local entrepreneurs would still have incentives to enter the market as expected returns over the long term should make good any short-term losses. *Second*, if government, nonetheless, insists on aiding an infant industry, more efficient and less welfare-reducing means exist (a production subsidy, for example) than trade barriers.

Ignoring the theoretical deficiencies of the argument, we have the experience of developing countries as Kenen (1994, p. 281) observes:

> The histories of developing countries that have used infant-industry protection teach us three lessons. First, it is hard to choose the right industries [to shelter from competition]. If protection is granted very freely, some of it will go to industries that cannot reap economies of scale or experience.
>
> Second, firms obtaining infant-industry protection are reluctant to give it up. They do not want to suffer cuts in output . . . , and they frequently acquire enough political influence to block trade liberalization. Third, infant-industry protection can hurt other industries, even when it is confined to promising candidates.

The Infant Industry Argument

The ***infant industry argument*** holds that new domestic industries should be sheltered from foreign competition if they hold promise of ultimately competing successfully against foreign rivals. The future gains to the economy will more than make good the welfare losses from the temporary protection accorded the industry. Two versions of the argument exist, both of which rely on the selected protected industries having a comparative advantage. The first, based on economies of scale, assumes that once the protected firms achieve a certain minimum size, they can compete successfully with foreign firms.

The second version, based on economies of experience, argues that inexperienced local firms need shelter from foreign competition until they have "learned by doing" sufficiently to be able to compete with foreign firms. Under this theory, allowing foreign firms into the market too soon under either version could mean the ruination of local firms.

As these general lessons are applied to the insurance context, we could draw the following inferences: *First*, many have questioned whether most emerging markets can reasonably expect a comparative advantage to exist for their domestic insurance industries in international competition. If it does not exist, the "infant" can never forgo protection if it is to survive.

Second, infant industry protection has already been accorded most developing countries' insurance industries for two, three or more decades. Enough time has passed for local companies to have achieved the necessary economies, if they are ever to achieve them.

Third, insurance services represent an input to business production. To the extent that local businesses pay higher-than-world prices for insurance or receive inferior services, their goods and services are less competitive.

Foreign Insurers will Service the Market Selectively

A second set of policy arguments urging caution in granting greater foreign insurer market access falls under the theme that foreign insurers might service the domestic market only selectively.[34] This selective marketing could be because foreign insurers would (1) write insurance only in the most profitable segments; (2) service foreign corporations only; or (3) avoid serving the retail market. In each instance, the effects could be that local insurers are left to fight for the remaining picked-over, less profitable sectors. A further variation of this theme is that foreign insurers, lacking an in-depth understanding of local market needs, will market products similar to those marketed in their home countries and ill-suited to local needs.

Examining the last point first, it could

[34]The obvious is worth stating. The preceding concern (that foreign insurers will dominate the domestic market) and this concern (that they will market selectively) are largely mutually exclusive. Excepting extraordinarily hypothetical situations, foreign insurers as a group cannot both dominate and selectively market within a country. The intent of including both arguments, of course, is to suggest the entirety of possible objections to foreign entry, only some of which may be applicable to a given market.

prove correct that foreign insurers, at first, attempt to market services and products not well suited to local needs. Previously established insurers could be expected to have a superior understanding of many local needs, in which case the competitive insurance market would take care of this problem. Products and services ill-suited to local needs presumably will not sell well. Insurers will alter them accordingly or cease their sale. Unless government is to be the arbiter of what insurance products and services consumers and businesses should purchase, this concern (which in any event applies to all new market entrants and new products, irrespective of nationality) seems largely irrelevant for policy makers.[35]

Concerning the other three areas of potential concern to policy makers, it is completely possible that foreign insurers will engage in various types of market segmentation. Market-driven business strategies suggest that all insurers will attempt to define market segments in which they can gain a competitive advantage. Foreign insurers, perhaps having more sophisticated marketing and product design processes, may be better at this than locally owned insurers; but the locals will learn.

Foreign insurers might try to introduce products and services that have been successful elsewhere. Some may establish agencies, branches, representative offices or subsidiaries primarily to service their multinational clients. Each locally established, foreign-owned insurer is likely to have particular specialities and expertise that it will attempt to exploit to its financial benefit. Some will specialize in commercial or industrial insurances, some in individual life savings products, others in group retirement products, and so forth.

New entrants can be expected initially to service only selected aspects of the market. They naturally may seek the most profitable and avoid the least profitable segments or those that require specialized understanding of and service to the local market (for example, automobile insurance). With increasing success, they can be expected to expand the scope of their operations.

Also, new competitors come with financial success through market segmentation. As other insurers and entrepreneurs see the specialist insurers making handsome profits, they will be drawn to those more profitable market segments. Prices will be driven down, offering better value to customers, as will profits. Ultimately, the market segment may become unattractive financially, with those insurers that initially targeted the segment moving to other niches that promise more lucrative returns.

It is in this way, of course, that the competitive system causes insurers continually to seek new means of satisfying consumer and business demand more effectively and efficiently. All insurers would be subject to these same market pressures and would have strong incentives toward continual improvement. This outcome is precisely that sought within a competitive model framework.

That some insurers, whether locally owned or not, are unable to meet the challenge and may exit the insurance industry should be viewed as a natural byproduct of the competitive system. Of course,

[35]An exception can occur where insurance products are exceptionally complex or offer the illusion of benefits that are not there. Government policy makers could have sound reasons to intervene in a market economy where these and similar types of information asymmetries exist such that ill-informed consumers could be harmed. The intervention, however, would not be limited to products sold by foreign insurers.

government prudential regulation should ensure orderly exits with minimal consumer and economic harm.

Similarly, some market segments (such as the automobile, rural, or agricultural sectors) may be under served because of the competitive system. In a perfectly competitive market, of course, all market segments would be well served. Yet no national insurance market is perfect.

The government's role is to identify and redress those imperfections judged important. The government may conclude, therefore, that certain under served segments warrant a greater insurance supply, lower prices than those set by market forces or other special consideration. From an economic efficiency standpoint, government should take action to bring about these results without resort to welfare reducing and market distorting supply restrictions applied exclusively to foreign insurers.[36]

Foreign Insurers Do Not Contribute to the Local Economy

A third area of concern to policy makers is that foreign insurers, in spite of their potential to do otherwise, often fail to make lasting contributions to the local economy. The literature of this issue hypothesizes that such failures may flow from a weak commitment to the local market, from extensive use of expatriates, from inadequate training opportunities for locals or because technology and skill transfers are unsuitable for local conditions. Each is discussed below.

Weak Local Commitment. Policy makers sometimes express concern that foreign insurers are often less-than-fully committed to the local market and that they may quickly cease operations if problems arise in either host or home country markets. Such actions could disrupt the national insurance market if foreign insurers had a large share of it.

Certainly international insurers, as with purely national insurers, alter, stop or suspend operations in particular markets or market segments from time to time. When a withdrawing insurer has a large share within a market, its withdrawal can cause short-term disruptions. Market stability is a worthwhile policy objective. If insurers essentially continuously cycle between full use of their capacity and substantial withdrawal of it, government has a legitimate concern to discourage this practice.

Still, policy makers would be unwise to assume that all foreign insurers would engage in this practice and that all locally owned insurers would not. Evidence from many markets shows that ownership nationality has little to do with this issue.

Further, circumstances provoking withdrawal range from poor performance to changes in corporate strategic direction. These actions are, however, means by which the competitive market continuously repositions its resources, and it leads to greater economic efficiency. While international insurers follow different approaches to managing and have different time constraints for certain managerial results, only a few examples exist worldwide of foreign-insurers lacking "staying power." Moreover, those insurers that have entered and soon

[36]The most preferable (in the sense of the least welfare reducing) means of redress usually is for government to provide a subsidy either to the disaffected insurance purchasers or to insurance companies servicing that segment. The total cost to government (taxpayers) from this course of action ordinarily will be less than the total cost to society from trade restrictions.

withdrawn from markets have had minuscule market shares and, therefore, their withdrawal has caused minimal or no disruption on the market.

Poor Employment Opportunities for Locals. Concern also is sometimes expressed that foreign-owned firms hire expatriates for important positions and offer host-country nationals jobs with less challenge and fewer opportunities for learning and advancement. It may be true that international insurers rely on expatriates for the more senior positions in staffing foreign affiliate operations, although we have inadequate survey data on the extent.

However, in a 1980s survey of foreign affiliates generally, 40 percent of the senior positions of US-owned European affiliates were staffed by home-country (33 percent) or third-country (7 percent) nationals. By contrast, expatriates held 53 percent (44 percent home-country nationals and 9 percent third-country nationals) of senior positions in US-owned Latin American affiliates.[37]

The UNCTAD's *World Investment Report* notes that reliance on expatriate personnel is explained, at least in part, by the age of the investment and that reliance on expatriates can aid communication and is one mechanism by which managerial and technical skills are transferred. The *Report* observes:

> In general, reliance on expatriate managers and technicians is higher for new investments but tends to decline as affiliates get rooted in the local market and their local workers gain experience and can make more operating decisions themselves. In addition to their role in organizing enterprises in their early phases, main reasons for employing managers and professionals from the home country include ensuring the availability of technical expertise and developing the international management expertise that TNCs require.[38]

International insurers have natural incentives to maximize their use of local personnel in their creation or acquisition of subsidiaries. For one thing, expatriates are expensive. Every insurance company today is witnessing incredible pressures to hold the line on expenses, and use of expatriates is ordinarily quite expensive.

Subsidiaries are the most substantive form of commitment to another country's market. Their success in insurance usually depends on familiarity with the host country, including its culture and language. Staff localization helps an insurer market and underwrite its products more effectively. The interaction of these and other factors ". . . tends to encourage the replacement of expatriates by host country nationals through professional development and advancement within a foreign affiliate."[39]

Therefore, although foreign insurers may rely on expatriates to some degree in an operation's early years, this reliance can be expected to wain over time and to offer home country nationals important opportunities.

Training of Locals is Inadequate. Another variation of the concern is that foreign insurers will fail to train host-country nationals or offer them only minimal training. The interests of emerging economies, after all, are to see substantial training opportunities.

Again, broad-based insurance-specific evidence on this point is nonexistent. Anecdotal evidence within many countries,

[37]Tung (1988), pp. 6-7.

[38]UNCTAD (1994), p. 238.

[39]UNCTAD (1994), p. 240.

however, suggests that policy makers can safely expect most international insurers to engage in substantial training of local personnel. The *World Investment Report* echoes this view:

> Indeed, training practices in transnational banks and financial institutions, for instance, suggest that training, particularly of management personnel, is given considerable importance (ILO, 1991a). Such training is intended to provide managers with both the technical skills and the wider knowledge required to direct an enterprise. As opposed to the earlier approach of focusing on particular jobs, the emphasis of management and supervisory programmes is increasingly placed on modern management skills, such as setting goals, defining tasks and building teams. . . .[40]

Skill and Technology Transfers are Minimal. A final argument within the failure-to-make-lasting-contributions theme relates to technology and other beneficial transfers. The following quotation might typify this viewpoint:

> As regards a possible technology transfer through multinational companies, it's been pointed out that there is no high insurance technology to speak of and that whatever exists is already readily accessible (through acquisition of software and training in its use obtained by direct purchase and/or as part of technical assistance by major reinsurers).[41]

Assuming the author of this assertion intends it to apply exclusively to "hard" technology and setting aside the question of whether the assertion is correct, it clearly trivializes the role that technology, managerial skills and technical knowhow play in insurance operations. Certainly, reinsurers are important sources of transfers of technical knowhow. Certainly, also, computer, telecommunications, and software vendors offer exceptional insurance-support products and related training. And managerial expertise can be obtained through sending nationals to study abroad and by engaging managerial training consultants locally. In other words, all of the individual elements that make up insurer operations can be obtained through means other than foreign direct investment.

Still, at the end of the day, the question is: would obtaining these elements externally make for a successful, functioning insurance company? Would an emerging economy's insurance industry evolve into a world-class operation? The answer is almost certainly "no." Insurance requires learning-by-doing and, as with any other financial service, its intricacies cannot be mastered without substantial on-the-job training and experience.

The motivations for international insurance groups transferring both technology and technical and managerial skills along with their foreign direct investment are self-interest. FDI via creation of a subsidiary is the most substantive form of foreign presence. As discussed earlier, the international insurer's long-run interests lie in recreating locally an efficient, knowledgeable operation that largely replicates operations in its home country.

Market Opening Should Await Certain Reforms

Another pair of arguments for slowing insurance market liberalization revolves around the need to await two types of

[40] UNCTAD (1994), p. 232.

[41] UNCTAD (1993), p. 22.

governmental reforms. Adverse consequences could follow from opening the market before undertaking these reforms.

Insurance Regulatory Reform. Observers correctly note that insurance regulatory oversight in many emerging economies may not be sufficiently attuned to protecting consumers in a liberalized market. Moreover, deregulation often accompanies liberalization efforts, thus complicating the process and causing uncertainty.

Prudential oversight and supervision become even more important with deregulation and liberalization. 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, as the experience of several Latin American countries attests. Certainly, foreign insurer entry into formerly closed markets should not be allowed to overwhelm government's ability to protect consumers and the stability of the national insurance industry.

Moreover, policy-maker concerns about possible consumer harm that could flow from not having completely revamped insurance regulation is, in some respects, more appropriately directed inward than outward. Deregulation and liberalization connote market opening and reductions in government's regulatory role for all possible market entrants, not just for foreigners. The great majority of foreign insurers domiciled in developed market-economy countries are subject to strong home country regulation, and international regulators increasingly share information about questionable international insurers. Such international insurers often enjoy reputations for financial soundness and good business practice. They place high value on their reputations for fairness, ethical behavior and being a good corporate citizen in host countries. Newly created insurers or insurers new to the international arena may not always have the same motivations or capabilities as established insurers. Of course, the challenge for regulators is where and how to draw the line between ethical, well-run, financially sound foreign insurers and those whose characteristics are less desirable.

Macroeconomic Reform. A further concern of policy makers is that complete macroeconomic reform should be in place before admitting foreign insurers into the market. The IMF, for example, has cautioned developing countries and economies in transition about disruptions to national economies that could accompany a premature liberalization of capital account transactions. The IMF suggests that the prerequisites for complete freedom of capital movements are (1) the existence of a reasonably strong financial system, including the accounting, legal and supervisory infrastructural elements and (2) macroeconomic stability. They cite the 1994 Mexican economic difficulties as an example.

Acknowledging that some disagreement exists about the IMF's economic prescriptions, they are couched in the broadest terms. They intend to apply to all capital account movements, of which foreign direct investment is one component.

The more developed a country's financial services system and industry, other things being the same, the more open can be the country to all forms of foreign direct investment. In other words, the establishment of a reasonable financial services

infrastructure should be an important component of market opening, according to the IMF.

An essential element of any country's financial services infrastructure is, of course, an insurance industry. While a country should have appropriate capital account processes and the necessary legal, accounting and other support capabilities, a case can be made for the financial services business being among the first to be open to foreign investment. Sound foreign competitors can aid the further development of a nation's financial system.

The Market is Already Well Served by Locally Owned Insurers

Another argument sometimes made against greater foreign insurer involvement is that the market is already well-served by locally owned insurers. Having been established for many years and having worked closely with national businesses, individuals and government, such local insurers, it is sometimes argued, have a deep understanding of local needs that foreign insurers will not.

Sometimes coupled with this argument are references to (1) the market already being saturated (meaning a sufficient insurance supply already exists) or (2) the great effort that the government or the local insurance community has expended over time to develop local expertise in insurance. The following quotation from an UNCTAD (1993, p. 21) document that apparently reflected views from an earlier time is representative:

> There may therefore be reason to approach the liberalization of insurance with particular caution and to maintain a certain degree of protection for a sector which has been developed at considerable expense and which, since it is geared to the satisfaction of domestic needs, is less dependent on outside influences.

Of course, the fact that "considerable expense" might have been expended in attempting to develop indigenous insurance capacity is irrelevant. Whether the decision to expend national resources in this way in the past was wise or foolish should not affect whether a government should continue a protectionist policy. Policy makers should assess the policy on its current merits. As every economist, accountant and rational policy maker knows, sunk costs are irrelevant for assessing the viability of future economic action.

Assuming the validity of the argument that established insurers already adequately serve the local market, the effect of allowing new entrants presumably would be that they would be unsuccessful. Further assuming adequate prudential and competition regulation, the only entities that might suffer harm in allowing new entrants would be the new entrants themselves.

The danger of allowing government to decide whether a market is adequately served is that government is apt to "get it wrong." As has been well documented, governments are notoriously bad at making such market calls. Competitive markets are far superior at doing so. Moreover, it is doubtful that any national insurance market, no matter how developed it might be, is "adequately served." Room always exists for improvements and innovations.

Policy-maker concern about too many competitors usually stems from allowing the establishment or continuation of too many very small insurers, because minimum capital requirements and continuing solvency margins are set at too low a level. This issue is best addressed with upgrades in such minimum requirements.

Local Ownership Is Important for Strategic Reasons

A sixth classification of policy-maker concerns involves the argument that the national insurance industry should remain locally owned for various strategic reasons. Two proffered reasons relate to national security and economic diversification.

National Security. Two commonly cited examples of the tie between insurance and national security involve the London market. In creating two large Arab insurance groups, investors cited the desire to reduce the region's vulnerability to the London market's withdrawal of marine insurance capacity in time of conflict.[42] During the Falkland Islands' conflict between Argentina and the UK, Argentine transportation was threatened when UK insurers and reinsurers suspended cover on Argentine ships, aircraft and cargo.[43]

Two observations seem relevant to these examples. *First*, in each instance, the relevant capacity withdrawn was via cross-border insurance trade. At that time, neither the concerned Arab countries nor Argentina permitted local establishment of foreign-owned insurers. In doing so, they discouraged the creation of more national insurance capacity which, at least conceptually, could have reduced dependence on cross-border insurance. Of course, foreign-owned domestic insurers might also have withdrawn capacity during any conflict between the host and home countries. However, domestic insurers—whatever their ownership—remain fully subject to national government oversight, unlike the situation with cross-border insurance.

Second, if a country is concerned about possible harm to the real economy from a withdrawal of foreign insurance or reinsurance capacity, it should ensure that its national insurers and businesses practice good risk management. They should avoid becoming highly dependent on carriers from a single country and spread their insurance or reinsurance placements among carriers of various nationalities. Such diversification probably offers greater economic promise of stability than limitations on foreign insurer involvement.

National Economic Diversification. Another cited strategic reason for why an insurance industry should remain locally owned is the desire for national economic diversification. Too great a concentration of national resources in a handful of mining, manufacturing or other commercial operations could subject the national economy to undesirable volatility as a world market imposes prices and other conditions on local producers. To avoid this situation, policy makers may encourage diversification of national production across a range of industries. Insurance is sometimes earmarked as one of those industries whose local production is both feasible and desirable.

Two observations seem relevant here also. *First*, the question arises about whether government truly can identify the right industries that warrant favored treatment. In this sense, the concern here is identical to that of the infant industry debate. The competitive model argues for allowing entrepreneurs and other investors to make their own decisions. Government should establish a neutral position with respect to such decisions.

Second, even if policy makers, nonetheless, decide to encourage the creation of additional national insurance capacity, nothing in the diversification argument suggests that the local capacity need be exclusively or even primarily locally owned. Foreign direct investment can

[42]Skipper (1987), pp. 79-80.

[43]Skipper (1987), p. 80.

be a great assistance in diversifying a national economy.

Foreign Insurers Will Provoke a Greater Foreign Exchange Outflow

Policy makers from developing countries have long expressed concern that foreign insurer operations can adversely affect their countries' balance of payments. Indeed, this concern has been one of the main driving forces behind desires of policy makers to develop indigenous insurance capacity; the theory is to reduce insurance-related foreign exchange outflow by having local insurers providing the bulk of the national insurance supply.

The Nature of Insurance-Related Currency Flows. Insurance-related foreign exchange transactions attach to both cross-border and establishment insurance trade. With cross-border trade and agency establishment trade, premiums paid by domestic insureds (or direct writing insurers) flow directly to foreign insurers (or reinsurers). These remittances will be offset partially by commissions paid to local intermediaries or ceding insurers and by claim payments. These flows are all current account items. In a given year, outflows could exceed inflows or vice versa. Over the long run, however, it is to be expected that outflows will exceed inflows.

With foreign-owned subsidiaries and most branch offices, premiums paid by domestic insureds (or direct writing insurers) are purely national transactions and do not enter international current account flows. The same is true for commission and claim payments. Of course, the funds required to establish the branch office or subsidiary are capital account inflows. Profits represent current account outflows. If the local firm retains them, they represent additional capital infusions. Further foreign exchange outflows can emanate from the local establishment reinsuring with the parent and paying for services from the

parent. Thus, with establishment insurance trade, the host country could expect a large foreign exchange inflow initially, followed by likely outflows in the future.

Import Substitution. The approach followed by many developing countries has been to rely on a policy of import substitution. The idea was to promote and protect those local industries that competed directly with imports. In this way, scarce foreign exchange reserves could be reserved for other foreign goods and services whose purchase was essential to economic development or social welfare.

The problem, of course, was that government had to decide among hundreds or even thousands of industries, each claiming to be a good candidate for local promotion and protection. Even had governments made optimal decisions, the economic effects still could have been expected to be harmful to the local economy in the long run.

Import substitution requires the diversion of an economy's scarce resources to import-competing sectors. By doing so, the export-competing sectors are handicapped because of having to pay more for inputs (including insurance). They must pay more both because of being discriminated against in the national competition for resources and because of inefficiencies (and attendant higher costs) inherent in having to purchase inputs from the protected import-competing sectors. As a result, exports are less competitive. Such a policy, therefore, may actually deplete foreign exchange reserves. Because of these shortcomings, most governments have largely abandoned import substitution policies as hindrances to economic growth.

The Insurance Situation. The twin arguments of import substitution and infant industry protection in insurance contributed to the creation of a locally owned, national insurance industry in virtually every developing country. Because local capacity was often inadequate, domestic insurers sometimes placed heavy reliance on foreign reinsurers. In the process, an indirect foreign exchange outflow was sometimes substituted for a direct outflow, with little net difference to the country.

One aspect of the import substitution policy is supportable. Additional national insurance capacity can reduce insurance-related foreign exchange outflows. That additional capacity, however, need not be locally owned and government need not try to "pick winners." Locally established, foreign-owned insurers bring additional risk-bearing capacity to the market, which can mean a greater domestic retention (and a possible reduction in foreign exchange outflows). In addition, insureds that formerly placed their business offshore could have an incentive to bring it into the national market.

For its part, government need not feel compelled to try to engage in the unrewarding process of "picking winners" to which promotion and protection are accorded. Reliance can be placed on the market to do this.

Emerging markets are, nonetheless, likely to realize a net outflow of insurance-related foreign exchange. Most countries worldwide, including developed countries, are net importers of insurance. It is critically important to realize, however, that drawing direct policy inferences from any such outflow is exceedingly risky. Indirect effects should be carefully considered. For example, assume that a national market is a net importer of insurance. Assume further that this result is partially attributable to recent liberalization moves by the government. A liberalized insurance market will offer lower prices and better value than a protected market, other things being equal.

As a production input, insurance affects

prices charged for other goods and services produced in the economy. The more competitive are the economies' goods and services the greater the foreign exchange inflow. Thus, foreign-provided insurance may offer better value, but constitute a foreign exchange drain. As a lower cost production input, however, it helps in export promotion. Also, goods and services sold exclusively domestically can be somewhat more competitive with competing imports; thus, resulting in less foreign exchange outflow.

In summary, it is true that foreign involvement in emerging countries' insurance markets is likely to lead to a net insurance-related foreign exchange outflow over the long term. We cannot similarly assert, however, that a country's overall balance of payments will be adversely affected. Potentially important indirect effects should be considered.

Conclusions

This paper has examined the economic issues associated with foreign insurer establishment in emerging markets. Some policy makers continue to believe that foreign insurers should play but a limited, if any, role within their markets. Most states shared this opinion at one time. The number of its proponents today continues to shrink as policy makers increasingly embrace the liberal market model as offering better opportunities for economic growth.

Of course, all countries acknowledge that foreign *reinsurers* have an essential role to play in their markets, although some governments limit this role in various ways. Policy makers also generally recognize the need for some foreign involvement, either directly or indirectly, in insuring complex industrial, transportation and infra-structural risks. Beyond these areas, however, some governments prohibit foreign insurer establishment altogether, limit ownership shares, or inhibit market access through other means. Even governments with officially liberal market access rules may tolerate national treatment inconsistencies and fail to provide reasonable transparency.

The UNCTAD's 1964 pronouncement that "a sound national insurance and reinsurance market is an essential characteristic of economic growth" grossly understates the role of insurance in economic development. Insurance is not merely a "characteristic of economic growth." It is a necessity.

Regrettably, the precise linkages between insurance and economic development are poorly understood. As noted throughout this paper, in-depth research on this issue is sparse and largely anecdotal, unlike the situation with banks that enjoy by comparison a substantial body of supportive research. Not surprisingly, therefore, policy makers do not fully appreciate the role and importance of insurance in economic development.

The financial services literature suggests that economic evidence favors the opening of markets to foreign insurer participation. Subject to reasonable prudential, market conduct and competition regulation, foreign-owned domestic insurers offer the potential for improved customer service and value which can lead to increased domestic productivity and efficiency; increases in domestic savings which can lead to greater economic growth; technological and managerial transfers; and other microeconomic and macroeconomic benefits. A necessary precondition is that the foreign interests are financially solid, technically and managerially competent and behave ethically. Of course, these same conditions apply to local interests.

Policy makers in emerging markets have expressed many reservations about foreign insurer participation in their markets. In classifying these concerns around seven common themes, we found that five reservations either (1) could be resolved efficiently without market access restrictions or (2) had no factual basis. The sixth concern, that foreign insurers may provoke a greater foreign exchange outflow, cannot be ascertained *a priori*, and even *a posterior*, their effect on the national balance of payments is ambiguous.

The seventh reservation, that full market liberalization should await certain insurance and macroeconomic reforms, is assessed as valid in certain situations. Reasonable insurance laws and regulation are essential. Ideally, they should be in place before full

market liberalization to avoid abuse by the unscrupulous. At the same time, we acknowledge that if market access could somehow be limited to those international insurers that enjoy reputations for honesty and integrity, the issue would be less crucial. The difficulty for policy makers is in determining where to draw the line between acceptable and unacceptable insurers.

This paper has examined the issues from an economic point of view. As noted herein, the decision about the extent of foreign insurer participation in a domestic market is political. What route a country chooses to take in this matter is, of course, its own concern. Certain social or other non-economic factors could be important considerations. Policy makers should, however, understand the likely economic consequences of their decisions.

Simultaneously, policy makers can expect local private interests to oppose liberalization efforts that challenge their market position. Their arguments will not be blatantly self-serving or protectionist, but rather couched in terms of protecting the national interest in some way. The challenge for policy makers is to resist the easy temptation to succumb to any such special interests' well-structured protectionistic orchestration in favor of the interests of ill-organized consumers and the economy as a whole.

Opening insurance markets to appropriate foreign insurers is likely to aid economic development, enhance overall social welfare, and carry few unresolvable negative possibilities. Conversely, 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.

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