Importing Risk into Insurance

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On October 4, in a cabinet decision that had been predicted by the media and expected by the stock market, the UPA II government announced hikes in the ceiling on foreign equity ownership from 26 to 49 per cent in units in the insurance sector and from nil to 49 per cent in the pension fund industry. This hike in the FDI ceiling, which was contrary to the recommendations of the Parliamentary Standing Committee, was part of a package of "insurance reforms", that included: (i) granting permission to the public sector general insurance companies and the GIC to raise capital from the market to meet future capital requirements, subject to a floor of 51 per cent to the government's share in equity; (ii) allowing foreign insurers to conduct reinsurance business in India; and (iii) reducing the minimum capital requirement for a stand-alone health insurance company to Rs. 50 crore from Rs.100 crore.

The immediate motivation for approving these measures was the government's declared intent of winning the approval of international rating agencies and foreign investors. To that end, the insurance reforms were presented as part of a set of decisions, including clearance for FDI in multi brand retail and civil aviation, hikes in diesel and LPG prices and changes to the forward contracts regime, announced end-September and early-October. This combined reform thrust was aimed at establishing that the government was not just committed to reform, but also not paralysed on the policy front. Thus, the measures also would, according to Finance Minister P. Chidambaram, "one, stabilise the rupee; two, reverse the direction of capital flows from outflow to inflow; and three, control expenditure" (in order to reduce the fiscal and current account deficits).

However, as of now, the liberalisation of foreign investment norms in the insurance and pension fund industries is still symbolic. The cabinet decision requires parliamentary approval before it becomes law and can be implemented. To secure support, the increase in the FDI cap is being justified as a measure aimed at attracting much-needed capital for the insurance industry itself. As the Finance Minister put it: "The estimated capital requirement in the insurance sector is about $5-6 billion in the immediate future," ostensibly to increase insurance penetration. Hari Narayan, the Chairman of the Insurance Regulatory and Development Authority, has declared that FDI in insurance was in any case required, and that the new measure could attract the Rs. 30,000 crore the industry requires over the next five years. More capital in insurance is also seen as the base required for mobilising the resources needed to finance crucial investments in the infrastructure sector, even though a small proportion of insurance funds flow directly to the infrastructure sector at present. For example, the figure is 4 per cent in the case of the life insurance companies.

The validity of these claims is suspect. Moreover, what is being underplayed here is the implication for financial stability of allowing easy entry for profit-seeking players known to adopt practices that have had adverse consequences even in countries like the US. Insurance has always been a highly regulated sector, with some emphasis on restricting rather than encouraging competition. This is because what the industry sells as "products" are mere promises to pay specified amounts, if and when, specified events occur. The buyers of insurance seek to insulate themselves from risks such as fire, theft or illness or to provide for dependents in case of death. To that end they enter into contracts requiring them to pay in advance large sums in the form of premia, in lieu of a promise that the insurer would meet in full or part the costs of some future event, the occurrence of which is uncertain. The difficulty is that the distance in time between the payment of the advance premia and the registration of any likely claim is large, during which time the insurer would have to deploy funds in investments that are safe and offer returns that ensure the availability of adequate funds to meet those claims from the insured.

There are many risks here. Given the likelihood of the event insured against afflicting any among the insured, the insurance company would have to price the contract such that the sums collected and invested yield stable returns needed to cover claims that arise. The contract may be underpriced. The probability of claims arising may be underestimated. The insured may not take adequate precautions to prevent the occurrence of the event insured against, such as ill health or fire. The insurer may make wrong investment choices. As a result of any one or a combination of these either the insurer or the insured (or both) can suffer losses.

This makes excessive competition in insurance a problem. In an effort to expand their business volumes and earn higher profits, insurance companies could underprice their insurance contracts, not obtain or ignore information on policy holders, and invest their funds in high-risk, ventures that promise higher returns. Not surprisingly, countries where competition is rife in the insurance industry, such as the US, have been characterised by a large number of failures. As far back as 1990, a Subcommittee of the US House of Representatives noted in a report on insurance company insolvencies revealingly titled "Failed Promises", that a spate of failures, including those of some leading companies, was accompanied by evidence of "rapid expansion, overreliance on managing general agents, extensive and complex reinsurance arrangements, excessive underpricing, reserve problems, false reports, reckless management, gross incompetence, fraudulent activity, greed and self-dealing." The committee noted that "the driving force (of such 'deplorable' management practices) was quick profits in the short run, with no apparent concern for the long-term well-being of the company, its policyholders, its employees, its reinsurers, or the public." The case for stringent regulation of the industry was obvious and forcefully made.

Things have not changed much since, as the failure and $170 billion bail-out of global insurance major American International Group (AIG) during the 2008 crisis made clear. AIG was the world's biggest insurer when assessed in terms of market capitalisation. It failed because of huge losses in its financial products division, which wrote insurance on fixed-income securities held by banks. But these were not straightforward insurance deals based on due diligence that offered protection against potential losses. It was a form of investment in search of high returns, which allowed banks to circumvent regulation and accumulate risky assets.

As one witness at a post-crisis hearing of a Senate committee on AIG put it: "At AIG, it was not enough to insure lives or property or health. A largely unregulated corner of the company decided it would make enormous bets on exotic financial arrangements, providing insurance where there were no actuarial tables, almost no actual experience, and no Government regulation and no oversight." When a lot of the assets turned worthless AIG could not be allowed to go because of the systemic effects it would have, necessitating a tax payer-financed bail-out that amounted to nationalisation.

It is firms like this that are now being offered a foothold in the Indian market, with even less experience of regulation. Through much of the post-Independence period, risks of insurance company failure were substantially reduced in India because of two factors: regulation, especially of the investments undertaken by insurance companies; and public ownership, which helped government ensure that insurance managers adopted sound business practices. Both these are now being diluted.

The insurance business in India has gone through four phases, with some variation across the life and non-life business. In the first phase starting around the last quarter of the 19th century to the First World War, an emerging insurance industry functioned without any statutory regulation, with attendant adverse consequences for firm survival, insurer protection and financial sector stability.

In response, starting in 1912 and going up to 1950, the British government and then the government of independent India put in place and consolidated a regulatory regime, geared initially to protecting the interests of those buying insurance by limiting bad business practice and stalling company failures. However, one problem remained, which was relatively free entry, leading to excessive competition and unviable and speculative investments in the industry, which in turn contributed to failures.

Finally in 1956 in the case of life insurance and 1972 in the case of general insurance, the industry was nationalised. At the time of nationalisation there were 245 Indian and foreign insurers in the life insurance business. In the case of general insurance there were 107 companies. These were consolidated under the Life Insurance Corporation on the one hand and four companies (namely National Insurance Company Ltd., the New India Assurance Company Ltd., the Oriental Insurance Company Ltd and the United India Insurance Company Ltd) in the general insurance business on the other. The General Insurance Corporation of India was incorporated as a holding company in 1971 and began operations in 1973.

Nationalisation had four principal objectives. One was the extension of the reach of insurance to a larger proportion of the Indian people. The second was the protection of the interests of the public that was to be encouraged to develop the insurance habit. The third was the use of the large volume of resources expected to be mobilised for developmental purposes. And the fourth was to ensure the stability of the insurance industry, which was an important segment of the financial sector. Public ownership was seen as a means to achieve these objectives, by keeping rates low, cross-subsidising activities and pre-empting a significant share of the mobilised resources for government-financed investments.

Despite the relative success of nationalisation, the post-1991 liberalisation wave saw the onset of a fourth phase in the history of the Indian insurance business. The phase began in 1999 when the 1994 recommendations of the liberalisation-inspired Malhotra Committee (set up in 1993) began to be implemented with the constitution of the Insurance Regulatory and Development Authority (IRDA). This was followed by the decision to implement the recommendation to permit the entry of private sector firms into both the life and non-life business, with provision for up to 26 per cent ownership by foreign firms.

Further, in December 2000, the subsidiaries of the General Insurance Corporation of India were made into independent companies and the GIC was converted into a national re-insurer. Since then there has been a continuous stream of private entrants into the business, so that after a little more than a decade there were 23 life insurance companies and 24 general insurance companies (including the ECGC and Agriculture Insurance Corporation of India) populating the industry.

The justification for and the declared objectives of insurance liberalisation were the promotion of competition so as to improve customer service, the enhancement customer choice and the reduction of premiums, while ensuring the stability of insurance firms and the insurance market. The actual outcome seems different. One effect has been a sharp increase in the volume of the insurance business with total premia in the life insurance business, for example, growing at a compound rate of around 25 per cent per annum during 2000-01 to 2010-11. This was partly because of a faster pace of expansion of business in the private sector, resulting in a decline in the share of the public sector Life Insurance Corporation from 100 per cent in 2000-01 to 70 per cent in 2010-11. In the non-life sector the market share of PSUs fell even faster, from 96 per cent in 2001-02 to 58 per cent in 2010-11.

Unlike in the case of the LIC, where the original infusion of equity was small given the implicit sovereign guarantee provided by the government, the norms for private entry require a much larger infusion of equity into private insurance firms. Equity capital in the combined life and non-life business rose from Rs. 3,186 crore in 2001-02 to Rs. 29,938 crore in 2010-11.This, together with the fact that there is at present only one fully Indian private company in the life business, meant that the expansion of the insurance sector did bring in a reasonable amount of foreign capital into the country.

Among the new features of the insurance sector after liberalisation, a few are particularly worth noting. First, equity infusion into the life business segment of the industry has been much greater than into the non-life business, resulting in the equity share of the former rising from 52 per cent of the total to 80 per cent. This may be indicative of private, including foreign, interest in areas that are more profitable and less risky. However, despite the large inflow of equity, the overall ratio of equity to assets under management remains small, amounting to just 1.7 per cent in the case of the life business as a whole in 2010-11. This increases the possibility of insolvency. Second, within the life segment, the share of hybrid instruments, such as unit-linked insurance plans that involve market investments, which ensure better returns for the insurer and higher cost and more risk for the insured, have been increasing. The share of funds garnered through such instruments in the total rose from nil in 2000 to 28 per cent in 2010-11. Third, within the non-life business too, private firms seem to be concentrating on the motor insurance area, with its share of outstanding private, non-life premiums rising from 24 per cent in 2005-06 to 42.4 per cent in 2010-11.

The focus on motor insurance is partly because of the large and growing market and the ability of the industry to hike premia. For example, in July 2002, just when liberalisation was resulting in private entry into the non-life insurance business, a number of nationalised general insurance companies took measures to raise rates of premium and actually reduce the number of policies on offer. Rates of premium went up by a third to around 40 per cent on many policies. Insurance firms justified these increases by pointing to the much higher rates being charged by new private entrants into the insurance business. Competition under liberalisation was clearly not lowering prices but equalising profits across private and public, with public sector companies required to show that they were no less “efficient” than private players. Keeping premia low by accepting just reasonable profits and resorting to measures like cross-subsidisation was no more acceptable, and insurance companies were calculating profits on each line of business separately. This was despite the fact that both the LIC and the general insurance sector were already highly profitable. The thirst for profits also resulted in an unwillingness to provide insurance cover to consumers who cannot pay enough to deliver a "competitive" profit.

Given these trends it is indeed surprising that the government has decided to increase foreign presence, on the grounds of increasing insurance penetration and density. This is unlikely to increase the spread of insurance across the population by much, but would import practices of the kind described earlier that characterise the industry in the US. This would subject the savings of the middle classes to increased probability of loss by enticing them into investing in new schemes that are opaque but involve higher risk. The government, of course, argues to the contrary. But the direction of movement is clear from the fact that, having introduced the new pension scheme that diverts a part of the lifesavings of the middle classes to investment in the market, the government has decided to allow foreign equity participation to the tune of 49 per cent in the pension fund industry as well. That may appeal to foreign investors and temporarily enthuse speculators in stock markets. But the consequences in the long run are likely to be the return of fragility and increased failures.

* This article was originally published in the Frontline Vol. 29: No. 21, Oct 20 - Nov 02, 2012.