

Insurance sector reform has become one of the most contentious issues in India's economic reform process. Unlike in the banking sector ... the insurance sector continues to defy and stall the course of financial reforms in India

Liberalisation of the Insurance Industry: Some Lessons from the US experience

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Abstract

While no aspect of the reform process in India has gone smoothly since its inception in 1991, no individual initiative has stirred the proverbial hornets' nest as much as the proposal to liberalise the country's insurance industry. However, the political debate that followed the submission of the report by the Malhotra Committee has presumably come to an end with the ratification of the Insurance Regulatory Authority (IRA) Bill both by the central Cabinet and the standing committee on finance. The new Parliament is expected to ratify the Bill by the end of the calendar year. Hence, it is time to initiate a new debate about the future of the insurance industry in India, one shorn of political rhetoric and jingoism. In order to facilitate such a debate, the paper examines the experience of the US insurance industry during 1970s and 1980s. It traces the evolution of the life insurance companies in the US from firms underwriting plain vanilla insurance contracts to those selling sophisticated investment contracts bundled with insurance products. In this context, it brings into focus the importance of portfolio management in the insurance business, and the nature and impact of portfolio related regulations on the asset quality of the insurance companies. The paper also highlights the experience of the US insurance companies with respect to the other important determinant of profitability, namely, cost management. In the process, it provides a rationale for the increased automatisisation of insurance companies, and the increased emphasis on agent-independent marketing strategies for their products. Further, while acknowledging the need for regulations, the paper draws our attention to the fact that regulations can be influenced by political agendas. If politicised, regulations have potential to adversely affect the pricing of risks, especially in the non-life industry, and hence the viability of the insurance companies. Finally, the paper uses the backdrop of US experience to provide some pointers for Indian policymakers.

Introduction

Insurance sector reform has become one of the most contentious issues in India's economic reform process. Unlike in the banking sector, which has seen both greater competition and a better regulatory framework since the submission of the report by the first Narasimham Committee in 1992, the insurance sector continues to defy and stall the course of financial reforms in India. It continues to be dominated by the two hedgemons, Life Insurance Corporation of India (LIC) and the General Insurance Corporation of India (GIC), and is marked by the absence of a credible regulatory authority.

The first sign of government concern about the state of the insurance industry was revealed in the early nineties, when an expert committee was set up under the chairmanship of late R.N.Malhotra. The Malhotra

Committee, which submitted its report in January 1994, made some far-reaching recommendations which, if implemented, could change the structure of the insurance industry. The Committee urged the insurance companies to abstain from indiscriminate recruitment of agents, and stressed on the desirability of better training facilities, and a closer link between the emolument of the agents and the management and the quantity and quality of business growth. It also emphasised the need for a more dynamic management of the portfolios of these companies, and proposed that a greater fraction of the funds available with the insurance companies be invested in non-government securities. But, most importantly, the Committee recommended that the insurance industry be opened up to private firms, subject to the conditions that a private insurer should have a minimum paid up capital of Rs. 100 crore, and that the promoter's stake in the otherwise widely held company should not be less than 26 per cent and not more than 40 per cent. Finally, the Committee proposed that the liberalised insurance industry be regulated by an autonomous and financially independent regulatory authority like the Securities and Exchange Board of India (SEBI).

Subsequent to the submission of its report by the Malhotra Committee, there were several abortive attempts to introduce the Insurance Regulatory Authority (IRA) Bill in the Parliament. While several political parties were against the very idea of allowing private firms to enter the insurance industry, others were unsure about the extent of the stake that foreign investors/firms should be allowed to have in the post-liberalisation insurance companies. However, it was evident that there was broad support in favour of liberalisation of the industry, and that the bone of contention was essentially the stake that foreign entities was to be allowed in the Indian insurance companies. In November 1998, the central Cabinet approved the Bill which envisaged a ceiling of 40 per cent for non-Indian stakeholders: 26 per cent for foreign collaborators of Indian promoters, and 14 per cent for non-resident Indians (NRIs), overseas corporate bodies (OCBs) and foreign institutional investors (FIIs). However, in view of the widespread resentment about the 40 per cent ceiling among political parties, the Bill was referred to the standing committee on finance. The committee has since recommended that each private company be allowed to enter only one of the three areas of business—life insurance, general or non-life insurance, and reinsurance—and that the overall ceiling for foreign stakeholders in these companies be lowered to 26 per cent from the proposed 40 per cent. The committee has also recommended that the minimum paid up share capital of the new insurance companies be raised to Rs. 200 crore, double the amount proposed by the Malhotra Committee. The redrafted Bill, which was scheduled to be introduced in the Parliament during the budget session of 1999, is yet to see the light of the day.

The liberalisation of the insurance industry in India has thus emerged as the litmus test for the ability and the willingness of a central government to push through market friendly economic reforms. At the same time, the government's action in this sphere of economic activity is being viewed by some others as the indicator of the extent to which the govern-

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ment is willing to accommodate the dictates of the International Monetary Fund and the United States. The consequence has been politicisation of the reform of the insurance sector, and analyses of possible post-liberalisation scenarios have given way to jingoism and doublespeak.

The insurance industry is a key component of the financial infrastructure of an economy, and its viability and strengths have far reaching consequences for not only its money and capital markets,¹ but also for its real sector. For example, if households are unable to hedge their potential losses of wealth, assets and labour and non-labour endowments with insurance contracts, many or all of them will have to save much more to provide for events that might occur in the future, events that would be inimical to their interests. If a significant proportion of the households behave in such a fashion, the growth of demand for industrial products would be adversely affected, thereby reining in industrial and GDP growth. Similarly, if firms are unable to hedge against “bad” events like fire and on-the-job injury of a large number of labourers, the expected payoffs from a number of their projects, after factoring in the expected losses on account of such “bad” events, might be negative. In such an event, the private investment would be adversely affected, and certain potentially hazardous activities like mining and freight transfers might not attract any private investment. It is not surprising, therefore, that economists have long argued that insurance facility is necessary to ensure the *completeness* of a market.

However, while insurance companies provide hedging opportunities to households and the corporate sector by selling them *de facto* American “put” options that can be exercised in the event of a calamity, they themselves remain vulnerable to risks that are associated with risk management. Further, owing to changes in the nature of their products, they are increasingly becoming vulnerable to the risk that is usually associated with banks and non-bank financial intermediaries, namely, mismatch of assets and liabilities. While not a significant amount has been written about the experiences of the emerging markets, the US experience suggests that even in a developed financial markets with provisions for supervision, insurance companies can become insolvent and/or face runs. Since the viability of insurance companies is a necessary condition for the emergence of a robust insurance industry, it would be imprudent to ignore the impact that market forces might have on the aforesaid viability.

This paper will trace, in brief, the experience of the US insurance industry over the decades. First, it will introduce the readers to the organisational forms that dominate the structures of the life and non-life insurance companies. Next, it will highlight the factors that most affect the health of these companies, and the role that regulations might play in determining the eventual outcome. Finally, in the light of the above discussion, it will

¹ The potential impact of the asset flows generated by insurance companies on the capital market of a country is significant. For example, by the end of the eighties, the US life insurance companies’ annual support to the American capital and credit markets amounted to USD 98 billion, i.e., about 16 per cent of the total funds annually injected into the capital market, second only to the 27 per cent share of the commercial banks.

provide a backdrop for a more meaningful discussion about the liberalisation of the insurance sector in India.

Organisational Structures and Their Implications

Insurance companies can be broadly divided into four categories: stock companies, mutual companies, reciprocal exchanges, and Lloyd's companies.² The former two are the dominant forms of organisational structures in the US insurance industry.³ A stock company is one that initially raises capital by issue of shares, like a bank or a non-bank financial institution, and subsequently generates more funds for investment by selling insurance contracts to policyholders. In other words, there are three sets of stakeholders in a stock insurance company, namely, the shareholders, the managers and the policyholders. A mutual company, on the other hand, raises funds only by selling policies such that the policyholders are also part owners of the companies. Hence, a mutual company has only two groups of stakeholders, namely, the policyholder cum part owners and the managers.

As in any organisation, the objectives of the owners, managers and policyholders are significantly different, giving rise to conflicts of interest or *agency problems* (Jensen and Meckling, 1976).⁴ Specifically, owners and managers are often more keen to undertake risky activities than are the policyholders, largely because the former have limited liability such that, in the event of an unfavourable outcome, the policyholders will have to bear the lion's share of the loss. However, it is unlikely that in a company the risk appetite of the owners and the managers will be similar, and this provides the owners with a rationale to monitor the managers.⁵

In principle, both the shareholders in a stock company and the policyholder-owners in a mutual company have it in their interest to monitor the managers. But whereas stockholders can exit a company easily by selling its shares in the secondary market, thereby paving the way for a

² Reciprocal exchanges facilitate risk sharing by individuals by way of exchange of insurance guarantees. In other words, given that an insurance contract closely resembles an American put option, a reciprocal exchange works like a self regulated options exchange where each put option held by an exchange member is written by some other member of the exchange. A Lloyd's company, on the other hand, allows facilitates hedging against risks by allowing a risk to be parcelled out among the participating individuals. The underlying principle of such risk sharing is the same as that of a group of merchant bankers underwriting a large debt floatation of a client by way of syndication.

³ At the end of 1990, the mutual companies owned about half the assets of the US insurance industry (Wright, 1991). However, the share of assets held by the stock companies has risen since.

⁴ Fama and Jensen (1983) argue that an understanding of the nature of a set of agency relationships is extremely important when contracting is costly. This is because in a competitive market a firm can survive in the long run only if it can convert inputs to output at the lowest possible cost, and the organisational structure of a firm is an important determinant of the cost.

⁵ Moreover, the risk appetite of owners themselves might differ significantly across firms. For example, for the policyholder-owners of mutual companies, some of the expected gains from risky ventures are offset by the expected losses to the policyholders. However, the owners of stock companies do not face the possibility of such a "crowding out" of possible gains. Hence, the owners of stock companies are likely to have a greater appetite for risk compared to the policyholder-owners of mutual companies.

While a stock company has three sets of stockholders—shareholders, managers and policyholders, a mutual company has only two—the policyholder and the manager

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take-over, the policyholder-owners find it more difficult to exit because they then have to incur the informational cost of associating themselves with another (viable) company. In other words, the threat of exit by owners, and the associated threat of overhaul of the incumbent management by the new owners, is more credible for stock insurance companies than for mutual insurance companies. Hence, policyholder-owners of mutual companies are likely to allow the managers of these companies less operational flexibility than the flexibility of the managers in stock insurance companies. As a consequence, the mutual insurance companies are likely to be more conservative with respect to risk taking than the stock companies.⁶

Alternatively, if an insurance company writes lines of business that do not require a significant amount of managerial discretion, then it might be profitable for the company to adopt the mutual ownership structure and thereby eliminate the agency conflicts that can potentially arise between the owners and the policyholders. For example, if a life insurance company writes only straight life policies that do not have an investment component, then the company will not require debt treasury/portfolio management on a day-to-day basis. It can simply invest the collected premium in government bonds, highly rated corporate securities, and blue chip equities, and manage actuarial risk through risk-pooling. In other words, the discretion required on the part of its managers to efficiently run the company is minimal. Hence, it will be efficient for such a company to adopt the mutual ownership structure and concentrate on protecting the interests of its policyholder-owners.

The Role of Portfolio Management

Portfolio and asset-liability management are important for both life and property-liability insurance companies. However, the latter face the problem that their liabilities are far more unpredictable than the liabilities of the life insurance companies. For example, given a stable mortality table and other historical data, it is easier to predict the approximate number of death claims, than the approximate number of claims on account of car accidents and fire.⁷ As a consequence of such uncertainty, and perhaps also moral hazard stemming from reinsurance facilities, asset-liability management of property-liability companies in the US has left much to be desired. Indeed, empirical research has suggested that risk on account of interest rate exposure is the strongest and the most consistent predictor of insolvency among such companies (Cook and Cummins, 1996). Hence, a meaningful discussion about the changing nature and role of portfolio management for

⁶ This postulated pattern of managerial behaviour is known as the "management discretion hypothesis" or the Myers-Smith hypothesis. Empirical research has indicated that the cash flows of stock companies are more volatile than stock flows of mutual companies, and that the former write more policies in riskier states than the latter (Gardner and Grace, 1995).

⁷ However, according to Moody's Investor Services, deviations between assumed and actual mortality experiences are increasingly becoming evident in the US, as also in the rest of the world. This has added to the importance attached to portfolio management in the life insurance industry.

US's insurance companies is possible only in the context of the experience of its life insurance companies.

Although the role of an insurance policy is significantly different from that of investments, economic agents like households have increasingly viewed insurance contracts as a part of their investment portfolio. This change in perception has not affected much the status of the property-liability or non-life insurance policies, which are still viewed as plain vanilla insurance contracts that can be used to hedge against unforeseen calamities. However, the perception about life insurance contracts has perhaps been irrevocably altered, and it has changed the nature of fund management of insurance companies significantly, forcing them to move away from passive portfolio management to active asset-liability management. The evolution of the portfolio and fund management in life insurance companies can be best understood in the light of the experience of the US life insurance industry.

The change in perception of the households became apparent during the 1950s, when stock prices rose sharply in the US. Given the steep increase in the opportunity cost of funds, households shied away from whole life insurance products and opted for term life insurance policies.⁸ During the earlier part of a policyholder's life, the premium for a term insurance policy is lower than the premium for a whole life policy. Hence it was in a (young) household's interest to opt for term insurance, and invest the difference between the whole life premium and term life premium in the equity market. As a consequence, the life insurance companies were forced to think about development of new products that could give the investors returns commensurate with the gains in the stock market. An example of such a product is the variable annuity plan which came into existence during the early sixties.⁹

However, while the fifties gave the insurance companies an indication of the increasing demand for insurance products returns from which

⁸ Whole life policies require policyholders to periodically pay flat premia during the life of the policies. During the early part of a policyholder's life, the premium is higher than the "fair" premium that can be associated with his/her probability of death. However, this is compensated during the latter part of the policyholder's life when the actuarial risk associated with the policy increases substantially. Typically, the reserves backing whole life policies are substantial, and hence the policies are bundled with cash surrender values and loan privileges. On the other hand, term life policies are offered for a fixed number of years. The premium for a term life policy is fixed during each "term" but increases during renewal, the extent of the increase being dependent on the age of the policyholder. Term insurance is managed on the basis of the pay-as-you-go principle, and does not require buildup of substantial amount of reserves.

⁹ The launch of this product was facilitated by successful lobbying which resulted in an increase in the cap on equity investments of life insurance companies from 3 per cent to 5 per cent in 1957. The cap was further raised to 10 per cent in 1969. However, the increase in the value of the cap did not help the insurance companies significantly because pension funds could dedicate 100 per cent of their funds in equity. Hence, the insurance companies lobbied further to legitimise the use of "separate accounts," whose composition was not constrained by the rules governing the composition of the "general account." But the funds placed in the separate accounts were not backed by the capital and reserves of the insurance companies, and the market and other risks were borne by the contract holders.

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were competitive vis a vis the returns from pure investment products, the full impact of this changing demand pattern was not evident till the late sixties. During 1966, the market interest rates rose significantly,¹⁰ but the interest rates on policy loans remained fixed by law at 5-6 per cent. As a consequence, there was a surge in the demand for policy loans, and about 14 per cent of investible cash inflow was drained off by such loans. The drain during a normal year was about 4 per cent. The problem became even more acute during 1969 when rising inflation pushed up market interest rates once again. The drain off during the second half of the year was 20 per cent, and it remained above 14 per cent for six consecutive quarters. The problem resurfaced during 1979-81 when financial deregulation and double digit inflation led to interest rate spikes and raised the prospects of sustained financial instability.

The immediate impact of the financial volatility on portfolio or asset-liability management came by way of a change in the design of the life insurance products. The insurance companies started offering universal life, variable life, and flexible premium-variable life products. These policies bundled insurance coverage with investment opportunities, and allowed policy-holders to choose the amount of their annual premium and/or the nature of the portfolio into which the premium would be invested. Most of these contracts carried guaranteed minimum death benefits, but returns over and above that were determined by the inflow of premia and the subsequent investment experience. Some of the policies could also be forced into expiration if the aforementioned inflow and experience fell below some critical minimum levels. Further, policy loans were offered only at variable rates of interest. In other words, the policyholders were increasingly co-opted into sharing market and interest rate risks with the insurance companies.

As a consequence of these changes, which brought about a bundling of insurance and investment products, portfolio management of life insurance companies today is similar to that of a bank or non-bank financial company. They have to (i) look out for arbitrage opportunities in the market place both across markets and over time, (ii) use value-at-risk modelling to ensure that their reserves are adequate to absorb market related shocks, (iii) ensure that there is no mismatch of *duration* between their assets and liabilities, and (iv) ensure that the risk-return trade-off of their portfolios remain at an acceptable level.¹¹ During the 1980s, the life insurance companies gradually reduced the duration of the fixed income securities in

¹⁰ The yield on one-year T-bills, for example, rose by about 180 basis points over its 1962 level of 3.2 per cent.

¹¹ It should be noted that the management of fixed income securities, which constitute a significant part of an insurance company's portfolio is in its infancy in India. Many of the deals are struck over the telephone, and in this "telephone" market appropriate pricing of the securities come at a premium. Even otherwise, bonds are selected on the basis of their yields-to-maturity, rather than on the basis of the more appropriate option-adjusted spreads. Further, if a bond has an embedded call option, the yield-to-call of the security is used for making trading decisions, and the probability adjusted cash flows subsequent to the call's strike date are ignored.

their portfolio, thereby ensuring greater liquidity for their assets. They also moved away from long-term and privately placed debt instruments and increasingly invested in exchange traded financial paper, including mortgage-backed securities.¹² However, while the increased liquidity of their portfolios reduced their risk profiles, they also required active management of these portfolios in accordance with the changing liability structures and market conditions. Today, while life insurance companies compete for market share by changing the nature and structure of their products, their viability is critically dependent on the quality of their portfolio and asset-liability management.

Implications of Cost Management

As is the case with most competitive industries, profitability and viability of a firm in the insurance industry significantly depends on its market share, and its ability to minimise its cost of operations without compromising the quality of its service and risk management. Perhaps the easiest way to reduce cost is to reduce the cost of processing and underwriting policy applications. In the US, the average cost of processing and underwriting an application has been estimated to be in excess of USD 250. As a consequence, insurance companies have increasingly resorted to replacement of personnel by computer-based “expert” systems which apply the vetting models used by the companies’ (human) experts to a wide range of problems.¹³

However, the US companies have found it more difficult to reduce their cost of marketing and distribution. This, indeed, is a major challenge confronting these companies because about two-thirds to three-fourths of a company’s annual expenses are on account of distribution.¹⁴ A significant part of these expenses accrue on account of the commissions paid to exclusive and/or independent agents, the usual rate of commission being 15-30 per cent, depending on the line of business. As such, independent agents have greater bargaining power than the exclusive agents because they “own” the insurance contracts held by the policyholders, and can switch from one insurance company to another at will. These agents also benefit from the perception that, as outsiders having bargaining power vis-à-vis the insurance companies, they will be able to ensure better service for the

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¹² Cook and Cummins (1996) have argued that the increased investment in mortgage backed securities have increased the risk of pre-payment and/or extension of payments, especially in an environment of volatile interest rates. If pre-payments and extensions occur, they might lead to asset-liability mismatch by way of changes in the pattern of cash inflows.

¹³ A Coopers & Lybrand survey indicated that about 100 mid-tier companies were in the process of implementing expert systems. At the same time, large companies like Cigna, ITT Corp and Royal Insurance reduced their combined staff strength by about 1600.

¹⁴ Marketing costs also absorb a significant part of the insurance premia collected by the property liability insurers. The industry’s average on this account was 17.2 per cent in 1991.

The insurance industry in the US has historically been one of the most regulated financial industries. Regulation of the life business has typically emphasised asset quality, while the regulation of the property liability business has largely concerned itself with policyholder's "welfare"

policyholders (Cummins and Weiss, 1991).

The agent-distribution related cost problem is more acute for property-liability companies than for life insurance companies because the former are unable to compete for market share significantly by way of product differentiation. Indeed, they are largely dependent on the marketing capabilities of their agents. On the other hand, life insurance companies, which bundle investment products with insurance products, are able to differentiate themselves from each other by varying the nature of the bundled products. Moreover, life companies are less vulnerable to the threat of agents switching loyalties, because unlike the property-liability insurance companies, they enter into long-term contracts with the policyholders.

In order to mitigate the cost-related problem, insurance companies in the US are increasingly looking at alternative ways to market and distribute their products. Direct marketing has gained popularity, as has marketing by way of selling insurance products through other financial organisations like banks and brokers. These actions might lead to significant reduction of cost of operations of insurance companies, but it is not obvious as yet as to how the small policyholders will fare in the absence of powerful intermediaries with bargaining power vis-à-vis the insurance companies.

The Impact of Regulation

While portfolio and cost management are important determinants of the viability of insurance companies, the US experience indicates that the nature and extent of regulation too plays a key role in determining the viability of these companies. The insurance industry in the US has historically been one of the most regulated financial industries. The nature of regulation of life insurance companies, however, has differed significantly from the nature of regulation of property-liability companies. Regulation of the former has typically emphasised asset quality, while the regulation of the latter has largely concerned itself with policyholder's "welfare."

Although the regulations governing asset quality of American life insurance companies vary across the states, often the regulations of New York State act as the binding set of regulations. The attraction of the New York insurance market is its large size, and in order to sell policies in that state an insurance company has to "comply in substance" with New York's laws and regulations, even if it is domiciled in some other state. Indeed, New York's insurance regulatory laws have had significant effect on the portfolio composition of the life insurance companies.

The aforementioned regulations have restricted investment in equities¹⁵ and mortgages¹⁶ which are perceived to be high risk-high gain financial securities (see footnote 8). As mentioned above, life insurance

¹⁵ As of 1990, only 3 per cent of the outstanding stock of equities in the US market was held by the life insurance companies.

¹⁶ The loan-to-value ratio for mortgages is 75 per cent, but the insurance

companies were able to circumvent the problem by introducing “separate accounts,” initially only for group pension plans and later also for individual plans. However, equities and other high risk-high return assets still account for a small part of the industry’s asset portfolio. At the end of 1990, separate accounts accounted for USD 160 billion, i.e., about 11 per cent of the industry’s assets. Of this, less than half was held in the form of equities, and the rest in the form of bonds, mortgages, real estate and other assets.

The regulations of New York and other states have also had impact on the quality of bonds held by the life insurance companies. New York’s insurance regulatory laws require that life insurance companies ensure that, for all bonds purchased by them, the companies issuing the bonds have had enough earnings to meet debt obligations for the previous five years. The bond-issuing companies are also required to have net earnings 25 per cent in excess of the annual fixed charges, and they should not be in default with respect to either principal or interest payments. Further, regulation of various states impose quantitative restrictions on the amount of “risky” bonds that can be purchased by the insurance companies. For example, in June 1987, New York imposed a 20 per cent limit on the high-risk bonds issued by companies for financing leveraged buyouts. In June 1991, this regulation was extended to all private placements and medium grade bonds and, effective 1992, “inside limits” of 10 per cent, 3 per cent and 1 per cent were imposed on three categories of low-grade bonds.

Finally, regulations of all states subject the life insurance asset portfolios to the Mandatory Security Valuation Reserve (MSVR) requirement. According to this requirement, which came into effect in June 1990, life insurance companies are required to make mandatory provisions for all corporate securities. The minimum provisioning, for A-rated and higher quality bonds, is 0.1 per cent of par value, and the maximum provisioning of 5 per cent is required for Caa-rated (or equivalent) and lower quality bonds. If the issuer of a bond goes into default, the relevant loss is adjusted against the MSVR account rather than against the company’s surplus.

The consequence of these regulations has been a significant increase in the life insurance companies’ appetite for government securities, securities issued by government agencies, and mortgage-backed securities. Indeed, the proportion of assets held in the form of government securities increased significantly from less than 3 per cent in 1977 to about 12.8 per cent in 1990, and these treasury securities accounted for 24 per cent of the industry’s bond portfolio. At the same time, at the end of 1990, the insurance companies held only 6 per cent of their general accounts in the form of “junk” bonds (rated B or lower). The total junk bond exposure of the life insurance industry stood at about USD 60-70 billion, about 5 per cent of the industry’s total asset base.

companies are allowed some flexibility by way of “leeway clauses” which allow these companies to invest a certain percentage of their funds in assets that are not otherwise specified in the regulations. As such, all mortgage related investments in excess of the 75 per cent barrier are spilled over into “leeway accounts.” The percentage of assets that can be held in these accounts was 2 per cent in 1958 and was raised to 10 per cent by 1990.

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The life insurance industry has clearly benefited from the regulatory restrictions imposed upon it by the state governments. The regulations have protected their asset quality and, at the same time, they have been accorded some flexibility and opportunities for yield enhancement in the form of “separate accounts” The experience of the property-liability insurance industry, on the other hand, is mixed at best. Political correctness on the part of the states’ lawmakers have led to regulation of premia on workers’ compensation and auto insurance policies in a large number of states.¹⁷ Their actions find support from a section of the literature on insurance markets which argues that insurance companies indulge in retroactive loss loading, thereby passing on the cost of their past errors to the policyholders. Thus vindicated, state legislative bodies also make it difficult for insurance companies to exit the markets for the politicised “lines,” even if the companies feel that they are not earning a fair rate of return in these markets.¹⁸ Often, an insurance company is forced to write policies in unprofitable lines of business, in order to retain the right to write policies in other lines of business.

Further, the non-life industry has suffered significantly as a consequence of changing legal ethos. In the recent past, the US courts have retroactively granted citizen-policyholders coverage against hazards, like those from use of asbestos, that were not factored into the actual insurance contract. As a consequence, the premia actually earned by the property-liability companies fell short of the “fair” prices of these contracts, and hence these companies had to bear huge losses on account of these policies.¹⁹

However, while politics and changing ethos might together have dealt an unfair blow to the non-life insurance companies, the importance of regulation cannot be overemphasised. The cyclical nature of the property-liability firms’ profitability requires that they be monitored/regulated such that they are not in default during the unfavourable phases of the cycle. The property-liability cycle is typically initiated by an exogenous shock which increases the industry’s profits. The higher profits enable the companies to underwrite more policies at a lower price. During this phase, the insurance market is believed to be “soft.” The decrease in price during the

¹⁷ Political correctness was stretched to its limits in California where the citizen-policyholders were asked to express their opinions as to whether or not the auto insurance rates were too high. Proposition 103, which sought to roll back the rates, was passed with a significant majority. The legal status of this controversial “rate rollback” proposition is as yet unclear.

¹⁸ Empirical evidence (Grace and Barth, undated) suggests that the internal rates of return (IRRs) were high for the six major lines of business during the early 1980s. The IRRs fell sharply during the crisis years of 1984 and 1985. Thereafter, the IRRs rose again for general liability and commercial multi-peril insurance policies. However, the IRR for workers’ compensation remained low, and that for private automobile declined even further.

¹⁹ Note that while other economic agents in an economy can hedge against unforeseen circumstances by simply insuring themselves, the very nature of the insurance industry makes insurance companies *manage* risk through risk-pooling and appropriate pricing of risk. If, therefore, regulations prevent insurance companies from pricing risks appropriately, these companies remain vulnerable to significant financial losses.

soft phase, in turn, reduces the profitability of the companies, and initiates the downturn in the cycle leading to the “hard” phase. Hard markets are characterised by higher prices and reduced volumes. Once the higher prices restore the industry’s profitability, the market softens again and the cycle starts again.

In order to prevent widespread insolvency among property-liability companies, presumably during the soft phases, the National Association of Insurance Commissioners (NAIC) evaluates the financial condition of each property-liability company annually, using 11 financial ratios. If a company fails to meet the minimum acceptable mark for 4 or more of these ratios then they are singled out for special regulatory scrutiny. As a consequence, the asset quality of property-liability companies has not been significantly affected by proliferation of risky assets like junk bonds. Indeed, as of 1989, junk bonds represented only 1.5 per cent of the industry’s bond portfolio or 3.4 per cent of its equity. It has been argued that the property-liability insurance industry in the US is much more vulnerable to fraud and non-treasury related mismanagement than insolvency/bankruptcy on account of bad assets. During the late 1980s, for example, many of the large multi-state insolvencies were a consequence of the refusal by reinsurers to honour reinsurance contracts on grounds of fraudulent activities on the part of the ceding companies.

Summing up: Pointers for Indian Policymakers

A significant part of the activities of the insurance industry of an economy entails mobilisation of domestic savings and its subsequent disbursement to investors. At the same time, however, they guarantee minimum payoffs to both individuals and companies by way of the put-like insurance contracts. As discussed above, these contracts can significantly affect behaviour of economic agents and, in general, are perceived to lead to better outcomes/equilibria for economies. Herein lies the importance of the viability of insurance companies: insolvency/bankruptcy of an insurance company can be fast transformed into a systemic problem in two different ways. The part of the systemic crisis that can be attributed to the quasi-bank like function of a section of the insurance industry is easily understood. However, even if an insurance company does not default on its credit and investment related obligations, and merely reneges on its insurance obligations, the adverse impact of such default on the economy and the society at large can be quite devastating. For example, it is not difficult to imagine the closure of a company that had not made provisions for damages on account of (say) product related liability because it had believed that it was protected from such damages by an insurance policy.²⁰ The consequent insol-

²⁰ Suppose that Oil India Limited has taken out an insurance policy from GIC, covering itself against all claims arising out of oil spills. If now GIC becomes insolvent and, at the same time, OIL requires cash flows from the insurance company to meet spill-related expenditure then OIL will be in serious financial trouble. If OIL becomes insolvent in the process, then all of OIL’s creditors and suppliers will be in trouble, thereby precipitating a systemic crisis.

The property-liability cycle is typically initiated by an exogenous shock which increases industry’s profits. Higher profits enable companies to underwrite more policies at lower prices . . . the decrease in price during the soft phase, in turn, reduces profitability of companies, and initiates the downturn in the cycle leading to the “hard” phase

... decisions about what constitutes acceptable portfolio quality, and the extent of price regulation hold the key to insurance regulation in a post-liberalisation insurance market

While a part of US insurance companies portfolio comprise of equity, mortgages and other relatively risky securities, much of their portfolio is made up of bonds and liquid (and highly rated) mortgage backed securities

veny of the company can affect a number of banks and other companies adversely, and a systemic problem will be precipitated. In other words, the insurance industry in any country should be subjected to regulations that are at least as stringent as, and perhaps more stringent than those governing the activities of other financial organisations.

It is evident from the above discussion that decisions about what constitutes acceptable portfolio quality, and the extent of price regulation hold the key to insurance regulation in a post-liberalisation insurance market. As the US experience suggests, insurance companies are usually subjected to stringent asset quality norms. Indeed, while a part of their portfolio might comprise of equity, mortgages and other relatively risky securities, much of their portfolio is made up of bonds and liquid (and highly rated) mortgage backed securities. An Indian insurance company, on the other hand, is constrained by the fact that the market for fixed income securities is very illiquid such that only gilts and AAA and AA+ rated corporate bonds have liquid markets. At the same time, absence of a market for liquid mortgage backed securities denies these companies the opportunity to enhance the yield on their investment without significantly adding to portfolio risk. This might not pose a problem in the absence of competition, especially if the government helps to increase the returns to the policyholders by way of tax breaks, but might pose a serious problem if liberalisation leads to “price” competition among a large number of insurance companies.

It might be argued that if the insurance and pension fund industries are liberalised, and if the fund managers of all these companies indulge in active portfolio management, the liquidity of the bond market will increase significantly. Such increase in liquidity across the board would enable the fund managers to invest in investment grade bonds of lower rating and thereby add to the average yield of their investment without adding significantly to their portfolio risk. The problem, however, is that till the imperfect character of the bond market is removed to a significant extent, the insurance companies might either have to operate with thinner margins or remain exposed to unacceptably high levels of liquidity risk. It might, therefore, be prudent for the policymakers to impose stringent capital and reserve norms on the insurance companies, in order to ensure their viability in the short to medium run.²¹

Subsequent to liberalisation, the Indian insurance industry might also be at the receiving end of regulations governing insurance prices/premia. Specifically, there might be highly politicised interventions in the

²¹ Note that while an insurance guaranty fund might be necessary to ensure policyholders' confidence in the insurance companies, such a fund might lead to greater risk taking on the part of the management of the insurance companies. The magnitude of the risk is likely to decrease with increase(s) in the size of the insurance company, the stake of the management in a company, and the franchise value of the company (Brewer, Mondschean and Strahan, 1996). This problem, the genesis of which is said to be moral hazard on the part of the saver-policyholders, is common to all financial institutions.

markets for workers' compensation and medical insurance. The government might also be under pressure to "regulate" the prices of infrastructure related lines like freight and marine insurance. In principle, the risks associated with such liability insurance policies may be hedged by way of reinsurance. But if the reinsurers price the risks accurately and the Indian insurance companies are forced to underprice the risks, the margins of the insurance companies will be affected adversely, thereby reducing their long-term viability. In view of these political and financial realities, it might be better to subsidise the policyholders of politically sensitive lines directly or indirectly through tax benefits, if at all, rather than distort the pricing of the risks themselves.

At the end of the day, it has to be realised that while competition enhances the efficiency of market participants, the process of "creative destruction," which ensures the sustenance and enhancement of efficiency, is not strictly applicable to the financial markets. Hence, while exit is perhaps the most efficient option for insolvent firms in many markets, insolvency of financial intermediaries calls for government action and usually affects the governments' budgetary positions adversely. At the same time, other things remaining the same, the risk of insolvency is perhaps higher for insurance companies than for other financial intermediaries because of the option-like nature of their liabilities. Therefore, competition in the insurance industry has to be tempered with appropriate prudential norms, regular monitoring and other regulations, thereby making the robustness of the industry (in India) critically dependent on the organisation (and efficiency) of and regulatory powers accorded to the proposed Insurance Regulatory Authority. Preventing a malady, as conventional wisdom goes, is better than trying to cure it once the disease has set in.

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