International Symposium

Enhancing Life Insurance Regulatory Regimes in ASIA

Multilateral agencies and regulatory changes in life insurance and pension systems – the World Bank perspective

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Introduction and Overview

The topic of this symposium is “Enhancing Life Insurance Regulatory Regimes in Asia”. There is an implicit assumption in such wording that we are looking at an incremental effort, an improvement of something which is already in place and working. For a number of countries in Asia this could hardly be further from the reality we are facing today.

At least two of the main Asian life insurance markets are suffering from systemically insolvency. Even where assets appear to exceed liabilities, solvency levels are often well below what industrial countries would consider to be adequate for ongoing non intervened operations, and liquidity levels are often far to low. The genesis of this situation goes back many years, however the 1997 financial crisis has surfaced reality much more rapidly than would otherwise have been the case. Thus, while this gathering is extremely timely I should warn participants that we are facing down a crisis rather than engaging in a pleasant academic dialectic.

My personal view, after seeing many life insurance sectors and their regulatory systems around the world is that we should narrow our attack, and concentrate on solvency as the number one issue for the foreseeable future. The other important issues of licensing, on site supervision and derivatives are already adequately covered by the relevant IAIS standards. For most other issues the IAIS principles will suffice for the time being, the one possible exception being regulatory intervention when life insurers look as if they are going to get into trouble. Market practice issues in particular appeal to industrial country regulators, however they are very much an issue for the longer term in most of the countries in which I work.

I would also argue that the World Bank will need to be closely involved in the drafting of solvency and liability standards. If industrial country actuaries prepare these based on their own backgrounds and experiences they are likely to be inapplicable to many World Bank client countries and we will have no choice but to draft a separate standard for developing countries. Happily the World Bank and the IAIS executive have been engaged for some time in a dialogue and I am sure we will resolve this issue.

Before getting into the details of the World Bank’s involvement however I should explain why I have taken such a strong stance on Life Office regulation.

Issues in Asian Insurance Markets

To illustrate my points I am going to mention the names of some countries today. The fact that I have mentioned a name can be taken as an indication that there

are good people doing their best to solve regulatory challenges in those countries. I certainly do not want to make life harder for them and where possible I will lay out a generic picture of the situation we are facing.

With the exception of Korea, which is only a temporary World Bank client, the life insurance sector is largely underdeveloped in most client countries in Asia. Typically it consists of a few dominant companies, often North American which have been in Asia for many years, and a raft of closely held and smaller local companies. Distribution is invariably through tied agency forces and there are often strong rules against agent poaching. Products tend to be traditional bundled structures such as whole of life and endowment, reflecting underdeveloped capital markets, a very strong savings ethic (particularly for family needs such as education) and limited actuarial resources. What actuaries there are sometimes have low status and actuarial standards are often specified by law. Because net premium valuation methods have often been used, combined with book values for assets, the false perception has arisen that balance sheets are strong and that explicit solvency margins could be held down: they are often to less than one or two percent of liabilities against an international rule of thumb of five percent .

Asset markets in most World Bank client countries in Asia are only just beginning to be developed and whilst the international life companies usually adopt conservative investment strategies it is not uncommon for local companies to be heavily invested in property and equities. These are not always at arms length from the proprietors of the institutions involved.

Aside from specification of actuarial assumptions the regulators usually approve new product designs and release can sometime take months if not years. In addition agency licensing is often centrally monitored, if not controlled.

Life insurers in Asian countries suffer the added burden of being subjected to heavy tax regimes. Income tax is treated as a game rather than an obligation in many developing countries and the authorities tax anything that smacks of wealth accumulation. We should not be overly judgmental in this regard as exactly the same syndrome applied in the early days of the United States.

Another force at work is the conservatism of the central bankers in many Asian countries. The 1997 crisis is seen as a financial construct rather than a macroeconomic problem and central bankers, usually the elite within the public sector, are rightfully concerned about loosening up too much until they are happy that their financial systems are robust. In particular they tend to have a bias to ensuring the banking system is dominant. However as recent events have demonstrated narrow bank based systems are not as resilient as those where capital markets can step in when the banks are under pressure.

Thus we see weak, but overly prescriptive regulatory systems with an unusual coalition of entrenched players, fiscal concerns and central bankers resisting change. This system is increasingly vulnerable and the challenge is to find a sequence of reforms which will free up markets while strengthening the financial system. To emphasize this it is worth describing some of the pathologies which have and continue to emerge.

- The first of these is the emergence of financial systems outside the regulatory system. The pre need industry in the Philippines is a good example. As with the Victorian Friendly Society movement in Australia entrepreneurs were able to take advantage of regulatory arbitrage and grow something which was never intended to be a major savings mechanism, let alone a source of funds for other activities such as property development. The rapid growth of the life insurance system in Korea reflects its transformation into a secondary banking sector in the 1990s. In some countries systemic links exist between the banking system and the secondary system, as happened in this country with the bank finance and merchant banking subsidiaries.

- Another outworking of the current approach is the inhibition of innovation and genuine competition. In practice the entrenched players have sometimes captured the system and have nothing to gain by allowing new players to compete effectively.

- The potential weakness of the traditional actuarial pricing and valuation model used by many of the regulators has also been highlighted post crisis. The usual approach is to prescribe key premium assumptions and to then value according to those assumptions using a net premium approach, possibly with some allowance for initial costs. The lowest minimum discount rate I have seen used is 6% and this appeared to be conservative in the high interest rate environment prior to the crash. This is no longer true and regulatory systems are, if anything, adding to the weakness of life insurance sectors.

The internal pressures on the current system are thus often substantial and growing. These will be added to by a number of exogenous developments including the December 1997 World Trade Organization financial services agreement (FSA) which is due to become effective this year. While little was achieved in terms of banking, the significant emerging market economies did offer significant new access to their insurance sectors. This is being reinforced by the need to develop long term savings for infrastructure development and in some cases opening up has been hastened by the need to recapitalize damaged insurance sectors.

A further emerging concern is the need to develop private sector institutions which can manage the occupational pension, and private pension and provident fund arrangements which are being planned or even implemented in a number of Asian countries. We often find that these come under ministries of labor or the

internal revenue department and there is no concept of prudential management, including enforcement of minimum funding levels, by a separate regulator.

An encouraging development, which I have only recently discerned, is a concern on the part of the actuarial and accounting professions in some countries for their professional reputations. I do not know what is driving this but there is certainly a major international push underway for appropriate levels of governance and transparency and I have to wonder how long some of the big five accounting firms can live with some of the work that is currently being done under their banners. The excuse that partners in different jurisdictions are independent is beginning to wear thin. A further factor may be that we are just beginning to see the emergence of concepts of accountability and liability, and whilst these are mainly derivative actions at present, we will probably see class actions in some countries within the next decade.

As already intimated I am strongly of the view that the best way forward is to emphasize a solvency model of regulation.

Sequencing Life Insurer Regulatory Reform

The development of life insurer prudential regulation can be characterized by a developmental ladder:

Table 1

Prudential egulatory Models

Stage	Characteristics	Regulatory Model
1	Foreign players	Nil except for deposits and tax
2	Local industry starting	Basic contractual definitions, minimum capital, tax, controls on foreign entry
3	Industry growing but closely held or mutual	Basic solvency concepts emerge, actuarial prescription, central approvals, and control of agents, some investment rules including directed investments

4	New entrants, need to innovate, capital markets offering more choices, professions are becoming stronger	EU style solvency model, some easing of regulatory straight jacket but on site supervision is important regulatory tool
5	Rapid product innovation, stock exchange listing, wide asset choice	Move towards self governance model, supported by risk based capital approach to solvency, tax becomes more rational
6	Convergence of financial services sector	Banking concepts such as VAR and stress testing are adopted and a risk based approach to regulation can be taken

While the sequencing may vary from country to country this provides a useful model for the future evolution of life insurer regulation in Asia.

In most cases we are working at levels three and four and the challenge is to get proprietors to accept that they will have to put more capital into their life insurers and that certain assets, particularly non arms length assets, are not acceptable for the determination of solvency. I am sure that many see this as a conspiracy by the West to take over the financial sector and much education is required. The approach we have taken in some jurisdictions is to allow for a gradual phasing in, supported by strong investment guidelines.

I should say at this stage that there are two philosophies extant at the moment and the one that applies tends to reflect whether the World Bank or ADB is advising the government concerned. The ADB takes the view that it is better to engender familiarity with risk based capital concepts earlier rather than later, even if this means the EU approach with a few more factors in practice. The World Banks's view to date has been driven by the desire to keep things simple and affordable. However we do point to the need to move to a risk based capital approach at a later date when capital markets are more developed, stronger actuarial and accounting professions have emerged and at least a minimally acceptable solvency regime is in place.

The human resource issue in particular is critical in our view and I have often had this reinforced by colleagues in Asian client countrires.

Human Resource Issues

I have borrowed the following table from a joint diagnostic study of the Korean actuarial profession being carried out by the World Bank and ADB. One of the authors is Bob Glading who is participating in the symposium and the other is a senior Canadian actuary.

Table 2

Actuarial Density

Country	Fully Qualified Actuaries	Life Premiums Billion $	Actuaries per $ billion Premiums	Population ('000)	Actuaries per 1 m pop.
Average			46,8		41,7
Korea	235	46	5,1	45 949	5,1
USA	15 957	316	50,5	265 560	60,1
Japan	1 118	270	4,1	125 860	8,9
France	1 207	93	13,0	58 380	20,7
UK	5 527	87	63,5	58 780	94,0
Germany	1 306	72	18,1	81 880	16,0
Switzerland	298	23	13,0	7 090	42,0
Netherlands	690	20	34,5	15 490	44,5
Italy	173	19	9,1	57 470	3,0
Australia	997	16	62,3	18 290	54,5
Canada	2 197	11	199,7	29 970	73,3

What this demonstrates is a strong correlation between actuarial density and regulatory model. I have not taken out numbers for other client countries however if I tell you there are typically less than twenty western fellows in most countries in which I work and that their populations are usually in excess of 40 million the conclusion becomes clear; overly sophisticated self governance regulatory models are not a viable option. I would also be prepared to bet that there is a significant correlation between actuarial density and life insurer solvency.

If we turn to the accounting profession the situation is usually better however the standards to which auditors have to work are often substantially weaker than

those applying in industrial countries. For example NPL provisioning is often substantially less demanding and the concept of marking to market is usually quite foreign. The concept of the independent professional director is a distant dream for most of our client countries, although under President D. J. Kim, Korea is taking steps in this direction.

Regardless of the human resources available it should be possible to establish a solvency regime which provides some protection to the financial system and individual savers. The ease with which this is accomplished is usually a function of the environment. In some ways it could be argued that those countries which suffered the worst from the crisis will be the luckiest in the long term as they are usually the most prepared to contemplate change. However The World Bank deals with both crisis countries, through its Special Financial operations unit, and those able to contemplate less urgent action, through its regional and country units. These activities are often carried out, both formally and informally, in coordination with other organizations including the IMF, ADB and our private investing arm, the International Finance Corporation (IFC).

The Role of the World Bank Group

The World Bank is a bank, and its profits come mainly from lending activities, which benefit from sovereign guarantees. Because it can draw on industrial countries for funds the Bank has a AAA rating and is thus a credit transformation mechanism for developing countries, to which it lends at slightly above LIBOR. Financial sector loans are typically either for broad adjustment purposes or are directed at specific technical assistance projects.

The Bank Group's private sector investment arm, IFC is also able to generate capital profits from its equity investments. Asian countries in which IFC has insurance investments include Sri Lanka and Indonesia, with Korea imminent. Other countries in which we are looking at opportunities include China and India, and preliminary overview work has been carried out in Thailand and the Philippines. The combination of detailed due diligence at the company level and high level Bank overview often gives us a unique insight into the insurance sector in client countries.

The Bank and IFC often provide substantial technical support in the course of developing and disbursing loans and investments, often with the support of trust funds which can be used to employ outside consultants. Sometimes work will begin years in advance of any financial support being granted and this is called economic and sector work or ESW.

The Bank's active involvement in the financial sector is however a relatively recent phenomenon. It follows a growing recognition that there is a connection between growth in the real sector and stable financial intermediation. This was

strongly reinforced by the 1997/’98 Asian financial crisis. Prior to this the consensus was that the first priority after establishing the right macroeconomic settings is the construction of a resilient payments and demand deposits system. The remainder of the financial system is then addressed and finally capital flow controls are released. A more sophisticated, context sensitive model is now emerging, however a strong financial system remains a core immediate objective, and this accommodates a broader view than the traditional bank centric approach.

A number of initiatives have been undertaken following the crisis, and one of the most important is the joint FSSA/FSAP program being developed by the World bank and the IMF. This has as its objectives the examination of the vulnerability of member country’s financial systems, the observance of compliance with international standards and the development of recommendations for increasing the efficiency and soundness of the system. The output of these health checks will be appended to the Article Four Reports in the case of the Fund and to the Country Assistance Strategy in the case of the Bank. A number of countries including Canada, Columbia, Lebanon and South Africa have volunteered to be the guinea pigs for this exercise, and all appear to be quite pleased with the results so far.

As the World Bank is the only repository of high level insurance skills in the Bretton Woods institutions it is likely that we will become the main independent observers of compliance with the IAIS principles and standards. In fact the report structure which is developing consists of the country’s own annual self assessment followed by the FSAP missions independent review of compliance. The IAIS secretariat are aware of this development and we are now working to strengthen our coordination. This need for a cooperative approach is reinforced by the fact that the insurance unit in the Bank has been granted funds for the development of standards, and we are particularly concerned with solvency and liability methodologies. A Financial Sector web page is being developed, and insurance is one of the core activities listed. I have no doubt that this will become the clearing house for information for bank client countries and we will be establishing links to key players such as IAIS and IAA, and best practice regulatory sites such as OSFI and APRA.

More recently we have begun to establish closer links with ADB and I am pleased to say that, after a mixed start, we are now beginning to understand each other much better and to seek opportunities to work together. Certainly the level of trust is now at an excellent level in the non bank units and we have no trouble exchanging information.

The involvement with APEC is already established on the banking and securities fronts following the publication of the ‘strengthening training’ reports in April, 1998. Richard Zechter, who chaired both working groups, has already asked me to comment on how this could be extended to the insurance sector and I have no doubt that we will be happy to support any initiatives in this direction. As most

symposium attendees will be aware the Bank played a major role in establishing the Toronto Center, which provides case study based training for Senior Regulators, and an Insurance component will be added in 2000.

Any activities we take in the future will need to allow for the changing strategic objectives of the Bank however, and in particular its growing pre occupation with the question of poverty.

Future Developments

The Financial Sector Vice Presidency of the World Bank is currently developing its strategy statement, following its separation from the Infrastructure and Private Sector Development sectors. This is still very much a work in progress however the outlines are now becoming clear. Our activities will be devoted to three broad objectives within the overriding mission of fighting poverty. These are:

1. *Reducing the vulnerability of financial systems and developing resilience.* The key issue affecting insurance markets under this heading is the prevention of regulatory arbitrage with the banking system and this will inevitably mean some intervention in the regulatory environment.

2. *Increasing financial system efficiency and supporting the role of the financial sector in promoting growth.* The role of the insurance sector as institutional investors is central to its inclusion under this heading, with particular reference to pensions management, provision of life annuities and reduction of national contingent fiscal liabilities.

3. *Facilitating access to key financial services by the poor and by SMEs.* The reference to insurance in this component is likely to concentrate on such poverty reduction activities as natural disasters funding and mitigation and crop insurance.

The main item which is obviously missing from this list is supervision. This does not mean that the Bank will not be monitoring insurance supervision: our involvement in the FSAP/FSSA process will require this in those countries where the insurance sector is seen to have a material role. In addition if a region within the Bank asks for support in strengthening supervision we will try and respond. Insurance supervision will not however be a priority.

I suspect that IFC will go a long way towards taking up the slack. It has a major interest in seeing good governance practices in the countries in which it invests and has already facilitated a considerable amount of technical assistance. The World Bank's insurance unit works very closely with IFC and I suspect we will continue to have an active interest in supervision through this association.

Conclusion

The World Bank has the only significant 'in house' insurance skill base in the Bretton Woods community and amongst most of the development community. This means that we often tend to be the default operators on the ground in many countries, although we use standards and technologies developed by a wide range of professional and governmental entities. For this reason we are most anxious to contribute our practical experience to the various international organizations with an interest in the development of the insurance sector. In particular we have a strong view that solvency and liability standards are a pre requisite for market liberalization in many Asian countries and will be developing appropriate standards. Ideally this will be accomplished as part of a cooperative effort with IAIS and other interested parties.