

# **Enhancing Life Insurance Regulatory Regimes in Asia**

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**Regulatory Arrangements Relating to Pensions  
and Life Insurance**

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Madam Chairperson, Ladies and Gentlemen,

Thank you very much for affording me the opportunity to address this very distinguished gathering. I have heard with keen interest, presentations made yesterday on (i) the emerging life insurance and pension products, (ii) the existing and new regulatory regimes both from a regulators' and participants' perspectives, and (iii) the global and regional challenges thereto. While agreeing generally with the deliberations made thus far, please let me share with you a few thoughts on the Asian Development Bank's (ADB's) perspectives on regulation and supervision of contractual savings.

The ADB's mission has been to promote economic growth and alleviate poverty in its member countries. Sustainable economic growth requires a high rate of savings and investment. A necessary albeit not sufficient condition for continued economic growth is a stable and vibrant financial system that intermediates efficiently between savers and investors. This is a tautology and not a theology. Empirical evidence in East Asia has shown that a problem-ridden financial system can bring about an economic breakdown notwithstanding these countries high domestic savings rates. With relative ease for capital mobility and advances in information technology, an imbalance in one financial market spreads easily as contagion to another. The ADB has played an important role in financial sector adjustment policies in all its developing member countries (DMCs). The magnitude of its intervention was however much higher in countries most affected the East Asian crisis namely Thailand, Indonesia, and Korea. The ADB through its loan and technical assistance programs has sought to improve regulatory oversight and prudential supervision of financial markets. In its holistic approach towards addressing the problems of financial sector, the ADB's assistance has covered not only the banking sector but also other aspects of the medium to long term capital markets namely stock

markets, bond markets, and the contractual savings systems.<sup>1</sup> Life insurance and pension systems form an important core of the contractual savings system.<sup>2</sup> Both these subsectors are therefore important links in the process of financial intermediation. In my presentation, I will first discuss the regulation of life insurance. I will then draw out its generic similarities to funded pension systems and then raise the synergies for harmonizing their regulation.

Life insurance performs an important function for risk planning and channels a large flow of savings into investments through financial and capital markets. Life insurance is an important vehicle for encouraging and mobilizing individual savings calculated on an actuarial basis, to provide for a certain sum of money (the policy) in an uncertain future.<sup>3</sup> It is an instrument for contractual savings, based on an anticipated future value (i.e., the policy claim) from a sum of discounted present values (i.e., the premiums). The rate of premium would of course be determined actuarially, based on life expectancy, present and projected inflation and a plethora of other factors. At the micro-level, these premiums (together with the insurer's investment earnings) should be adequate to cover the insurer's claims and other administrative expenses to provide its shareholders adequate returns. The life insurance premiums collected by insurance companies form an important pool of resources. This is a form of capital formation in the economy *a priori* condition necessary for investment. The profitable investment of such resources is necessary to safeguard the future value of the policyholders' claims. The investment of such funds also provides the necessary capital investment required for economic growth. Life insurance companies therefore play an important financial intermediation function

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<sup>1</sup> As this symposium covers regulation of life insurance and pension, the paper will not dwell on the regulation and supervision of other aspects of the financial system, namely banking, bond markets, equity markets, and other forms of contractual savings.

<sup>2</sup> The contractual savings system encompasses all life and non-life insurance, quasi-insurance products, mutual funds, and pension funds. In consonance with the theme of this seminar, this paper will focus substantially on life insurance and funded pension systems.

<sup>3</sup> Unlike general insurance, which seeks to indemnify its policyholders to the extent of the actual loss suffered or the depreciated value of the insured asset, a life insurance policy is for a specific sum of money.

albeit over a longer duration. Their regulation therefore assumes paramount importance.

The life insurance sector in the ADB's DMCs has been subject to different degrees of regulation ranging from the activist and prescriptive to prudential. In some DMCS, there is a state monopoly on life insurance. This had been justified as an interventionist policy of the state in making insurance policies available to different socio-economic sections of the population. In some countries, the state, as a matter of covert fiscal policy used life insurance as a vehicle for deliberately cross-subsidizing certain deemed vulnerable sections of the populace. Prescriptive guidelines on the permissible investment of life insurance premiums, oftentimes required insurers to invest a substantial portion of their investible funds in low return and low risk government bonds. This was an important trade-off for the insurance companies. This scheme allowed the insurance company relatively low risk investment, while providing the Government with relatively low cost funds to finance its budget. Governments justified this phenomenon as a means of ensuring that contractual savings were invested within a country. If the nominal rate of interest on the government's bonds were lower than the country's annual inflation rate (i.e., negative real interest rates), the (inflation adjusted) value of the policies on their maturities would be far lower in real terms. Prevalence of exchange controls in such countries and restrictions on the activities of foreign life insurers could deny opportunities for the domestic population's other choices.

In some DMCs, the life insurance business was marked by high concentration with a small number of large companies dominating the market, creating an oligopoly. Conversely, in other DMCs, there have also been a large number of small companies competing aggressively but with limited capital adequacy. During the Asian financial crisis, many of such insurance companies faced severe contraction in the value of their portfolios, thereby endangering the interests of their policyholders. In a DMC, life insurance companies began from the mid-1980s

issuing dollar-denominated policies, and charging dollar denominated premiums. However, to comply with the insurance investment regulations of the country, a sizeable portion of premiums had to be invested on-shore in local currency denominated portfolios. This created a currency-mismatch between the insurance companies' assets and their contingent and actual liabilities. The steep depreciation of the local currency against the dollar during the East Asian crisis exacerbated the companies' problems. This is an indication of insurance regulators focussing traditionally merely on the boiler plate of the insurance company's investments. The focus did not extend to lifting the boiler plate to determine the true worth of the investments. From such treatment, one could probably infer that the regulators' attentions focussed on symptoms rather than their underlying causes. It would appear that traditional oversight resulted in overlooking by regulators of the exchange risks of such mismatch. Arguably, there is the need for insurance regulators to critically examine the (risk-based) capital adequacy for life insurance companies (similar to the Basle Committee of Banking Supervision's recommendations for risk weighted capital adequacy for banks). The consolidation of insurance companies if it improves their capital adequacy should be encouraged. To reduce the probabilities of currency-wise mismatches between their assets and their actual and contingent liabilities, life insurance companies should be permitted or even encouraged to invest a portion of their assets outside the country in hard currencies. This is particularly relevant for insurance companies in countries whose currencies have seen secular international depreciation. It is even more relevant for companies in countries whose currencies have depreciated rapidly and/or erratically over the past three years.

In some DMCs where life insurance market has monopolistic or oligopolistic tendencies, premiums tend to be high. This is because those premium rates were established actuarially a generation ago when life expectancy was much lower. Overall economic development increased life expectancy. Domestic life insurance companies however in the absence of

competition saw little reason to reduce their premium rates, which in reality constituted economic rent. In the absence of effective exchange controls, the market moved offshore beyond the domestic regulators' control. In such circumstances, having more foreign insurance companies in the domestic market would have been preferable. Even if one were to accept the political argument of governments of the need to keep premium incomes invested within the country, having foreign insurers operate within the country under the domestic supervisors' jurisdiction would have offered more competitive products to the domestic consumers while keeping the premium income invested within the countries.

In all DMCs, the Insurance Regulatory Authorities, tend to be conservative in terms of safeguarding their policyholders' interest. In practice, however, excessive restrictions on investment policies of insurers without taking into account macroeconomic developments have worked against the very interest of that section of the population, whom such regulations intended to protect. A narrow and prescriptive supervisory system has created a domestic insurance sector that is over-administered and yet, under-regulated. It devotes too much attention to compliance with rules whose relevance may have long expired, and too little to their micro and macro impact. This inevitably has created considerable regulatory gaps. Excessive and restrictive regulation has seen the movement of insurance businesses offshore. This trend has been further encouraged by the gradual relaxation in national exchange controls (as explained in the previous paragraph) and assymetrical tax treatment of the life insurance business across national boundaries. In another DMC, excessive regulation of the life insurance industry has the emergence of companies offering products similar to those of life insurance policies but of much shorter time frames. Such companies are not life insurance companies and are therefore not supervised by the insurance regulatory authority. Such companies do not face an actuarial supervision of risks and are not subjected to the same degree of prudential control or supervision as insurance companies. Arguably, this loophole has seen more domestic savings

diverted into such shorter-term products than in conventional life insurance policies. From the examples quoted, it can be inferred that when prescriptive regulations distort market principles, the market for insurance products tends to circumvent a regulator's jurisdiction. This could occur within a country. It could also see the movement of a country's insurance market offshore, which could create further regulatory problems from the domestic supervisor. It would therefore be reasonable to surmise that in this era of diminishing exchange controls and creative accounting practices coupled with advances in information technology, prescriptive regulations for life insurance have outlined their utility.

Prudential supervision of life insurance encompasses providing policyholders protection against losses arising from insolvency of and/or fraudulent practices or market abuses by insurance companies. Such supervision is therefore more focussed through its attention to the insurance company's management quality and business performance, particularly its standards of transparency and corporate governance. Amid a growing complexity of a rapidly emerging financial sector, sound corporate governance can be facilitated through better self-regulation, to complement prudential external supervision. In the analysis of an insurer's risk profile, the role of a prudential supervisor is similar to that of an investment advisor, This involves the use of appropriate information technology to analyze the trends from vast volumes of information. Effective prudential supervision also requires close coordination with the insurance company's statutory auditors and actuaries, as also the insurer's accounting standards. The actuarial reserves on the liabilities' side is an important benchmark for assessing an insurer's health. In risk analysis, oftentimes it is essential for the supervisor to study the insurers' assets side of the balance sheet (similar to the approach of the Basle Committee for Banking Supervision in the case of banks). This would reveal the quality of the insurer's realisable assets needed to meet

the claim liabilities. A Dynamic Capital Adequacy Test<sup>4</sup> measuring a company's ability to meet its present and contingent liabilities is a useful analytical tool. The quality of prudential supervision can be enhanced through rigorous training of the supervisors. The supervision function should as far as is practicable be immune to political interference. A more sophisticated system of prudential supervision may also encompass a dispute resolution mechanism through an out of court settlement. In the ultimate analysis, prudential supervision of insurance aims at striking a balance between the public policy aims at ensuring strong financial institutions and public protection and competitiveness. This is necessary to build public confidence in the insurance industry and the financial sector.

The ADB has supported reforms of life insurance regulations in moving from an activist to a prudential supervision system and has conducted significant policy dialogue with its DMCs to support their movement in this direction. This facilitates creating a more competitive insurance market on a more level playing field. In doing so, the ADB believes, it can contribute towards enhancing the efficiency of the financial intermediation function of life insurance while protecting the imputed savings of policyholders. Towards this end, the ADB has provided technical assistance to the life insurance regulatory authorities in Bangladesh, Bhutan, Indonesia, Pakistan and Philippines in support of the above stated objectives. As my colleague will be discussing, its details I will not repeat them here.

Closely aligned with the question of regulation and supervision of life insurance, arises the question of regulation of pension systems. In the political, economic, and geographic diversity among the ADB's DMCs, we witness different types of pension systems. These range from the pay-as-you-go (PAYG) system, to the partially funded, to the fully funded public and

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<sup>4</sup> DCAT measures a company's capital plus actuarial reserve to meet its liabilities.

private pension systems. The ADB has assisted its DMCs in reforming their pension systems particularly in the conversion from the PAYG to fully funded systems. More on this will be discussed later in this paper. I introduced this distinction here briefly to establish some common ground between life insurance and funded pensions. Conventional life insurance policies, provide a future value of benefits to the policyholder's assigned beneficiaries on the death of the policyholder. These may be in the form of a lump sum amount (i.e., the policy) or a stream of future annuities.<sup>5</sup> While the basic purpose of life insurance is to provide a lump sum income for the beneficiary on the death of the insured, an annuity is intended to provide income for the life of an annuitant. Another insurance product offered by life insurance companies is the endowment insurance policy. Under an endowment insurance policy, the policyholder receives the face value of the policy if he/she survives the endowment period (usually 20 to 30 years after commencement of the policy). If the insured does not survive the endowment period, his/her beneficiary will receive the policy on expiration of an endowment period. Since endowment policies are contingent on the (relatively less uncertain) passage of time, rather than on the actuarial probability of death, endowment policies are the most expensive in terms of premiums. Thus, insurance policies, endowment policies, and annuities, essentially constitute varying savings vehicles and are thus very similar to fully funded pension schemes. They are both vehicles for contractual savings. Their similarities also extend to their overall macroeconomic effects.

Fully funded pension schemes are built by contributions both from employers (through payroll taxes) and employees and invested in stipulated securities. These schemes could be in

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<sup>5</sup> For this purpose, an annuity is defined as a contract sold by an insurance company that pays a monthly (or quarterly, semi-annual, or annual) income benefit for the life of one or more persons (the annuitants) or for a specified period of time. The annuitant can never outlive the income from the annuity.

the nature of defined contribution or defined benefit pension plans.<sup>6</sup> They accrue to the beneficiary on his/her retirement. They may be claimed by their beneficiaries in lump sum, i.e., the corpus of the pension fund or provident fund as known in some countries. Such a scheme has financial and accounting similarities to an endowment insurance policy. Another option available to the beneficiary is the annuity pension scheme, which entitles the beneficiaries an annuity commencing from their retirement from the scheme. If the person entitled to the pension fund dies prior to its maturity, the employee/participant's beneficiaries get immediate rights to such funds. The legal and accounting treatment for pension annuities is very similar to that for insurance annuities. The success of a funded pension scheme is contingent on the consistency in contributions both from the employee and employer and their prudent investment. In some countries, funded pension schemes are mandatory. Mandatory pension funds were sought to be justified in the past as a form of forced savings by a certain segment of employees in the organized sector. It was believed that by forcing such employees to forgo current consumption, the state could bridge the nation's savings-investment gap. Both mandatory and voluntarily funded pension schemes were seen as instruments of widening social security coverage to a larger section of the population, while facilitating the mobilization of savings to fund national capital investment. In others, they are voluntary.

Some countries have a hybrid mix of both mandatory and voluntary pension systems. This is known as a two-pillar system. Mandatory pension schemes whether on a PAYG or funded (partially or fully) basis form the first pillar in such a system. Voluntary pension plans form the second pillar complementing the minimum mandatory pension scheme. In this scenario, life insurance policies form the third pillar in complementing the other two. Life

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<sup>6</sup> Defined Contribution Pension Plan is a retirement plan under which the contributions are fixed in advance by a stipulated formula under which benefits vary. Under Defined Benefit Pension Plans, benefits are fixed in advance by a stipulated formula and contributions strategy.

insurance policies (whether in lump sum or annuity) offer a policy's beneficiary immediate (or staggered) payment as compensation for the loss of continued benefit streams from the other two pillars, arising from the unexpected death of the policyholders. Life insurance policies have become the third pillar in this scenario, because of the fall in demand for endowment insurance policies in competitive markets. Endowment policies, are increasingly being replaced by voluntary pension funds which are less costly, more efficient, and of a relatively shorter duration. Life insurance policies in this situation seek to provide an actuarially quantifiable indemnity against any interruption in benefits from the other two pillars.

The contributions collected by the pension funds form an important pool of resources thereby augmenting domestic savings. It also provides an additional basis for capital formation necessary for investment. The profitable investment of these resources is a condition necessary *a priori* to safeguard the value of the pensioners' claims. The prudent investment of such funds therefore provides a portion of capital investment necessary for economic growth. The policies in the ADB's DMCs relating to the regulation and supervision of public/private and/or voluntary/mandatory funded pension schemes have been mixed. In many of the ADB's DMCs under public sector funded pension schemes funds, were required to be invested in Government securities. This was justified as providing low risk investment to the funds' contributors while providing relatively low cost funds to the government to finance its budgets. The real value accruing to the fund holders in such circumstances would depend on whether the nominal interest rates offered by Governments on its bonds were adequately inflation adjusted to provide a reasonable real rate of return to the fund holders.

In many of the ADB's DMCs, regulation and supervision of funded pension systems is already moving albeit at varying paces from compliance based systems to one of prudential supervision. In many DMCs, both public and private pensions are permitted to invest in

corporate bonds and equities. In some DMCs, depending on their exchange control regulations, pension funds are allowed to invest outside their country of regulation. These reforms were undertaken to optimize the return to the pension fund contributors. In a corollary regulatory measure, foreign pension funds have been allowed to invest in debt and equity instruments in a DMC's domestic market. This will have the salutary effect of improving domestic financial disclosure principles to bring them in line with accepted international practices. This widens the choices available for domestic pension funds to invest prudently at home. Prudential regulation and supervision of the pension funds encompasses providing protection to its contributors against losses arising from bad investment decisions or fraudulent practices. Prudential supervision therefore is more focussed on the pension fund's management quality, business performance, corporate governance, and transparency. Efficient prudential supervision of pension funds would involve creating clear and transparent investment guidelines. This in turn will encourage the emergence of efficient credit rating agencies in a particular market to assess corporate securities as portfolios for potential investment by pension funds. The establishment of an efficient legal, regulatory, and institutional framework for the management of pension funds facilitates social security coverage to a wider segment of the population. It also promotes efficient long-term financial interim education by providing productive investment opportunities for the larger flow of savings mobilized.

As has been illustrated in the previous paragraphs, both life insurance companies and pension funds work broadly towards common goals. They also operate within a generally similar financial and accounting frameworks. The requirements of IAS-17, (of the International Accounting Standards Committee) relating to the measurement of an institution's benefit liabilities, have many common characteristics with the IASC's recent exposure draft (issued in September 1999) on measurement of the liabilities by companies for insurance products. This is indicative of a trend towards harmonization of accounting and disclosure of standards for

broadly similar generic products. Yet in many countries, there are separate regulators for the life insurance and pension fund industries. Their perspectives to regulation have been different and their regulatory effects oftentimes fragmented. This has been further exacerbated by asymmetries in tax treatment for life insurance and pension fund products, which brings about further distortions. Given the common micro and macroeconomic objectives and similar legal and accounting characteristics of life insurance and pension products, it makes sense for countries to have one common regulator and supervisor for both these industries. As their products are generally similar and at times complementary (i.e., the analogy of the third pillar), their holistic regulation will bring in synergies. Such a step would bring about better uniformity, consistency, and harmonization for a generic approach to prudential regulation. It could considerably enhance regulatory efficiency through the economics of scale. This could result in increasing the breadth and depth of prudential supervision of both pension funds and life insurance industry. It could probably be the first step towards having a single regulator for all non-banking financial products. The creation of the Financial Services Authority in UK is an important benchmark in this direction. Within a country, the need is seen for harmonization in the tax treatment on a generic basis for life insurance and pension products.

As the economies of East Asia and the Pacific, get more integrated financially, there is the need for coordination between national regulators of the life insurance and pension fund industry. Harmonization of prudential regulatory policies between regulatory agencies will provide a level playing field to all market participants. It will obviate the need for the buyers and sellers of life insurance and pension products to seek cross border or offshore arbitrage. Sharing of information on market participants will also significantly strengthen the supervisory and regulatory depth and breadth of each domestic supervisor. It could also help create awareness in countries tax administrations for the need fiscal harmonization for the treatment of life insurance and pension fund products. Cross border harmonization in both regulatory and tax

policies for contractual savings could bring about substantial synergies both in the revenue effect for governments and profit maximization for the insurance companies and funds which could in a competitive environment be passed on to their stakeholders. The paradigm of common regulatory and tax standards for these two industries in the European Union is particularly demonstrative. I am therefore particularly thankful to the organizers of this conference for bringing together insurance and pension funds regulators in this region to begin a session for active brainstorming.

The previous paragraphs have illustrated the generic similarities between funded pension and life insurance products, and emphasized the benefits of harmonization in their regulation. To realize the above synergies, it is necessary over time for countries individually to move over from the PAYG pension systems to fully funded systems. This is more so for countries with aging populations. Under the PAYG system, as the ratio of active contributors to beneficiaries decreases, it could cause immense fiscal strain to the country as a whole. Moving to a funded systems alleviates this burden. The ADB believes, it is rational to allow countries adequate transition periods, considering their social, cultural, historical, political, and demographic characteristics. If even the United States faces difficulties in moving from its PAYG systems (for Social Security) towards a funded investment account system, DMCs are likely to find the transition more difficult.<sup>7</sup> Moreover, the academic debate on the pace of pension systems reform is not on the agenda of this seminar. The ADB does not believe that there is any single blue print suitable for every country. In this direction, the ADB has provided technical assistance to China, Indonesia, Kazakstan, Kyrgyztan, Pakistan, Thailand, and Uzbekistan towards encouraging the movment from PAYG to funded systems and for enhancing the legal and regulatory frameworks from the latter. In cooperation with the Pacific Pension Institute, the

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<sup>7</sup> Economist, 13 March 1999, article by Dr. Martin Feldstein.

ADB conducted a workshop on the subject in Manila between 3-5 December 1998. My colleague will dwell on this subject to greater detail.

## **CONCLUSION**

It is said that nothing is more definite in life than old age, and ultimately death.<sup>8</sup> While not attempting to redefine metaphysics, rational policies on contractual savings could provide some protection against the financial consequences of the above two immutable constraints. The gross domestic savings rate in East Asia has risen rapidly in one generation, a factor necessary for economic growth. It is interesting that despite the East Asian financial crisis, the domestic savings rates of affected countries did not decline thereafter. Poorly regulated and loss making banking systems created inefficient financial intermediation which brought about declining or negative growth rates. The immediate intervention by multilateral institutions sought to correct anomalies in their banking systems. As illustrated earlier in this paper, life insurance and pension fund management also constitutes financial intermediation albeit in the longer sense, but no less important towards overall balanced macroeconomic growth. In the urgency of the financial crisis, as attention moved to the banking system, there was noticeably less attention on this aspect of long-term financial intermediation. This conference has demonstrated valuable the equal relevance of contractual savings towards the same goal. I therefore wish to thank the organizers of this conference for articulating this theme to its audience. May I quote an old Chinese proverb that a thousand-mile journey begins with its first step. I believe that this conference may be the step towards a better-focussed and more integrated national and international prudential regulation of contractual savings system.

Thank you very much for bearing with me.

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<sup>8</sup> The third constraint was said to be taxes. However, the emergence of Reagonomics and the Laffer curve analysis (no laughing matter) has possibly made taxes less uncontrollable.