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LIBERALISATION OF INSURANCE MARKETS: ISSUES AND CONCERNS

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This paper addresses several issues that may be relevant to insurance markets and governments in connection with liberalisation. This paper approaches liberalisation issues from several perspectives. First, I set out the role and importance of government policy in insurance. The essential point here is that government intervention into insurance markets is essential but should be carefully targeted to minimise undue interference. To some, this discourse might appear a bit academic, but it is the most important in this treatise because it lays the foundation for the circumstances under which government should and should not intervene into insurance markets.

Next, I discuss the role of foreign insurers, with particular emphasis on the concerns that have historically been expressed about their roles in national insurance markets of emerging economies. The essential point here is that such insurers should be expected to play an important role in market evolution and development.

Finally, I present a set of principles around which governments should craft their regulation of insurance. A market regulated in accordance with these principles will be one in which consumers enjoy a wide range of fairly priced insurance from financially sound insurers.

THE MEANING OF LIBERALIZATION

I should first note that liberalisation cannot be separated from regulation – hence, I cover both. By **liberalisation**, I mean the process by which government takes actions to move toward liberal markets. A **liberal insurance market** is one in which the market, subject only to economically justifiable government restrictions, determines:

1. who should be allowed to sell insurance,
2. what products should be sold,
3. how products should be sold, and
4. the prices at which products should be sold.

The first item, therefore, deals with issues such as market access and equality of competitive opportunity, including national treatment. In turn, market access issues encompass prudential regulation. Items 2 through 4 commonly deal with issues such as product, price, and market conduct regulation. All four items subsume competition regulation.

THE ROLE AND IMPORTANCE OF GOVERNMENT POLICY

Competitive insurance markets are in the national interest because they generally offer businesses and individuals greater choice and better value than alternative approaches.[1] Formerly restrictive markets are made competitive through a combination of liberalisation and deregulation.

Of course, many governments have undertaken liberalisation and deregulation efforts. At the same time, some seem tentative — facially endorsing competitive markets while retaining elements of restrictive regulatory systems. Thus, many governments continue to deny their citizens and businesses access to low-priced, high-quality insurance policies and services. These actions suggest either that (1) regulation exists more to protect established private interests than the overall national interest or (2) policy makers remain sceptical that competitive markets will deliver the benefits to the national economy as suggested above. I analyse both issues below.

Different Regulatory Approaches Reflect Different Interests

Government intervention into insurance markets takes many forms; some direct, some indirect. Its stated purposes are always noble — to protect consumers, to raise revenue to support worthwhile social objectives, or to ensure orderly, well functioning markets. However, in reality, regulation does not always serve noble purposes.

Various factors influence regulatory policies and behaviour. These factors include market problems that regulators are seeking to rectify ideology, special interests, and regulatory resources. Other

[1] This section draws in parts from Harold D. Skipper, Jr. and Robert W. Klein, *Insurance Regulation in the Public Interest: The Path Towards Solvent, Competitive Markets*, Working Paper no. 99-4, Center for Risk Management and Insurance Research, Georgia State University.

factors sometimes distort regulation. Often, private interests or special interest groups exert undue influence on regulation to serve their own interests at the expense of consumers and the overall national welfare. For example, established insurers might support government action that bars entry and diminishes competition from new insurers — both national and foreign. The resulting restrictions might be cloaked in the guise of "consumer protection," but consumers are actually hurt by such restrictions. Special interest groups typically are better informed, financed, and organised than consumers.

Regulation unduly influenced by such special interests is characterised by:

- restrictions on entry of new national and especially foreign insurers
- suppression of price and product competition
- control of interindustry competition from those selling similar or complementary products

Insurance regulation that exhibits these characteristics is likely subject to "capture" by the local industry, with the result that both individual and commercial insureds are penalised through high prices, lack of product innovation, and poor product choice. I can but point out the obvious fact that private interests sometimes take precedent over the greater national good — to great harm to the overall national interest. Citizens and businesses — through dedicated government representatives and through publicity — must be ever vigilant in exposing such abuses of the public trust and should support measures that expose and thwart such abuses. The glaring light of truth coupled with transparency in all relevant government decisions and processes provide the strongest, most effective means of preventing and detecting abuse. I return to this important point later.

Competition Enhances Choice and Value

Some policy makers seem sceptical about the benefits of competition. I address this concern here, fully aware that this presentation is unnecessary for most of readers, for which I apologise. Nonetheless, the case for liberal insurance markets, while clear to those schooled in economics, can be a confused array of conflicting claims to those charged with making policy decisions.

Empirical Evidence in Favour of Liberalisation

Until recently, we have had scant empirical evidence about the practical effects of insurance liberalisation within emerging markets. A recent doctoral dissertation at Georgia State University might be the first to explore this important issue empirically. In her research, Dr. Thitivadee Boonyasiai – now a professor at Chulalongkron University in Thailand – examined the effects on life insurer efficiency of insurance market opening (defined as liberalisation in her study) and deregulation efforts undertaken by Korea, the Philippines, Taiwan, and Thailand.[2] All four countries undertook some market opening during the past decade, with Korea and the Philippines undertaking modest deregulation as well. In neither instance could these deregulation efforts be characterised as substantial. Nonetheless, these two markets can be contrasted with those of Taiwan and Thailand, which undertook virtually no deregulation during the study period.

Dr. Boonyasai found that liberalisation and deregulation of the Korean and Philippine life insurance industries seem to have stimulated increases and improvements in productivity. In addition,

[2] Thitivadee Boonyasai, *The Effect of Liberalization and Deregulation on Life Insurer Efficiency*, unpublished Ph.D. dissertation, Georgia State University, 1999.

liberalisation and deregulation of these markets created more competitive markets as witnessed by life insurers' improving efficiency; e.g., achieving cost savings and adjusting their scale of operations. Merely allowing greater market access without dismantling restrictive regulatory regimes – as was the situation with Taiwan and Thailand – seems to have had little effect on increases and improvements in productivity.

Thus, study findings are consistent with the view that market access is a necessary but not a sufficient condition for contestable markets. Study findings also are consistent with the view that, in a restrictive regulatory environment, welfare gains will be minimal if deregulation does not closely follow market opening. Dr. Booyasai's rigorous research speaks eloquently in favour of liberal insurance markets.

The Case for Liberal Insurance Markets

Of course, the objective that a market-oriented economy has for its insurance industry is the same as that which it has for other industries — an efficient allocation of society's scarce resources. Furthermore, society desires an economic system that leads to continuous innovation and improvement. These objectives are most likely to be achieved through reliance on competitive markets.

Competition not only leads to economic efficiency, it provides an automatic mechanism for fulfilling consumer needs and wants and for creating a greater variety of choices. Additionally, competition compels insurers to improve their products and services, thus further benefiting buyers. A *perfectly* competitive market – one in which new entrants enter and exit the market with ease, buyers and sellers are perfectly informed, and all sellers offer identical products at the same prices – requires no government direction or oversight to accomplish these desirable social goals. Perfect competition, however, is an ideal that cannot be realised in practice.

Even so, this economic ideal provides a useful construct against which we can compare actual market functioning. We know that the closer a market is to this competitive ideal, the more efficiently it functions. Indeed, a market that is *workably competitive* functions well and provides most of the benefits of perfect competition. Markets characterised by workable competition generally have low entry and exit barriers, numerous buyers and sellers, good information, governmental transparency, and the absence of artificial restrictions on competition. The markets for numerous products satisfy these conditions sufficiently such that little government intervention is required for the market to function well. For an insurance market to be workably competitive, however, rather substantial government intervention ordinarily is necessary because of important imperfections that exist in such markets. Because of these *market imperfections* (also called *market failures*), government intervention into key areas is required to ensure healthy competition and good performance.

Competition has Limitations

The two major types of market imperfections in insurance relate to information problems and market power, each of which is discussed below. The efficiency of government intervention to address a particular market imperfection must be evaluated from a cost-benefit standpoint.

Information Problems

A critically important assumption of the competitive model is that both buyers and sellers are well informed. As a practical matter, we know otherwise regarding insurance. Information problems abound in insurance, and arguably are the industry's most important market imperfection.

Insurance is a complex business, with buyers having superior information to sellers in certain instances (e.g., buyers have better information about their relative risk when they apply for insurance) and vice versa in others (e.g., the insurer knows more about its financial condition than does the buyer). *Asymmetric information problems* exist when one party to a transaction has relevant information that the other does not have.

The nature of the insurance transaction involves a contract that makes a present promise of future performance upon the occurrence of stipulated events. Individuals and businesses purchase policies in good faith, relying on the integrity of the insurance company and its representatives. Even assuming that insureds could be induced to take an interest in the financial condition of their insurers, few are sufficiently knowledgeable to do so without some assistance. Insurance is necessarily a technical, complicated subject, and the true financial condition of an insurance company can be determined only by expert examination. Also, some individuals may have difficulty understanding the complex nature of insurance contracts. These statements are less applicable for sophisticated buyers, such as large businesses, than for persons.

Information problems for insurance customers provide the rationale for the great majority of insurance regulation. Insurers and their representatives have little incentive to disclose adverse information to potential customers. Doing so hurts sales. Governments seek to rectify the unequal positions between insurance buyer and seller by mandating certain disclosures for insurers, by monitoring insurer financial condition, by regulating insurer's marketing practices, and through other means.[3]

Because insurance is a financial future-delivery product tied closely to the public interest, governments judge this information imbalance between buyers and sellers to warrant substantial oversight of the financial condition of insurers. The widely accepted view is that the public, especially poorly informed consumers must be protected.

In many aspects of insurance processes, neither the buyer nor the seller has complete information because the desired information simply does not exist. Insurers cannot know the future. Environmental factors — such as the economy, inflation, new laws and regulations, and changing consumer attitudes and preferences — present great uncertainty to both insurance buyers and sellers.

Asymmetric information and other factors can lead to *principal-agent problems* in insurance markets. Such problems arise, for instance, when policyholders have difficulty in monitoring and controlling the behaviour of their insurer. The insurer might incur additional financial risk that is hazardous to its policyholders' interests or fail to meet its obligations to policyholders. If the insurer becomes insolvent or refuses to pay claims, policyholders may find it very costly or impossible to recover funds or force the insurer to fulfil its obligations. Unequal resources and bargaining power between the insurer and an individual policyholder can exacerbate the problem.

Because of these problems and other market imperfections, private insurers will not supply every type of insurance that consumers demand. Insurers may perceive excessive adverse selection or moral hazard problems or they may be unable to diversify their loss exposures. Thus, the private insurance mechanism generally offers little unemployment insurance and faces some difficulty in insuring catastrophic events such as earthquakes and nuclear disasters that could cause huge, concentrated losses in a particular area. In each instance, insurers perceive too much uncertainty occasioned by a change in the state of nature or state of the world, coupled with prospects for severe adverse selection.

[3] Another way government may address this problem is by providing consumer information and education. Private for-profit and non-profit organizations also can provide consumer information and education, but government may play a valuable role in this area as well.

Information problems also are responsible for individuals being so completely ill-informed that they are unable to know their own best interests. One of the premises for social insurance programs is that individuals will not or cannot fully arrange for their own financial security, so government must do it for them. Arguably, elements of social security programs could be privatised over time for individuals with sufficient financial resources to provide for their own security through the purchase of appropriate insurance and financial products. Government programs could be targeted more to low-income individuals who lack such resources.

Market Power

Insurers also can acquire market power, under some circumstances, which permits them to limit competition. *Market power* is the ability of one or a few sellers (or buyers) to influence the price of a product or service. Under the competitive model, sellers and buyers are price takers — meaning that they are so small compared with their market that they cannot exercise any meaningful influence over the price and quantity of a good or service, either individually or collectively. If some players in the market can affect price and quantity significantly to serve their interests, the allocation of resources generally will be inefficient.

In most cases, in the absence of government restrictions, insurance markets are structurally competitive. Entry and exit barriers and economies of scale and scope are not of a nature that would allow a small number of insurers to acquire meaningful market power. Even in highly concentrated markets, the ever-present threat of new entry can impose competitive discipline, i.e., the concept of "contestable markets." If insurers enjoy meaningful market power within a country, the cause usually can be traced to restrictive government control over entry and competition. The solution in such instances is not more regulation, but rather the removal of the government restrictions on entry and competition.

Several countries have monopolistic markets (e.g., Iran and India), and many others are oligopolistic (e.g., Japan and South Korea), because of government policies. Explicit or implicit collusion historically has been common in many insurance markets internationally, especially concerning pricing. Tariff markets, in which all sellers charge similar or identical prices, remain common in many developing countries and for certain insurance lines in some OECD countries.

National tax regimes can create market power. Some countries assess higher premium taxes on the local business of foreign insurers than they do on the local business of national insurers. Such practices are analogous to trade tariffs and have similar adverse economic consequences.

National licensing requirements technically are entry barriers, although they are justified on consumer protection grounds. Some entry restrictions are appropriate to ensure that insurers are financially sound and their owners and managers are honest and competent. However, some governments go beyond this legitimate objective and will not grant a new license unless a market need to do so is established. Other countries will not grant new licenses under any circumstances or require local equity participation. Transparency in the licensing process is less than desired in many markets, with numerous unwritten rules.

Reasonable freedom of entry does not exist in many of the world's insurance markets. Several countries prohibit or severely limit the creation of new national insurers, and many erect substantial entry barriers to foreign insurers, although the trend is toward more liberal markets. Ultimately, consumers should be the judge of whether an insurer responds to their needs, not government.

Insurance Regulation Should Rectify Market Imperfections

Other imperfections exist in insurance markets but the above are the most obvious and common. Government's role in crafting insurance regulation should be limited to rectifying imperfections that can cause significant harm. A pro-competitive approach, therefore, would witness governmental intervention into the insurance market only with respect to matters that meet three conditions:

- an actual or potential market imperfection exists,
- the market imperfection causes or can reasonably be believed to cause meaningful consumer or public harm, and
- government action can ameliorate the harm.

Conversely, if any one of the three conditions is not met, no government intervention is warranted. Thus, no government intervention is justified with respect to any insurer operation that does not cause demonstrable or reasonably expected harm. Even if some aspect of insurer operations might adversely affect some individuals, no intervention is warranted if the intervention would be ineffectual or might actually exacerbate the problem. Just as there is no perfectly competitive market, so too is there no perfect government regulation.

All existing and proposed insurance regulations should be tested against these three conditions. Some existing and proposed regulations will meet all three conditions. Others will not and should be abandoned.

The likelihood of consumer abuse because of market imperfections will vary from country to country. Thus, countries with a long history of competitive insurance markets will have already resolved many of the complex issues concerning appropriate government intervention. Countries moving from monopolistic and other restrictive regimes, on the other hand, must exercise a certain degree of caution to ensure that abusive practices do not undermine confidence in an embryonic, competitive insurance market.

Justifiable government intervention should be minimally intrusive and as efficient as possible. For example, one way to minimise consumer harm occasioned by insurer insolvencies is to allow insurers to collude to set prices so high that even the most inefficiently operated insurer is guaranteed a profit and, therefore, survival. Such an approach, however, results in high priced insurance and excessive profits for insurers — all at the expense of consumers and businesses and, therefore, at the expense of the national interest. The superior approach is to allow price competition but to establish reasonable capital standards while closely monitoring insurer financial condition. This approach yields lower priced insurance — thus benefiting the national economy — while minimising the possibility of consumer harm that would otherwise arise from excessive insurer financial risk and insolvencies.

THE APPROPRIATE ROLE OF FOREIGN INSURERS

Concern persists that certain dimensions of liberalisation 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.[4]

How Insurance Aids Economic Development

Insurance companies are financial intermediaries. As such, they perform the same types of functions and provide the similar generic benefits to a national economy as other financial intermediaries. At the same time, their role in individual and corporate risk management means that their contributions to economic development will not precisely overlap with other financial intermediaries.

Financial services generally and insurance in particular, of course, are of primordial importance to economic development. Another recent doctoral dissertation at Georgia State University established this importance in a way that no one has done before. In his research, Dr. Ian P. Webb investigated the mechanisms by which insurance and banking jointly stimulate economic growth.[5] At first, economists considered that economic growth was driven mainly by labor and capital inputs. When it was found that, in fact, these two factors alone left much of economic growth unexplained, economists added technology to their equations, thereby increasing their explanatory power but with troubling gaps remaining. Dr. Webb asked whether banking and insurance, when added to existing economic growth models, might further explain economic growth.

His research showed that non-life insurance, life insurance, and banking all have significant roles in explaining national productivity gains. The results indicated that the exogenous components of banking, life insurance, and non-life insurance are important predictors of economic productivity. Additionally, he found evidence of synergies among financial intermediaries. Thus, each sector fuels economic growth independently but they collectively provide greater growth impetus than suggested by merely summing their component contributions. Dr. Webb's research provides tangible support for what has been to date largely reasoned economic suppositions.

Thus, the more developed and efficient a country's financial market, the greater will be its contribution to economic prosperity. It is for this reason that governments should foster greater competition among financial service providers, while ensuring that the market is financially sound.

It is wrong to view insurers as simple pass-through mechanisms for diversifying risk under which the unfortunate few who suffer losses are indemnified from the funds collected from many insureds. Laudable though it is, this function masks other fundamental contributions that insurance makes to prosperity. Countries that are best at harnessing these contributions give their citizens and businesses greater economic opportunities. Insurance provides seven categories of services that collectively constitute the mechanisms by which insurance contributes to economic growth, as found in Dr. Webb's research.

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[4] This section draws from Harold D. Skipper, Jr., *Foreign Insurers in Emerging Markets: Issues and Concerns* (Washington, D.C.; International Insurance Foundation, 1997).

[5] Ian P. Webb, *The Effect of Banking and Insurance on the Growth of Capital and Output*, unpublished Ph.D. dissertation, Georgia State University, May 2000.

Insurance Can Promote Financial Stability

Insurance helps stabilise the financial situation of individuals, families, and organisations. It accomplishes this task by indemnifying those who suffer loss or harm. Without insurance, individuals and families could become financially destitute and forced to seek assistance from relatives, friends, or the government. 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, the firm's future contribution to the economy is foregone. Employees lose jobs, suppliers lose business, customers forgo the opportunity to buy from the firm, and government loses tax revenues. The stability provided by insurance encourages individuals and firms to create wealth with the assurance that their resources can be protected.

Insurance Can Substitute for and Complement Government Security Programs

Insurance, especially life insurance, can substitute for government security programs. Private insurance also complements public security programs. It, thus, can relieve pressure on social welfare systems, reserving government resources for essential social security and other worthwhile purposes, and allowing individuals to tailor their security programs to their own preferences. Studies have confirmed that greater private expenditures on life insurance are associated with a reduction in government expenditures on social insurance programs. This substitution role is especially important because of the growing financial challenges faced by national social insurance systems.

Insurance Can Facilitate Trade and Commerce

Many products and services are produced and sold only if adequate insurance is available. Insurance coverage is a condition for engaging in some activities. Because of the high risk of new business failure, venture capitalists often make funds available only if tangible assets and the entrepreneurs' lives are adequately insured. Entrepreneurs are more likely to create and expand their business ventures if they can secure adequate insurance protection. Insurance underpins much of the world's trade, commerce, and entrepreneurial activity.

This fact is unsurprising. Modern economies are built on specialisation and its inherent productivity improvements. Greater trade and commercial specialisation demand, in turn, greater financial specialisation and flexibility. Without a wide insurance product choice and constant service and pricing innovations, insurance inadequacies could stifle both trade and commerce. It is in these ways that insurance serves as "a lubricant of commerce."

Insurance Can Help Mobilise Savings

Studies have shown that, on average, countries that save more tend to grow faster.[6] Insurers play an important role in channelling savings into domestic investment. Insurers enhance financial system efficiency in three ways. *First*, insurers reduce transaction costs associated with bringing together savers and borrowers. Thousands of individuals each pay relatively small premiums, and insurers then invest these amassed funds as loans to businesses and other ventures. In performing this intermediation function, direct lending and investing by individual policyholders, which would be time consuming and costly, is

[6] IMF (1995). *World Economic Outlook*, May, pp. 69-70. Of course, this finding does not suggest that every country with a high savings rate will have a high growth rate. Countries whose financial systems are inefficient are less likely to achieve high growth rates even with high savings rates.

avoided. It is more efficient for insurers to acquire the information necessary to make sound investments than requiring individuals to acquire the same information. In turn, the efficiencies and higher returns achieved by insurers are passed to policyholders as lower premiums.

Second, insurers create liquidity. Insurers invest the funds entrusted to them by their customers to make long-term loans and other investments. Policyholders, however, have immediate access to loss payments and savings while borrowers need not repay their loans immediately. If all individuals instead undertook equivalent direct lending, the proportion of their personal wealth held in long-term, illiquid assets would be unacceptably high. Insurers and other financial intermediaries thereby reduce the illiquidity inherent in direct lending.

Third, insurers facilitate economies of scale in investment. Many investment projects are quite large, especially in relation to available financial capital in many emerging markets. Such large projects often enjoy economies of scale, promote specialisation, and stimulate technological innovations and therefore can be particularly important to economic development. By amassing large sums from thousands of smaller premium payers, insurers often can 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. For example, in the US, insurers provide financing for fully one-third of all corporate debt.

A well-developed financial system will have a myriad of financial institutions and instruments. Other things being the same, the greater the variety of financial institutions and products, the more efficient the system and the greater its contribution to economic development. 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 specialise in collecting short-term deposits and extending short-term credit, contractual saving institutions usually take a longer-term view. Their longer-term liabilities and stable cash flows are ideal sources of long-term finance for government and business.

Insurance Can Enable 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 resources are allocated.

Risk Pricing. A competitive market's success depends on pricing. The pricing of risk is fundamental to all financial intermediaries and is no less important to their resource allocation than to any other supplier of goods or services.

Insurers price risk at two levels. *First*, through their insurance activities, insurers evaluate the loss potential of businesses, persons, and property for which they might provide insurance. The greater the expected loss potential, the higher the price. In pricing loss potential, insurers cause insureds to quantify the consequences of their risk-causing and risk-reduction activities and, thus, more rationally deal with risk. Investors in projects judged too risky for insurance at any price are put on notice and should rationally expect returns commensurate with the risk. When governments interfere with accurate insurance pricing, their actions can distort the allocation of insurance and, therefore, other resources.

Second, through their investment activities, insurers evaluate the creditworthiness of those to whom they extend loans and the likely business success 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 overall risk characteristics and thereby make better informed decisions.

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 changed. Moreover, life insurers, by tailoring contracts to the needs of different clients, help individuals and businesses transform the characteristics of their savings to the liquidity, security, and other risk profile desired.

Risk Pooling and Reduction. Risk pooling and reduction lie at the heart of insurance and, as with risk pricing, occur at two levels. *First*, in aggregating many individual risk exposures, insurers can make reasonably accurate estimates as to the pool's overall losses. The larger the number of insureds, the more stable and predictable is the insurer's experience. This fact leads to a reduction in volatility and, by that, permits insurers to charge smaller risk premiums for uncertainty and maintain more stable premiums.

Second, insurers benefit from pooling through their investment activities. In providing funds to a broad range of enterprises, individuals, and others, insurers diversify their investment portfolios. The default of a few borrowers is likely to be offset by the many sound investments. The more stable and predictable an insurer's investment experience, the less it can charge for loans.

Insurance Can Encourage Loss Mitigation

Insurance companies have economic incentives to help insureds prevent and reduce losses. Moreover, their detailed knowledge about loss-causing events, activities, and processes affords them a competitive advantage over many other firms in loss assessment and control. If pricing or availability is tied to loss experience and risky behaviour, 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 activities; 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 losses to businesses and individuals and complement good risk management. Society as a whole benefits from the reduction of such losses.

Insurance Can Foster Capital Allocation Efficiency

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. While individual savers and investors may not have the time, resources, or ability to undertake this information gathering and processing, insurers have an advantage in this regard and are better at allocating financial capital and insurance risk-bearing capacity. Insurers will choose to insure and to provide funds to the soundest and most efficient firms, projects, and managers.

Insurers have a continuing interest in and monitor the firms, projects, and managers to whom they provide financial capital and risk bearing capacity. They encourage managers and entrepreneurs to act in the best interests of their various stakeholders (customers, stockholders, creditors, etc.). 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 impose minimum constraints on insurers' abilities to gather and evaluate information in this way should realize a more efficient allocation of capital and therefore stronger economic growth.

The Costs of Insurance

Insurance indeed offers societies great social and economic benefits. However, it also carries certain costs. Government, insurers, and insureds have an interest in minimising these costs. *First*, insurers incur sales, servicing, administration, and investment management expenses. These expenses are an indispensable part of doing business, but increase the cost of insurance. Such expenses may account for 10 to 40 percent or more of a policy's premium, with the loss payment portion accounting for the balance.

Second, the existence of insurance encourages *moral hazard* – the propensity of insureds to seek to gain unfairly from their insurance.[7] Some insureds inflate otherwise legitimate claim payment requests. Moral hazard can manifest itself in mere carelessness, with attendant higher losses than otherwise. Occasionally, individuals deliberately cause the destruction of or damage to property to collect insurance proceeds. From 5 to 15 percent of all non-life claims are believed to be fraudulent in Germany, Spain, Italy, Austria, Finland, and the US. Each year, some insureds are murdered for life insurance proceeds. All such behaviour causes premiums to be higher than they would be otherwise, represents a dead-weight loss to society, can lead to disruptions in otherwise well functioning markets, and truly is a cost of insurance.

Arguments Favouring Greater Foreign Insurer Involvement

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

- improvements in customer service and value
- increased domestic savings
- transfers of technological and managerial know-how
- 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.

I examined each of these items in detail in a study that I conducted in 1997. I concluded that each is potentially relevant.

Concerns About Foreign Insurer Involvement

Policy makers have expressed numerous reservations about foreign insurer participation in their domestic markets. In my 1997 study, such reservations were classified around seven common themes, five of which were found to have little or no justification or the associated issues can be addressed more adequately and with less welfare 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.

[7] One of the chief purposes of underwriting is to discourage and detect moral hazard and adverse selection. Insurance contract terms also attempt to limit moral hazard, as do insurable interest and anti-fraud statutes.

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 liberalisation 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. Of great political importance, as a practical matter, the likelihood of "foreign domination" seems slight in any event.

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. Specialisation 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) is 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. In my study, I could find no reasonable factual basis to support this belief.

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 liberalisation should await insurance and possible macroeconomic regulatory reforms so as to minimise 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 liberalisation 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.

THE PATH TOWARDS COMPETITIVE, SOLVENT INSURANCE MARKETS

In today's globally competitive financial services world, the nature and specific features of each government's intervention into its insurance market should be reassessed to ensure that every aspect is essential and is accomplishing its goal at minimum market disruption in light of the country's economic, political, and social situation.[8] The most common rationale for government intervention into insurance markets is to protect buyers — in economic terms, to rectify market imperfections. To do this, insurance regulation should seek to ensure that *quality, reasonably-priced* products are *available* from *reliable* insurers.

A well-structured competitive market will ensure that the *quality, reasonable-priced*, and *availability* goals are attained. Hence, an important role of government is to promote fair competition to achieve these goals, while protecting buyers from misleading, collusive, and other anti-competitive practices. At the same time, arguably the most important governmental role is to ensure that insurers are *reliable*.

To promote these twin goals of having a competitive *and* solvent insurance market, insurance regulation should have the following traits:

- adequacy
- impartiality
- minimal intrusiveness
- transparency

In structuring insurance markets that better serve each country's interest, regulatory reform should reflect certain principles that are designed to ensure competitive, solvent, and fair markets. Such a set of principles are summarised and discussed briefly below.

The principles should help move a national insurance market toward the competitive ideal. They are not an argument for elimination of regulation. In fact, as made clear below, pro-competitive regulation requires a greater — not lesser — emphasis on competition law, prudential matters, and market conduct.

Regulation Should be Adequate

Regulation should be adequate, meaning that it should be sufficient to rectify meaningful market failures and, thereby, protect the public. Several principles of adequacy follow.

8 This section draws from Skipper and Klein, *op. cit.*

Competition Law

To establish an adequate system of regulation, government must, first, have necessary laws and regulations in place that create the framework for a competitive market. The first principle, therefore, is that:

> ***Government should enact and enforce laws that provide an effective framework for competitive insurance markets.***

Competition law is a vitally important component of competitive markets. Competition law regulates the nature of competition in the marketplace rather than individual competitors. As markets move from restrictive to liberal regulatory approaches, competition law becomes more important as some firms will have motives to try to engage in anti-competitive practices. The law should give regulators clear and strong authority to prevent or punish collective behavior that lessens competition, such as collusive price setting, market sharing arrangements, and other anti-competitive collective actions.

Prudential Regulation

Insurance laws and regulations also should address all relevant aspects of insurer operations, from creation to liquidation. The most essential component relates to prudential regulation and supervision, which brings us to the next principle related to adequacy of regulation:

> ***Government should enact and enforce laws that establish reasonable solvency standards and regulation as the primary means of protecting the public.***

The more competitive a market, the more important is prudential regulation and accompanying supervision. The insurance regulator in a deregulated market faces more complex and difficult issues than his or her counterpart in a strictly regulated market. Indeed, prudential regulation and supervision can be deceptively simple in a market in which all insurers charge the same or similar prices such that the least efficient insurer can enjoy reasonable profitability. Insolvencies in such markets are diminished by overcharging – a form of pre-insolvency assessment.

Not all insolvencies can or should be prevented. In a competitive market, some insolvencies are inevitable. Government's delicate task is to minimise consumer harm occasioned by such difficulties but without signalling other insurers that mismanagement or other unsound business practices will be tolerated. Rigorous but fair enforcement of well-crafted prudential regulation is called for.

The emphasis of prudential regulation and supervision should be to prevent insurers from incurring excessive levels of financial risk and on timely intervention when an insurer's financial condition becomes hazardous. This can be accomplished by reasonable minimum financial standards and effective monitoring of insurers' financial conditions. Such a strategy should include frequent informal consultations with insurer executives to keep regulators well informed about potentially adverse developments and enable them to steer insurers away from actions that threaten their policyholders' interests.

Resolving the problems of financial difficulties for existing insurers should be a priority. Thus, the next principle would lead to the creation of appropriate and consistent ways of dealing with insurers that incur financial difficulties.

> ***As a part of reasonable solvency regulation, government should establish, make public, and enforce appropriate and consistent rules and procedures for identifying and dealing with financially troubled insurers.***

An objective of insurance regulation should be to establish proper incentives for efficient and safe insurer operation and institute safeguards to keep the number of insurer insolvencies to an acceptable minimum. A marketplace with no insurer failures likely is one in which insurance is expensive and consumer choice limited.

Government's responsibility is to establish rules and procedures for identifying and dealing with financially troubled insurers. A key element in the identification process is the establishment of appropriate accounting, reporting, and auditing standards and requirements. Government would be wise to borrow freely from international best practices standards.

The rules and procedures for dealing with troubled insurers should be sufficient to address the particular difficulty and should be consistently applied across all competitors. The rules and procedures should be made public and any changes subject to transparent regulatory processes (see below).

Regulatory Effectiveness

The next step to ensure adequate regulation in a competitive market involves creating an independent regulatory agency with sufficient resources to enforce laws and regulations efficiently, effectively, and impartially.

> ***Government should establish an insurance regulatory agency that operates in society's interest and has sufficient resources to efficiently, effectively, and impartially enforce the nation's insurance laws and regulations.***

If the agency is to function in *society's* interests, as opposed to *private* interests, it should operate independently of undue insurance industry and other special interest influence. It is insufficient that the regulatory body be established as an agency of the government. The means by which industry input is secured must be transparent, impartial, and consistent. Rules may be necessary to limit undue influence over regulatory decisions, such as not allowing former heads of the regulatory agency to lobby the agency for a certain period of time after vacating the office. Due process and transparency (see below) are critically important to ensuring that the regulator deals at arms length with the regulated.

The regulatory body must be provided sufficient financial and other *resources*, including information technology, to carry out its regulatory function. A critically important resource issue relates to the quality and integrity of supervisory personnel. Regulation in competitive markets is more complex and difficult than regulation in restrictive markets. Because of this fact, more competent, highly skilled, and technical employees are required for effective regulation in a competitive market.

Regulatory *efficiency* means that responsibilities are carried out expeditiously, with prudent use of the agency's resources. Regulatory *effectiveness* means that responsibilities are carried out in ways that genuinely ameliorate the identified market failure, but using approaches that are minimally intrusive (see below). Regulatory *impartiality* means that responsibilities are carried out with fairness to all market participants and without favouritism toward any. Impartiality is of such great importance that it warrants separate treatment (see below).

Phased-In Liberalisation

Observers correctly note that insurance regulatory oversight in many transition market-economy countries may not be sufficiently attuned to protecting consumers in a liberalised, competitive market. They may need to enhance prudential, competition, and market-conduct regulation and supervision as they re-regulate and liberalise their insurance markets. At the same time, the movement from a restrictive to a competitive market does not take place overnight, which brings us to our next principle.

> ***Government should develop and implement pro-competitive insurance regulation in a way and at a pace that ensures adequate protection of the public but that proceeds without undue delay and is subject to a reasonable implementation timetable.***

Certainly, new insurer entry and operations into formerly restrictive markets should not be allowed to overwhelm government's ability to protect consumers and the stability of the national insurance industry. On the other hand, experience suggests that consumer protection concerns are often asserted as a justification for unreasonable delays in liberalising and deregulating. Policy makers should recognise that entrenched interests will always urge slowness in reform. Yet, the road to reform should be travelled at the maximum possible *safe* speed, not the minimum. Moreover, reform should follow a reasoned, carefully crafted route, which means that an implementation timetable, with clear deadlines, is essential.

Regulation Should be Impartial

The principle of *impartiality* is fundamental to a competitive market. Impartially means that government should accord no competitor or group of competitors more favourable treatment than that extended to other competitors or groups of competitors. Thus, the next pro-competitive regulatory principle is that:

> ***Government should ensure that insurance regulation and enforcement are applied with consistency and impartiality between competitors, irrespective of the nationality.***

Historically, the fair trade principle of *national treatment* has been the standard for impartiality and, in minimally intrusive regulatory regimes, this standard is a reasonable test of impartiality. It is intended to ensure equality of competitive opportunity for foreign entrants.

National treatment problems exist for foreign insurers in some markets. Thus, some countries have different deposit or capital requirements for foreign insurers than for national ones. Many countries assess higher taxes on foreign than on national insurers. Some countries deny or restrict foreign insurer membership in local trade associations, thus denying them equivalent access to national statistics, research, and lobbying.

The national treatment standard is insufficient to ensure effective market access under certain circumstances. Other government actions that can distort the competitive balance include exchange controls, deposit and lending rate ceilings, privileged access to credit, and unnecessarily strict controls with respect to investments and business powers. Such strict regulation affords already established firms a competitive advantage over new entrants.

Regulation Should be Minimally Intrusive

The Limits of Regulation

As noted earlier, all insurance regulation should be based on the goal of rectifying meaningful market imperfection — that is, to protect the public interest. A government will have multiple ways of rectifying each imperfection that it identifies. All of the ways might meet the adequacy test in the sense that they are sufficient to accomplish the purpose. Some means, however, will prove less disruptive to the competitive market than others, while still accomplishing their purpose. In selecting among its many alternatives, government should select those that accomplish the purpose at minimal disruption to the smooth functioning of their insurance markets; in trade terms, government should select among those that are the least trade restrictive (i.e., that meet a “necessity test”). Thus, an important pro-competitive regulatory principle is that:

> ***Insurance regulation should be limited to that which is (1) justified as providing meaningful protection and (2) minimally intrusive to accomplish its purpose.***

Thus, government should avoid any regulatory intervention with respect to transactions and matters that have little or no possibility of harm to the public. Moreover, in selecting among alternative regulatory approaches to address problems that involve the possibility of meaningful public harm, government should always opt for those approaches that solve the problems with minimal interference with or imposition on insurance transactions. This is the principle embedded in the GATS Article VI requirement that measures should be no more burdensome than necessary to ensure the quality of the service.

This philosophy implies that insurers should be allowed to offer an array of insurance products at prices that they deem appropriate, without being subject to severe restrictions or cumbersome pre-approval process, unless meaningful consumer harm could result from doing so. Market forces should prevent insurers from sustaining prices above a competitive level. Insurers that charge inadequate prices or incur excessive financial risk can be removed from the market. Products that do not serve consumer needs also will not be viable. Through effective monitoring and actions, regulators should move decisively against insurers that attempt to defraud consumers or treat them unfairly. The threat of timely regulatory enforcement actions and appropriate penalties will help to discourage insurers and intermediaries from engaging in abusive practices. This approach conserves regulatory resources by directing them toward the small number of insurers and intermediaries that treat consumers unfairly, without subjecting all market participants to unnecessary constraints or burdensome oversight.

An important element of the minimally intrusive principle is government undertaking actions that can increase corporate accountability but without government itself being responsible for the details of oversight. Thus, requiring audits and certifications by independent actuaries and accountants can both relieve government of these tasks and create positive incentives for insurers. Placing more responsibility on management and boards of directors can have similar effects. The importance of “fit and proper” standards for key management grows with greater market competition.

It must be stressed that the standard of minimal intrusion does not imply a policy of *laissez faire* or no regulatory oversight. Rather, it implies that regulation should be confined to interventions that are truly needed and can meaningfully benefit consumers. Effective regulatory monitoring can help to ensure that regulators are alerted to problems that require action on a timely basis.

In determining appropriate regulatory restrictions, policy makers and regulators must consider the frequency and severity of market abuses and problems. It is not feasible to prevent consumers from ever making poor choices. In designing regulatory policies, government should focus on areas where there is a pattern of abuse or practices harmful to consumers, reflecting fundamental gaps in consumers' abilities to protect themselves.

Distribution and Product Regulation

Restrictive markets usually adopt a philosophy that insurers may do only that which is expressly authorized. Regulation tends to rely on an *ex ante* system of detailed oversight and approval. Such regulation can ensure a stable market, but such markets are rarely innovative, typically offer high-priced insurance, and provide comparatively limited consumer choice and value. Thus, consistent with the minimally intrusive standard, the next principle is:

> ***Subject only to that regulatory oversight essential to protect the public, government should allow the market to determine (1) what financial services products should be developed and sold, (2) the methods by which they will be sold, and (3) the prices at which they will be sold.***

Deregulation connotes a lessening of national regulation with the goal of retaining only that which is adequate and minimally intrusive. The most critical first step along the path toward reasoned deregulation is to adopt the philosophy that insurers should have the flexibility to respond to consumer needs in ways that *they* deem appropriate, subject, of course, to regulatory oversight to deal with solvency matters and to minimize misleading or abusive practices. Market forces will encourage insurers to develop and sell products on terms that are in the best interest of consumers.

This philosophy argues for greater reliance on an *ex post* system of oversight wherever it is most efficient. *Ex ante* regulation will remain appropriate for some areas, such as insurer licensing and solvency oversight, where certain market failures are best addressed by imposing minimum standards and prohibiting activities that could harm consumers. These will include situations where lack of information and unequal bargaining power between consumers and insurers can lead to abuses that should and can be prevented by regulators.

Many countries have shifted more to the philosophy of *ex post* regulation. Even so, remnants of earlier restrictive philosophies persist, if not strictly *de jure* then at least *de facto.* The product approval process in many countries is at best sluggish and at worst erratic, arbitrary, and opaque. The benefits of competition are blunted when regulation is slow, unpredictable, or inconsistent.

Prior approval and other restrictive approval approaches tend to retard adjustment of prices and product innovation. Such actions should be unnecessary in a competitively structured market.

A competitive insurance market will have numerous channels for insurance distribution. New products and services require channels attuned to the buyer's needs and wishes. Brokers and other marketing intermediaries can help insurance buyers make better informed decisions. Government-imposed limitations on distribution channels that could serve the market more efficiently are inconsistent with a market-driven regulatory philosophy. They are examples of governmentally created barriers to entry.

Disclosure and Consumer Information

When a government moves from a restrictive regulatory system to greater reliance on competition, some consumer protection functions shift from the government to consumers themselves.

Government should ensure that insurance buyers understand that such a fundamental shift has taken place. Buyers will need to become more active in evaluating insurers and their products.

Government should ensure customers have access to sufficient information to be able to make good purchase decisions and protect their own interests. This brings us to the next principle:

> ***Government should ensure that insurance customers have access to information sufficient to enable them to make informed, independent judgements as to (1) an insurer's financial condition and (2) the benefits and value of its products.***

This principle goes directly to the information asymmetry problems of insurance buyers. Regulation may be necessary to compel insurers to make certain disclosures in connection with their sales efforts. In other instances, it may prove most efficient and effective for government itself to be the source of needed unbiased information. This approach will require additional governmental efforts to facilitate informed and prudent customer choices.

Rating agencies and other independent information sources can greatly assist customers as a source of unbiased information. Unfortunately, some governments discourage or prohibit entry by rating agencies and other such independent financial service information firms. Such actions hinder competition in the national interest by denying local businesses and citizens information beneficial to their decisions regarding the purchase and maintenance of insurance and other financial service products.

The Regulatory Process Should be Transparent

Transparency in the regulatory process is fundamental to ensuring a competitive market. This brings us to two of the most important pro-competitive regulatory principles. The first is:

> ***Government should make existing insurance laws and regulations easily available to the public, including to consumers and businesses and to insurers and other financial services providers.***

The fair trade principle of transparency, as embedded in GATS Article III, requires that regulatory and other legal requirements regarding market access and national operation should be clearly and fully set out and easily available. Transparency problems are too common in insurance markets. Many governments' laws and regulations are incompletely set out and not readily available. Foreign firms, in particular, encounter transparency problems in countries that grant their insurance regulatory authorities broad discretionary powers, as the foreign insurer may have no clear understanding of the market access or operational requirements.

Many countries, especially those that historically have been relatively closed, may have unclear or nonexistent due process standards. In such instances, foreign (and national) insurers may not fully understand either their rights to appeal regulatory decisions or the process by which an appeal is undertaken.

The second dimension of the transparency principle applies to proposed laws and regulations. This dimension requires that all interested parties have the opportunity to know about and to comment on proposed regulations and that methods to challenge regulatory decisions be available.

> ***In crafting proposed insurance laws and regulations, government should (1) make such proposals easily available to the public, including to consumers and businesses and to insurers and other financial service providers; (2) invite comment on the proposals; (3)***

allow sufficient time for interested parties to provide comment; (4) provide justifications for decisions to accept and reject comments; and (5) establish and communicate a fair process by which decisions considered arbitrary or unjust can be challenged.

Although impressive gains in transparency have been made in many markets, others continue to draw criticism internationally. Close relationships between government and established insurers are inconsistent with the ideal of transparency. Transparency implies that regulators maintain an arms-length relationship with all insurers and that some insurers do not gain an unfair advantage through privileged associations with regulators.

CONCLUSION

The internationalization of financial services promises to continue. Some observers express concern about the competitive model, given the recent economic turmoil experienced in several countries. Competition itself did not cause the difficulties. Rather, the lack of certain government rules and policies inhibited truly transparent, competitive markets, making a bad situation much worse. It has been argued that greater market access and involvement by foreign financial services firms would have lessened the adverse economic effects. The lesson for governments is to craft laws and enforce regulations that promote more transparent markets supported by fair competition unfettered by government direction, favoritism, and unwarranted interference.

Competitive insurance markets serve each country's interest. Governments that deny their citizens and businesses such markets lessen consumer choice and value and needlessly hinder national economic development.