

**ENCOURAGING A DYNAMIC LIFE INSURANCE INDUSTRY:
ECONOMIC BENEFITS AND POLICY ISSUES**

by Gerry Dickinson

**Professor and Director, Centre for Insurance & Investment Studies, City University
Business School, London.**

1. Mobilisation of saving

Life insurance has historically been an important method through which individuals with relatively low incomes have been able to save and invest effectively for the longer term. By designing relatively simple life insurance and savings contracts, which can be purchased in small amounts on a regular basis, insurance companies have been able to accumulate large amounts of money from across a large proportion of the population. By pooling these savings from many small investors into large accumulations of investable funds, insurance companies have been able to invest not only in a wider range of investments than individuals would have been able to invest in directly themselves but have also been able to invest in larger scale and more risky investment opportunities which will be more beneficial to the economy. In addition, because in life insurance there is a regular or contractual nature to the payment of premiums by consumers, the level and stability of personal saving is increased, compared to what would be the case if the payment system is more discretionary. This contractual nature of the premium payment system in life insurance has been reinforced by insurance companies developing good marketing strategies in order to encourage individuals to save. There is no doubt that the efforts of insurance companies in creating effective sales and marketing techniques, despite the occasional criticisms of pressure selling, have played a key role in the growth of the life insurance business, and hence indirectly stimulated the level of long term saving within the economy as a whole.

2. Investment and the development of capital markets

It is through the investment of the premiums paid by policyholders (and also the investment of shareholder funds) that the transmission of saving is fed through into the wider economy. The mechanism through which this transmission takes place is the capital market. The range of investments in which an insurance company can invest its funds within a given economy will depend of the degree of development of the local capital market. Savings mobilised and invested in the capital market by life insurance companies clearly acts as an important stimulus to the growth of the capital market itself. However the relationship between the level of saving generated through life insurance and private pension contracts and the development of a domestic capital market is a two-way process. This is because life insurance and private pension contracts usually involve a voluntary decision to save on the part of customers. Customers will not wish to save through these contracts if the investment opportunities that are available to insurance companies in the capital market are not attractive. Hence there is a dynamic interaction process at work, with the development of saving through life insurance and the development of the capital market both evolving together, with one assisting the other.

It is worth noting here that if there are onerous regulations placed on the investment policies of insurance company funds by insurance legislation, even though they may have the sound intention of reducing the risk of insurance company insolvency, they can inhibit both the development of the life insurance industry and the capital market. Hence there should be co-ordination between the insurance regulatory authority and those drafting insurance legislation and other government departments charged with this wider responsibility of seeking to develop the local capital market.

In addition, life insurance companies also play a risk absorption role in the capital market as underwriters of new equity and bond issues. By guaranteeing the placement of issues and placing a floor on the issue price, this encourages the supply of new issues onto the capital market.

3. Assisting in the reform of the pensions system

World-wide there has been a general trend for governments to play a less pervasive role in

pension provision. This reflects in part political changes, but it also reflects the fact that governments are unable to justify to voters the higher taxes (or more state borrowing) necessary to support this government role. In recent times a major change has been the transfer of more of the responsibility for pension provision onto the private insurance sector. In developed economies, the projected future cost of unfunded state pensions, due to ageing populations and higher public expectations with rising standards of living has been a major determinant of this shift. And even in emerging economies with younger populations, the need for fiscal prudence, sometimes due to pressure from the IMF and World Bank, is requiring a reappraisal the balance between state and private pension provision. The life insurance industry usually plays a key role as the government wishes to shift the future burden of some of this retirement provision. This is because life insurance companies are in the long term savings business and have developed well tested pension products. Some of these pension products are personal pensions and some are group pensions, usually organised through an employer but sometimes through other affinity group, such as professional associations. It should be noted that group pension schemes offered by insurance companies existed before occupational or self-administered schemes run by the employers themselves. For occupational pension schemes the trend has been for companies, as they have become larger, to set up and manage their own pension schemes rather than have these group schemes managed by life insurance companies.

One weakness in most state pension schemes is that individuals who are self employed are often inadequately covered. This is due to non-compliance by individuals, sometimes due to variability of in their income or to the 'black economy', and to the difficulty of enforcing the collection of contributions by the social security agencies, especially in rural communities. Life insurance companies offer personalised products and since they operate through agent and broker networks, and their offices, located across a country they usually have a more effective collection system.

4. Economic benefits of a dynamic life insurance sector

What are the wider economic benefits that derive from the stimulation of private sector saving and its subsequent investment in the capital market within a given economy? Firstly, these savings can be made available, either in the form of equity or debt capital, to manufacturing, agricultural, energy, trading enterprises etc., in the private sector. New companies can be set up and finance is available for existing companies to increase their level of capital expenditure in new plant, equipment etc. Moreover, particularly for life insurance, since the time horizons for investment are long-term, these savings can be tied up for a long time and hence can be made available for capital expenditure decisions that only will produce profits in the future. This investment activity of life insurance complements the lending practices of the banking system, since banks can only provide short-term finance to manufacturing and other enterprises, because of the short-term nature of their deposits.

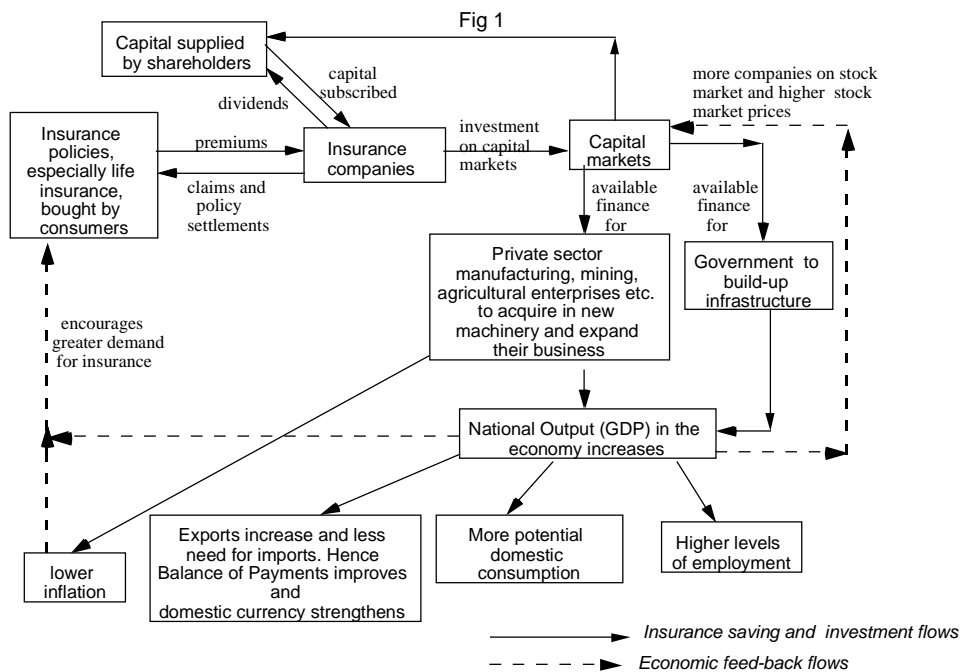
These long-term savings generated by life insurance companies can also be made available to government to allow to fund improvements in the infrastructure, since this infrastructure investment is important, especially in emerging economies, not only to underpin the growth of domestic private sector companies but also to encourage foreign companies to enter the local economy.

These capital expenditure decisions, both by the private sector and by the government, should lead to increases in the level of employment and increases in the standard of living across the economy. Moreover, as the productive base of the nation increases, the export potential of the country also increases, as well as allowing the country to supply more of the goods that it currently imports from abroad. Not only is the balance of payments and foreign exchange holdings improved, but the domestic exchange rate is also strengthened.

The stimulation of greater saving also has short-term economic benefits. If individuals can be persuaded to save more, then by definition they will be consuming less. This reduced consumption will help to lower any inflationary pressures that might exist within the economy.

This inflation-reducing benefit will clearly be greater within an economy where consumption is tending to squeeze out potential capital expenditure.

Figure 1



In addition, there is a wider psychological benefit from encouraging the growth of domestic saving within a country. This is because when a country generates its own domestic saving it is less reliant on inward foreign investment or, in other words, less reliant on the savings of foreigners, since all inward foreign investment ultimately derives from the long term savings of foreigners. Even though the world economy today is international in nature, there needs to be an adequate level of domestic saving to finance domestic capital expenditure. If domestic saving is too little, then the ownership of the economy will gradually tend, directly or indirectly, to fall more and more under foreign control. Clearly a balance needs to be struck between the level of domestic and foreign ownership within a country, a level which will depend on the political preferences and indeed on the psychology of the nation itself. But it should be noted that foreign manufacturing and commercial companies investing in a country like to see the existence of a well-developed capital market, since they themselves will wish over time to raise capital on this market to help finance the future growth of their local operations.

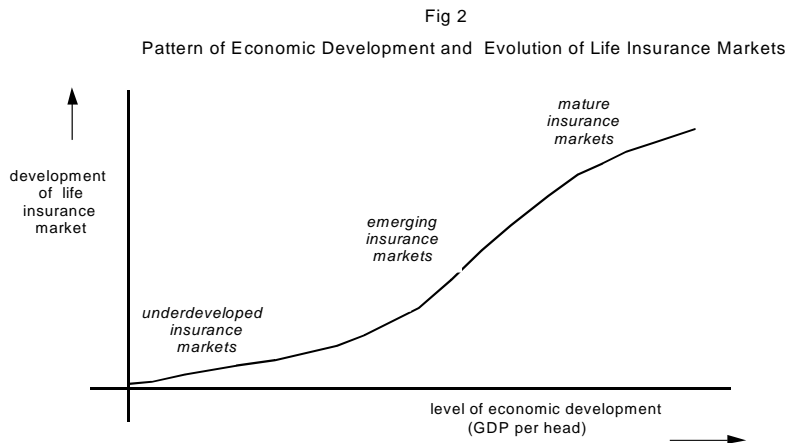
Figure 1 gives a graphical representation of the role that life insurance companies play in the mobilisation of saving and through the investment of this saving in the capital market its impact on the wider macro-economy. It is obvious that since the insurance industry is only a part of the economy, the insurance industry itself will be more affected by the economic environment than the economy itself will be affected by the activities of the insurance industry. More particularly, the general standard of living in a country will have a major effect on the level of demand for insurance, while high inflation has a major disincentive effect on all saving, including saving through life insurance.

5. Pattern of development in life insurance markets

Experience shows that life insurance markets tend to take time to develop, often developing later than banks and non-life insurance companies. This reflects the fact that long term savings across the population as a whole increases as standards of living rise and as standards of living rise, longevity also increases.

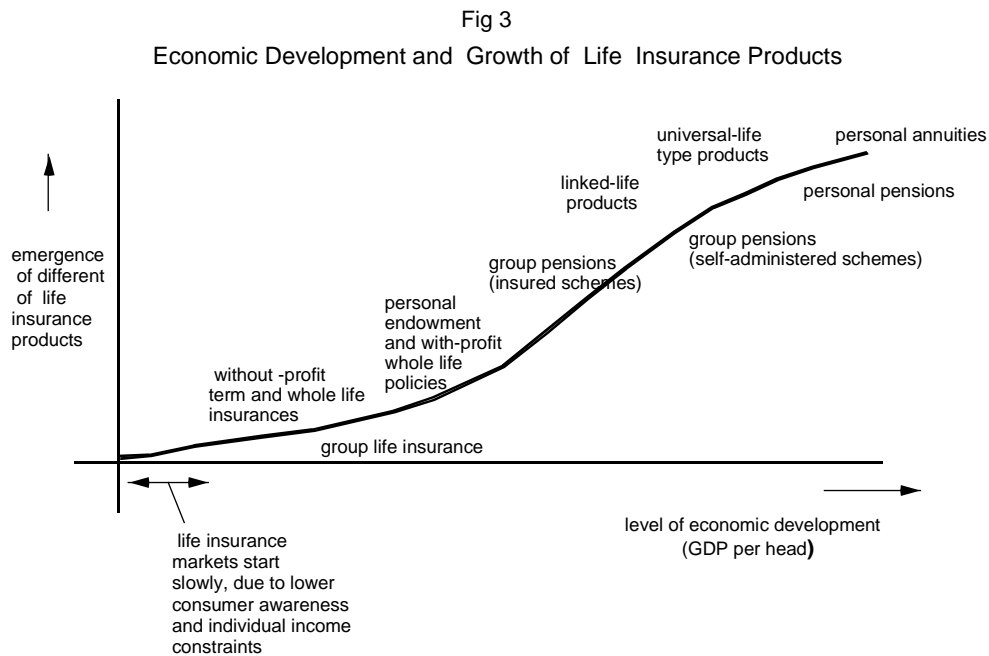
The pattern of the growth of national life insurance markets tends to follow an S-shaped pattern as depicted in Figure 2. As GDP per head within an economy remains low, spending on life insurance remains low, often growing less than the growth of GDP. But as GDP per head increases beyond a certain threshold, spending on life insurance begins to accelerate. At very high level of GDP per head, the rate of acceleration tends to slow, partly due to the fact that wealthier economies tend to have older populations who begin to draw down their savings during retirement.

Figure 2



It is difficult to generalise on how life insurance products change and widen in scope as a life insurance market matures. There are an interplay of economic, political and cultural and commercial factors at work, which vary from country to country, Nevertheless, there are two aspects of product development that has been evident in many countries. First, one is that life insurance products tend to move from having a primary emphasis on insurance protection towards a greater savings role, especially saving for retirement purposes. Second, there is a move away from simple products sold either on an individual and group basis to more complex products sold mainly on an individual basis. Figure 3 shows a common evolutionary path.

Figure 3



6. How governments can stimulate the development of life insurance sector

There are certain policy issues that governments can do to stimulate the growth of its national life insurance industry. The main ones are outlined below:

Regulation and Supervision

The government must create a sound but flexible system of regulation and supervision. It is important there is a sound system of regulation and supervision in place to give confidence to the public. Experience shows that the insolvency of one life insurance company can undermine the public confidence in the whole sector. In addition, the marketing of life insurance also requires supervisory attention. Agents, brokers and other insurance intermediaries advising and selling to the public must meet minimum competence and ethical standards. Professional education standards for agents and brokers should be required.

Insurance regulation should not be too restrictive in the classes of life and pension products that a life insurance company is able to offer. Consumers need to have choice. In addition, it is important that the regulation of insurance company funds are not too restrictive since such regulations can reduce the rates of return that policyholders earn on their savings, compared to other long term saving alternatives. Moreover, it should be noted that undue restrictions on investment policy also inhibit new life and pension product development.. A regulatory balance has been struck between ensuring sound investment policies of life insurance companies, which reflect the nature of the local capital market, and allowing insurance companies to earn competitive rates of return on the savings of policyholders.

Tax incentives

Individuals often need to be given incentives to save for the long term rather than consume. They tend to be myopic. Hence governments in most countries grant tax incentives to encourage this process of transfer. This is especially so for saving products linked to retirement purposes. Tax incentives can be in terms of income tax deductability on premiums paid, favourable tax treatment on the policy proceeds at the termination of a life insurance contract, and the tax treatment of the life insurance company itself.

These tax subsidies, where they exist, are viewed by governments as a good investment for the tax payer, since the taxes foregone are expected to be more than offset by lower tax support needed in the future.

Liberalising the domestic market

Life insurance markets grow faster if they open to foreign competition than if they are closed. Foreign life insurance bring new products, new marketing and distribution techniques and new methods of management and organisation. Efficient management of an life insurance depends more and more on up-to date IT systems, including specialist software. Foreign life insurance companies which enter a country have to take a long term view on their investment, since profitability from a life insurance operation takes a long time to emerge. Hence compared to

some other industries, including non-life insurance, life insurance companies can be expected to be more committed long term to the market. There are three main entry strategies for a foreign life insurance company: establishment of a new local life insurance company, a take-over of a local company or a joint venture with a local partner. In an emerging market, governments must decide for themselves what should be the balance between domestic and foreign ownership in the short term, but in the longer term the balance is determined by market forces.

Recognising a partnership role in pensions reform

Governments can encourage the growth of the life insurance industry by recognising that it wishes to be a long-term partner in pension provision. If government wishes to transfer some of its own traditional responsibilities to the private sector, the life insurance industry will inevitably be one of the key partners in this. A stated philosophy of partnership, together with a long term consistent strategy which does not change as governments themselves change from election to election, will encourage more investment by the life insurance industry, both domestic-owned and foreign-owned. But the local life insurance industry itself will have to convince the government that it can deliver in such partnership arrangement.

Public education

Finally, the government can stimulate the growth of the life insurance sector by encouraging better understanding of personal saving and financial planning through education. This can be done by widening the teaching curricula in schools and universities. In a number of countries, increasing public awareness can be effectively carried with the local insurance industry sponsoring educational material, under guidelines set by the Ministry of Education.