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INSURANCE ACTIVITIES GOVERNANCE: WORLD EXPERIENCE IMPLEMENTATION

Dr.oec., Professor ***Natalia P. Kuznetsova***
Saint Petersburg State University
Universitetskaja nabereznaja 7/9, Saint Petersburg, 199034, Russia
Phone/fax: +781 2 2732400 (office)
E-mail: nataliakuz2010@yandex.ru

Ph.D., Associate Professor ***Zhanna V. Pisarenko***
Saint Petersburg State University
Universitetskaja nabereznaja 7/9, Saint Petersburg, 199034, Russia
Phone/fax: +781 22732400 (office)
E-mail: janna12000@yandex.ru

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Abstract

The paper considers the following issues analysis: the reasoning of insurance activities state governance, understanding of financial (insurance) activities governance system formation structure, process and mechanism of insurance activities state governance (goals, instruments and insurance organization structure). Special attention is drawn to the goals (solvency assessment control, equal and just access to insurance services, national insurance undertakings support, new type of continuous and sustainable economic growth provision) adequate to the methods and principles of economic policy (liberal, state, restriction of market organization mechanisms), and to the types of insurance market structure (monopolistic, oligopolistic, competitive) in different countries and regions of the world economy. We examine insurance here as a social-economic mechanism (not distinguishing between insurance lines). **The goal** of the article is to promote the idea of financial (particularly insurance) governance necessity whatever is the market structure adequate to the regulatory system having specific objectives and instruments The **hypothesis** of the article is that processes of globalisation, liberalisation and concentration of the financial capital, have generated new outlines of national and world financial systems (financial convergence and a financial conglomeration) causing overcoming from functional to universal governance system development. The **methods** of the article deals with analysis-synthesis, historical and logical methods of investigation, methods of international comparisons. The main **summing up conclusion** of the article considers that due to the theory of the industrial organization governance the insurance market is regulated by state and non-state institutions supporting a balance between market and its structure from one side and state from the other side which keeps an equilibrium between market and state failures.

1. Insurance Activities Governance System Formation

Considerable liberalization and advancement of free market principles across national, regional systems and the global economy do not apply to insurance activities, where there is still a significant degree of state and supra-state regulation. That is characteristic even for traditionally liberal economic systems. Reasons for strict insurance activities state governance are as follows:

1. Social nature of insurance. Insurance products are in need, because they are necessary not only to the individual, but society as a whole. In many cases the state itself binds citizens to use insurance services, thereby creating the need for state regulation.

2. Uncertainty of product value. It is in an unambiguous assessment of costs effectiveness related to the insurance product at the moment of sale, and during the insurer's performance of its obligations, in particular, claims costs and loss control.

3. Non-transparent price setting. Pricing setting in the insurance requires expert's assessment of the net premiums rate and obligations to pay claims. Insurance products are intangible by nature and consumer is not able to assess insurance contract at the time of purchase. The products being offered could be designed accordingly and include errors and omissions which may turn out just after insured event. By above mentioned reasons insurance activities regulation is in need to avoid low-quality insurance products and services; to control an insurer for compliance with requirements of law; to prevent the abuse of insured.

4. One more essential reason for insurance activities regulation is that due to certain characteristics, insurance markets' soundness is fragile. Regulation is in need to allow policyholders to revise associated with significant *adverse effects* of *insolvency and / or financial instability* of insurance companies.

Due to mentioned causation insurance markets governance system could be described by the following scheme (Figure 1), embracing a set of state (and supra-state) regulation and self-regulation institutes. Insurance market as any industrial organization is the main institute of self-regulation and demand-supply interrelation establishment. The institutional part of self-regulatory system are insurers associations keeping the similar tariff's policy from one side and unions of insured – consumers of insurance services and products guided by the law protecting their rights from the other side. Unions provide information about insurance companies behavior into the supervisory authority body as a state institute which observes that the insurers don't break the law applying a set of regulatory tools to the market.

Consequently a system of industrial organization governance (a system of the insurance market regulation in our case) is formed supporting a balance between market and its structure from one side and state from the other side which keeps an equilibrium between market and state failures.

Contemporary world tendencies to the integration of bank's and insurance capital make national states to create legislative system governing new financial institutes (financial conglomerates [1]) activities and to develop new state economic policy providing interconnection and diffusion of banking, insurance, investment, etc. segments of financial market [2] without contradicting to the objective tendency to financial markets and their regulatory systems liberalization that reflects the necessity of market imperfections corrections Due to the financial convergence process radical changes of developed and emerging markets

governance concepts are going on. Governance separation period and prevailing of functional over universal approaches to different sectors of financial market regulation has finished. However these new phenomena in financial markets development are adequate to the already formed insurance market activities governance that is characterized by very special reasoning and logic (process, structure and mechanism) of its formation and development.

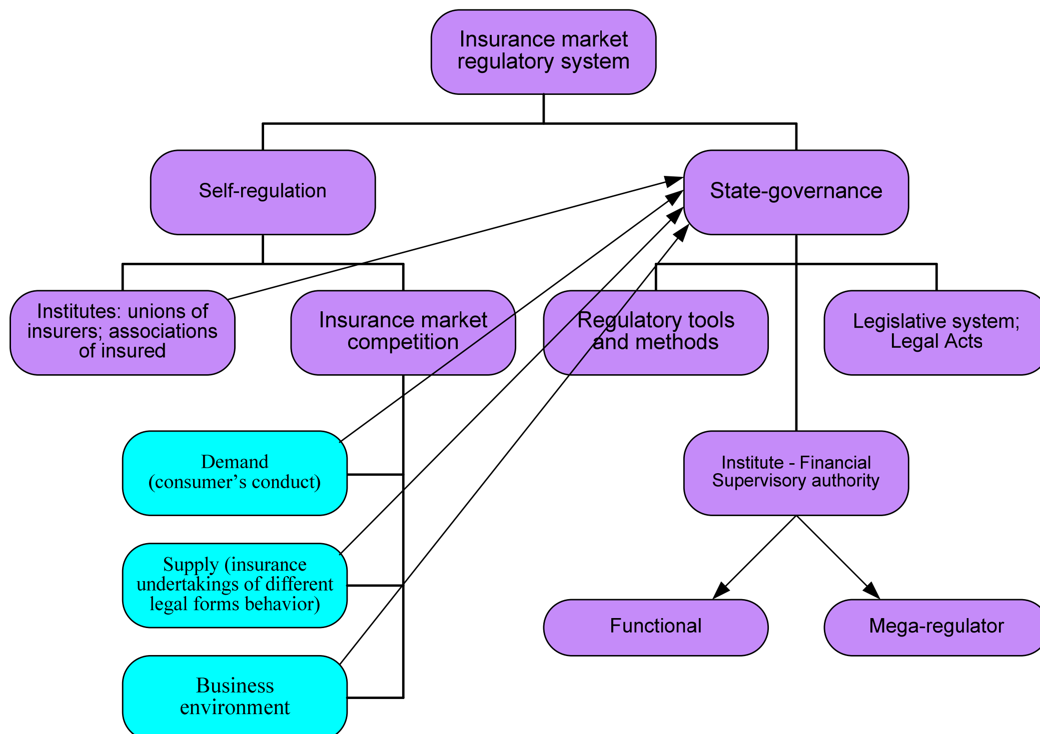

Figure 1. Insurance market regulatory system

2. Process, Structure and Mechanism of Insurance Activities State Regulation

Figure 2 shows the logic of the insurance market regulatory mechanism.

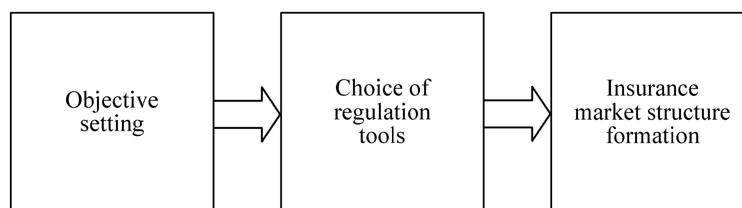

Figure 2. The mechanism of regulation of insurance activities

We figure out the details of the insurance market regulatory mechanism process.

The Objectives of the Insurance Activities Regulation

The main purpose of the insurance activities regulation is consumer protection and social values encouragement. We identify five specific objectives of insurance regulation: 1) solvency control, 2) affordability and fairness of the product, 3) market stability, 4) domestic insurance companies support, 5) encouragement to sustainable economic development.

Solvency control is the basic regulation initiative and historically the first form of regulation. It is related to the social importance of insurance as an institution of social protection. Regulation of insurance industry is recognized as necessary by the majority of countries and regions in the world economy.

Affordability of the product and fairness are closely connected to the information asymmetry. Insurer's decisions in transactions must be fair as it has more and better information about risks insured than the customer. This creates an imbalance of power in transactions which can sometimes cause abuse. The other part of the insurance contract (customer) is better informed about individual risks of his own. Therefore in general regulation it can ensure fairness both for insurers and insured. In the market economy insurers push up prices to achieve greater efficiency and form a stable, balanced pool of risks. However high prices limit affordability of insurance product for low-income households and constraints demand in actual uptake of insurance products. Regulation is needed to elaborate insurance products tailored to the poor who would otherwise are not able to take out insurance.

Market stability. Price stability is important for good image of insurance companies and trust of the population to the insurance market as a whole. Price fluctuations make consumers and political elite more active and they interfere into the process of regulation and disturb the balance between bureaucracy and insurers.

National insurance companies support. Every developed sovereign country regulates the provision of insurance in different ways. In highly-regulated jurisdictions, the scope of regulation extends beyond the prudential oversight of insurance companies and includes such matters as direct ban imposed and extra taxation for foreign insurers. In developed states protectionism would assume hidden forms.

Encouragement to sustainable economic development. Every developed sovereign state strives for sustainable economic development. Insurance regulation that governs the business of insurance is typically assures only the insurance companies solvency. They aim common interests stimulating economic development. These five objectives of insurance business regulation dictate the appropriate regulatory tools implementation (Table 1).

But the main reasoning for insurance regulation is the fundamental characteristic of the insurance market: the need for high financial stability, due to the durable nature of the insurance product. The fundamental purpose of insurance industry regulation is solvency provision. Methods and instruments of solvency supervision are the same in all national insurance markets. A solvency and capital requirements are imposed: to reduce the risk that an insurer would be unable to meet claims; to reduce the losses suffered by policyholders in the event that a firm is unable to meet all claims fully; to provide early warning to supervisors for them to intervene promptly if capital falls below the required level; to promote confidence in the financial stability of the insurance sector. Own capital minimum level depends on the class of insurance. In addition, expert knowledge of company management is required at the licensing stage of the insurance company.

Table 1

Insurance activities regulation tools

Objectives	Tools
Solvency provision	• Legislative requirements for minimum amount of owned capital • Profit distribution and prospective reserve funds • Company's management competence • Separation of life and non-life insurance • Statutory reserves and actuarial reserves regulation • Investment earnings guidelines • Assets and liabilities • Financial reporting requirements • Compulsory audit • Reinsurance regulation • Reinsurance capacity • Early warning systems • Solvency margin provision • Minimum size of tariff's rate
Affordability and fairness of the product	• Maximum size of tariff's rate, mandatory rate reduction • Information transparency and requirements to publish information • Insurance contracts regulation • Cost restriction • Ads' restriction • Government grants and subsidies • Compulsory insurance introduction • Legislative requirement for insurance service provision • Evaluation of operating expenses • Market conduct behavior governance
Market stability	• Collection, processing and publication of information about the insurance market development • Creation of professional insurers associations encouragement • The development of self-regulatory mechanisms • Creating a national guarantee fund
National insurance companies support	• Licensing of insurance companies • Foreign capital regulation • Fair competition policy • Regulation of distribution channels (including the activities of insurance intermediaries)
Sustainable economic development economic policy	• Taxation principles • Rules of insurance reserves investments • Forms of insurance companies organization • The participation of insurance companies in social protection provision

Usually life insurance and non-life insurance operations regulation is divided. Thus, at the stage of an insurance company creation supervisory authority establishes legislative

requirements for: minimum size of owned capital; competence of company's management; owner reputation; life and non-life insurance regulation.

For solvency provision *and financial soundness of* insurance company special rules are established: statutory reserves and actuarial reserves regulation, investment earnings guidelines, assets and liabilities adequacy, financial reporting requirements, compulsory audit; risk assumption limits are used to regulate reinsurance capacity of the company; prospective reserves amount designated as a future liability for life and health insurance to meet the difference between future benefits and future premiums; loss reserves for known claims due but not paid, known claims but not yet due.

The ratio of assets and liabilities is used as the main solvency indicator of insurance companies, which includes the calculation of the solvency margin and insurance company's minimum equity. The solvency margin is a minimum excess on an insurer's assets over its liabilities set by regulators reflecting the principle of early warning system implementation.

Insurance tariff policy is of particular importance for solvency regulation and affordability and fairness of the insurance product [3]. The more competitive the market is, the more adequate the tariff. In some countries rates are approved or even set by the regulator, the competition might still be transferred to the proposal stage. That increases the desirability of the regulatory rate setting [4].

We can distinguish three types of insurance tariff regulation: the first type regards mandatory approval of insurance tariffs by the supervisory authority before using them; the second type proposes tariffs made by the insurers themselves accompanied by supervisory authority informing; the third type presupposes no limitation in tariffs.

Another way to limit the price setting figures out the maximum share of the costs and fees paid by insurers in premiums. Insurers may be induced to charge dumping prices that eventually would not cover the claimants. Such tools can help to control evaluation of operating expenses and aim to affordability and fairness of the product.

For consumers solvency protection is not enough for estimation of insurance company's reliability because the latter may charge dumping prices, they also can exaggerate prices by abusing these consumers' relative disadvantages. To reduce existing information asymmetry in favor of insurance industry and, therefore, to achieve social justice at the level of the insurance company regulators control the following issues: mandatory provision of financial information; protection of consumers from misleading information about insurance companies; insurance contract regulation.

Supervisory authorities often act as the "Consumer Protection Commission", accepting and settling customer complaints and claims to insurance companies and handling, thus, market conduct of insurers. To ensure *equal access* ("for the sake of fairness and equality") to insurance products for various social groups, regulator establishes the following control tasks: 1) direct subsidies to the poorest strata of the population as they are in need of insurance coverage; 2) introduction of compulsory insurance as a foundation for active constraints leading to lower prices so far as insurance coverage should be accessible to anyone; 3) in some cases a requirement of the contract extension or renewal of the insurance; 4)setting adequate premiums for urban and suburban areas.

Simultaneously today in accordance with the theory of the insurance activities governance formation a significant role in maintaining the reputation and stability of the

insurance market is played by informal professional associations of insurers and self-regulatory mechanisms. For example in the emerging insurance market of Russia the self-regulatory organizations (SRO) could be applied in addition to some form of government regulation. The informal insurance regulation bodies are strongly connected to the formal authorities. They serve as a platform for information exchange and coordination of regulatory activity. The main cooperation between self-regulatory organizations (SRO) and State authorities relates to the insurers' financial conditions and bankruptcy prevention.

Market stability maintenance assists in early identification and business forecasting of market fluctuations. This is achieved by setting guidelines for commercial conduct and fair competition, by statistical analysis based upon the collected database of insurance market and its actors.

National insurance companies support and the restriction of foreign insurers is a specific distinction of developing insurance markets. The regulatory intervention in the insurance market could be expressed as active (restrictive practices of licensing, foreign participation in domestic insurance companies), or passive (access restriction to distribution channels.

Economic opportunities and positive consequences of insurance industry regulation for *economic development and innovative economic growth* achievement are almost unlimited. Among the most obvious are: taxation principles, insurance companies' investment regulation, social insurance. The tax incentives implementation is connected with a pension schemes development causing long-term savings and investment funds growth. Social solidarity resulted by insurance protection decreases state budget and separate insurance company's burden: the obligations to give (and the right to get) help in case of certain losses companies involved [5].

3. Regulation of Insurance Activities: The World Experience

3.1. Structure of Insurance Markets

The theory and practice of industrial organization link market structure and type of regulation. Structural and logical description of insurance markets is usually analyzed from the point of view of the structure-conduct-performance concept [6], where market ***structure*** − is the degree of concentration and ability to use market mechanisms by means of the entry barriers, institutional structure, limiting competition, market ***behavior*** figures out limited but fair competition and economic pressure impact on insurance market and ***effectiveness*** is characterized by long-term results of the insurance market dynamics and its key indicators.

According to the prior made analysis [7] we could distinguish three types of insurance market structure and behavior: free market: USA, Great Britain, Netherlands, etc, oligopolistic: Japan, emerging markets of CEE and Russia and monopolistic: China, India. ***Effectiveness analysis*** involves the study of market dynamics and its profitability. Key performance indicators of national insurance markets are: direct gross insurance premiums and gross claims payments, premium density (average insurance spending per capita), the importance of the insurance industry (insurance penetration) − measured by the percentage ratio *of premiums collected* to *GDP*. As to the characteristics of maturity of the insurance market we can use profitability, amount of own funds, amount of domestic insurance companies reserves.

Table 2

The major insurance markets development, 2010 (bln US$)

	Ranking by premium volume, 2010	Life premiums	Non-life premiums	Total premiums	Insurance density	Insurance penetration, 2010, %
Industrialized countries	**-**	**2156**	**1533**	**3689**	**3527**	**8.6**
USA	1	506	660	1166	3759	8.0
Japan	2	441	116	557	4390	10.1
UK	3	214	96	310	4497	12.4
France	4	192	88	280	4187	10.5
Germany	5	115	125	240	2904	7.2
Italy	7	122	52	174	2766	8.1
Hong Kong	24	23	3	26	3636	11.4
Emerging markets		364	286	650	110	3.0
Latin America and Caribbean		55	73	128	219	2.7
Brazil	15	33	31	64	328	3.1
Mexico	29	9	10	19	173	1.9
Central and Eastern Europe		20	68	88	272	2.6
Russia	**19**	**1**	**41**	**42**	**297**	**2.3**
South and East Asia		238	98	336	94	3.7
China	6	143	72	215	158	3.8
India	11	68	11	78	64	5.1
Middle East and Central Asia		8				
United Arab Emirates	46	1	5	6	1248	2.1
Africa		47	20	67	65	3.9
World		**2520**	**1819**	**4339**	**627**	**6.9**

Source: *swissre.com*

The most advanced countries in Central and Eastern European countries and emerging markets of Latin America, South and East Asia (GDP per capita − about $ 5-8 thousand) insurance penetration (insurance premiums as a percentage of GDP) is about 3-5%; USA, EU and Japan, Hong Kong (per capita GDP − about $ 30-40 thousand) it reaches 10-12%. Data show that emerging markets of CEE and Russia are far behind. In 2010, insurance sector penetration was 2.6% and 2.3% adequately, which is 3-5 times less than in developed countries.

The structure of the national insurance market − monopolistic, oligopolistic and competitive is adequate to the system of the state regulation.

3.2. Insurance regulation systems

In accordance with the structure of insurance markets we distinguish three main types of state regulation of insurance activities: *liberal,* regulation system that limits the market mechanisms and centralized state regulation (see Figure 3).

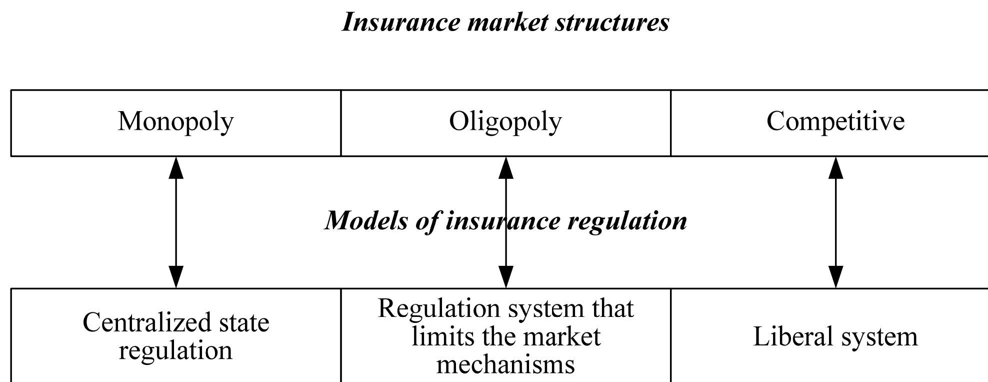

Figure 3. Interconnection of insurance markets structure and state regulation models

The first type of insurance market regulation − *liberal system* − a minimal governmental intervention and open free market competition. This model of regulation is limited to the control of the solvency of insurance companies. It can also be described as *ex-post* regulation: the government intervention has been carried out only after the deviation from the desired result has detected. Such a system of regulation of insurance activities exists in some European countries (UK, Ireland, the Netherlands), in most states in the U.S. and Chile.

Systems of the second type of insurance activities state regulation stipulate a significant *limitation of market mechanisms* and the partial or overall protection of private insurance companies from competition. Regulation of this type is known as *ex-ante,* that is, to prevent possible problems in advance by establishing rules of conduct on the market. Such regulatory systems has been implemented in Japan, South Korea, some of European countries (Germany, Sweden, Switzerland) and in developing countries.

The third type presupposes insurance markets, which are based on *state provision of insurance* and regulation for the benefit of economic and social purposes achievement. Public provision leaves almost no place for market mechanisms. The third type of regulatory system was observed in the former USSR and socialist countries of Central and Eastern Europe and still remains in China and India.

Insurance industry regulation has a considerable impact on the formation of national insurance market structure. The result of the first type regulation is usually the creation of a competitive market structure, second type develops market structure similar to oligopoly, the third type, usually forms a state monopoly on insurance activities.

Each regulatory system taken separately could be used in certain circumstances. There are advantages and disadvantages in each system.

The system of *state provision* guarantees the best control over the insurance market development, overcoming the distrust of the market and protecting the interests of

policyholders. However, in the course of time in monopoly insurance markets obligatory insurance has been prevailing over voluntary insurance. It is considered to be an extra tax burden (the government compensation for losses). Market development is slow, the burden on the state budget is increasing, without providing the potential demand for insurance services, sluggish innovation and new insurance product development. This approach is leading to bureaucratic regulation and development of collective irresponsibility.

Liberal regulatory systems offer significant advantages: (1) ensure wider demand for insurance products and develop new ones to adapt the market needs; (2) the competition provides a more efficient asset management and lower rates; (3) self-regulatory mechanisms lead to a reduction of government spending. In the early 1960s in the UK (liberal regulatory regime) Supervision Authority staff was only 8 people, while in the State of New York (one of the most severe regulatory systems in the U.S.) Supervision Authority staff reached 200 workers in early XX century [8].

Rivalry on a domestic market favors the development of national insurance companies and strengthens comparative advantages in comparison with the foreign insurance companies. This makes them more competitive when entering the international arena. Liberal regulation regime was one of the factors that had given European insurers leading positions in insurance services export.

In general, we should note a gradual leveling in the systems of state regulation of insurance activities. The number of monopoly markets is gradually declining, competitive markets introduce harder and faster regulation, and partly restricted insurance markets are gradually becoming more open. Among the reasons for harmonization of insurance activities regulation we identify general economic trends, financial convergence development [9], and the processes of global integration and institutionalization of regulation.

Special (sometimes contradictory) mode of governance is demonstrated by Russia which lags behind in the process of bringing the regulation of insurance activities in compliance with international standards. One of the factors of such mode of development is obvious tendency to return to the first variant of strict state regulation [10] According to the level of liberalization the Russian insurance market founds itself on the stage of limited liberalization [11]. From the other side particular influence is observed due to Russia’s accession into WTO in December 2011 and hence to GATS and Russia’s ratification of WTO deal in May 2012. In these conditions the inevitable transition to a more flexible liberalization allowing to be a prominent participant of international economic relations could be predicted [12]. However, neither the public provision of insurance, nor liberal regulation are not able to contribute to the development of the Russian insurance market; therefore we recognize the intermediate mixed type (regulation of market mechanisms) as the best. This model is almost ideal from the standpoint of promoting the internal market development, protection of national insurance companies, improving the stability of the results and eliminates cycles. This method of regulation is most common to countries with emerging insurance markets.

Instead of Conclusion

1. According to the theory of the industrial organization governance the insurance market is regulated by state and non-state institutions supporting a balance between market and its

structure from one side and state from the other side which keeps equilibrium between market and state failures. Insurance market activities governance is characterized by very special reasoning and logic (process, structure and mechanism) of its formation and development.
2. Due to the financial convergence process radical changes of developed and emerging markets governance concepts are going on. Governance separation period and prevailing of functional over universal approaches to different sectors of financial market regulation has finished.
3. Reasons of the state insurance regulation are: socially-significant nature, lack of costs transparency, uncertainty of product value, non-transparent pricing, significant adverse effects of insolvency and / or financial instability of insurance companies.
4. Structure and mechanism of insurance activities state regulation are determined by the definition of objectives and choice of tools of regulation.
5. The dominant structure of national insurance markets (competitive, monopolistic, oligopolistic) fixes the chosen model of state regulation of insurance industry: the liberal model, the regime of state security, the regime of limitations of market mechanisms.
6. Analysis of advantages and disadvantages of diverse regulatory systems results in the need to combine liberal and centralist control methods, the closest achievable in the model limitations of market mechanisms.

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