

INTERNATIONAL EXPANSION — A UNITED KINGDOM PERSPECTIVE

A DISCUSSION PAPER

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ABSTRACT

This paper looks at the reasons why a United Kingdom life insurance company would wish to consider expanding into an overseas market, the factors it ought to bear in mind when deciding upon which country or countries to enter and the entry routes open to a company wishing to expand overseas.

By way of examples of overseas life insurance markets, the paper provides a detailed description of the German and Indian life insurance markets.

KEYWORDS

Change; Competition; Consolidation; International Expansion; Germany; India

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1. INTRODUCTION

1.1 The Faculty of Actuaries' International Research Group has, as its current objective, to consider the attractiveness, to United Kingdom life insurers, of certain European and Asian markets, in the context of a globalising and consolidating financial services market. This paper is the result of recent work by this Research Group.

1.2 The most important sections of the paper are 3 and 4, which contain the results of the Working Party's research into the German and Indian life insurance markets. These particular countries were chosen as they reflected the expertise of the Group and provided a pair of countries with contrasting characteristics.

1.3 As well as looking in detail at these two markets, the International Research Group also considered the reasons why a U.K. life insurance company would consider expanding abroad in the current environment, and the possible routes for entering an overseas market. The results of our deliberations are contained in Section 2.

1.4 The content of this paper is the responsibility of the members of the International Research Group, and does not represent the views of the U.K. actuarial profession nor of the authors' employers.

2. INTERNATIONAL EXPANSION FROM A U.K. PERSPECTIVE

2.1 *Key Issues facing U.K. Life Insurers*

2.1.1 Retail financial services companies, in the U.K. and elsewhere, are having to deal with a number of major issues, including rapid and fundamental changes in their business environment. Examples of the issues affecting U.K. life insurers, directly or indirectly, are:

- Insurance groups are entering the retail banking market.
- Retail banks are penetrating further into the life insurance market.
- Fund management companies are entering the defined contribution pensions market, often by setting up life insurance subsidiaries.
- Food retailers, general retailers and other strongly branded companies are entering the retail financial services market.
- Competition in the retail financial services sector is increasing, and margins are coming under pressure.
- Pensions mis-selling and guaranteed annuity options have had, and are continuing to have, an impact on many life offices.
- Non-traditional direct selling is beginning to gain ground, especially for companies with strong brands.
- Many of the world's major financial services markets are consolidating.
- The large international insurance groups are becoming larger, with greater amounts of absolute capital. They are becoming more powerful and more diverse, both in terms of product range and geographically.
- In many developed economies, the public sector is facing serious challenges as a result of the ageing of their populations.
- The European Union single market is becoming more of a practical reality in all areas of commerce, including insurance, although at different speeds.
- The world's economies are becoming more interdependent.
- Providers of retail financial services are becoming more global in their outlook and in their search for growth and return on capital.
- Insurance markets are liberalising and are opening up to international competition.

2.1.2 U.K. life insurers, faced with the above issues, need to determine how they ought to react. For example, what opportunities and threats do they present and do they have the people, processes and systems to take advantage of the opportunities?

2.1.3 One of the options available to a U.K. life insurer in search of better returns for its stakeholders, or wishing to protect existing returns, is to expand abroad. Whether this option is taken should depend on the company's view of the returns expected by taking this route compared to the expected returns available from other options, such as re-engineering their operational processes, merger and acquisition activity within the U.K. market or developing new products for the U.K. market.

2.1.4 Having considered various overseas options, a company may decide that the best strategy is to focus on its home market. This ought not to be seen as a necessarily negative or 'head in the sand' response to the changes in the business environment. Management may well be making a wise decision to concentrate on what they know and do best, perhaps trying to do it better, rather than spreading themselves too thinly. Developing the home market may be the best use of limited capital and management resources. The ageing of the population and the blurring of the boundaries between alternative retail financial products could provide major opportunities for efficient companies with good marketing and a quality service offering. The recent consultative document issued by the U.K. Government on stakeholder pensions may, however, have reduced their attractiveness to life insurers.

2.1.5 There is widespread agreement that the make up of the U.K. life industry is likely to change considerably over the next decade. The number of traditional life insurers, and particularly mutuals, is widely expected to fall, while the number of direct marketing and fund manager owned life insurers is expected to increase. In this environment, even successful companies will not be immune to the threat of being taken over or having a change of ownership which could lead to a merger with another insurance company. Expanding abroad is unlikely, in itself, to prevent this happening to a U.K. life insurer.

2.2 *Which Overseas Market?*

2.2.1 The choice of where in the world to develop an operation is not easy to make. If a company is starting from a position of no current overseas operation, then it would need to carry out a significant amount of research. Even companies which already have one or more overseas operations would need to carry out research to decide whether to develop their current operations or to expand into new territories.

2.2.2 Having carried out research into potential new markets, the decision as to which one to choose is not necessarily obvious. The factors which need to be considered will include the following:

- The current size of the life insurance market and the likely share that the company could expect to achieve will depend upon how competitive the market already is and how far existing life insurers have penetrated the market.
- The demographic position of the country will affect the size of the life insurance market and the types of product that would sell best in that market. Pension and healthcare products may have more potential in a developed country with an ageing population, whereas term assurances and simple savings products may be of more interest in a developing country with a young population.
- The economic position of the country in terms of general standard of living and disposable wealth will affect the types of products that will sell best in the country and the expected average premium size.
- The regulatory environment, including modes of entry, solvency

requirements, and selling and marketing regulations, could make the difference between starting in one country or another, although, if the life company already operates in highly regulated countries, this may not be such an issue. If a life insurer decides to operate in a country which has a different regulatory regime to that to which it is used to, it would need to consider very carefully whether to allow practices which, although allowed in the overseas territory, would not be acceptable in the home country.

- The cultural environment, including, for example, the ways of doing business, the language, the marketing of products and the management, by head office, of the local operation will also need to be taken into consideration.
- The availability, at economically sustainable levels, of local support services such as banking, custodian services, office premises, IT services, communication networks and a suitably educated workforce, including actuaries, will need to be taken into account.

2.2.3 Having considered the above factors, a life insurer will need to assess whether it has, or could obtain, the skills necessary to make a successful entry into an overseas market. These skills will not just include technical skills, such as actuarial and technical knowledge of the local regulatory environment. The life insurer will need to have the softer skills, such as being able to manage the cultural differences between the head office and the local operation.

2.3 *Entry Routes*

2.3.1 An important part of the process of deciding which country, if any, to enter is the identification of the most appropriate entry strategy. Some countries provide a wider range of possibilities than others.

2.3.2 Insurance companies wishing to expand overseas have at least five means of doing so:

- set up a branch operation;
- set up a wholly owned subsidiary;
- set up a joint venture with a local company;
- acquire part, or all, of an existing insurance company; and
- market into the country without setting up a full operation there.

2.3.3 For a company wishing to expand internationally the above options will have advantages and disadvantages, and the same route may not be appropriate for every company. The choice of where to expand, and how to do so, are not separable. Some markets may, for a number of reasons, be very attractive, but, if the possible entry routes are not suitable for a company, then those markets should, perhaps, not be considered.

2.3.4 Where there are a number of options available for entering a particular market, the factors that need to be considered when choosing between them include the following:

- Which of the options will provide the best access to distribution?
- What is the company's preference regarding branding and own name awareness?
- Does the company have the experience of managing the various options, e.g. has it experience of running joint ventures or making acquisitions?
- What is the target market's legislative environment and the possible future evolution of this environment?
- What are the relative tax and actuarial reserving implications of the various options?
- How much capital does the company have available for expansion?
- Which of the options is likely to be the most acceptable to potential customers?
- What is the relative risk of each option, and the ease with which a withdrawal may be achieved, if required?

2.3.5 *Setting up a branch of the parent company*

2.3.5.1 This route has historically been the simplest and quickest way to enter a market. Where alternate routes are permitted, regulators may see opening a branch as the firmest possible commitment that a company can make, as it is staking its reputation and capital on supporting the business in that country. Consequently branch operations are often the regulator's preferred mode of entry, and the fact that the regulatory burden is shared with the home authority provides an additional level of comfort.

2.3.5.2 With a branch operation, the company may have more freedom to allocate capital to territories and business lines that require it. Some jurisdictions may require capital to be held in the currency and the territory of the branch writing the business. Local capital requirements may be lighter than those of the home country, necessitating an allocation within the head office's books, over and above the amount held in the territory in question.

2.3.5.3 A branch operation allows a minimalist approach to building operational infrastructure; many of the operational functions may remain with the head office, although language can be a limiting factor, along with distance and time zones. Local employment rules may also mitigate against the minimalist approach.

2.3.5.4 The identity of the company is possibly strongest with a branch operation. The buying public and intermediaries may derive more comfort in dealing with a branch, particularly where the parent is a known quantity.

2.3.6 *Setting up a new wholly-owned subsidiary*

2.3.6.1 This route allows the regulation of capital flows to and from the parent company. Local incorporation, licensing, reporting and residency requirements for senior management can strengthen the regulator's hand, versus a branch operation. On the other hand, liability is limited to the amount of capital

in the subsidiary, although, in practice, the parent company may feel obliged to stand behind the subsidiary.

2.3.6.2 The wholly owned subsidiary route, like the branch approach, has the advantage of allowing complete management control and freedom to develop the business at the desired pace, and allows all of the profits of the overseas operation to be kept within the group. As with a branch, all of the expertise in technical areas and in distribution must be developed from within the parent or recruited locally. Accordingly, this route, like the branch route, may be preferred where some familiarity with the operating environment is present.

2.3.6.3 Forming a subsidiary will require an allocation of capital sufficient to meet its operational and solvency needs. This capital is obviously not available to the other parts of the group. Only when operating profits and shareholder dividends emerge will the parent have access to a return on its original investment, although embedded value, or equivalent profit reporting, may enable the parent to report on the profitability, or otherwise, of the operation.

2.3.6.4 Although a branch and a wholly owned subsidiary have no practical differences in terms of ownership, there can be important differences in the way that the operations are perceived within the group. A branch may often be viewed as an extension of the head office, albeit in another country, but, aside from the geography, no different from a branch in the home country. A subsidiary, however, is a head office in its own right, with responsibilities for licensing, statutory reporting, compliance, policy record keeping and the major functions of a life company. A clear separation of roles between head office and the overseas operation is an important way of ensuring that the local management has sufficient autonomy to run the operation. This may be easier to achieve in a subsidiary than in a branch.

2.3.6.5 A subsidiary offers the chance to promote an identity different from that of the parent company. This can be desirable for various reasons, not least of which may be to avoid confusion with existing local companies.

2.3.7 *Setting up a joint venture with a local company*

2.3.7.1 This is the most common mode of entry permitted in the developing world. The World Trade Organisation negotiations on financial services are ongoing at present, and potential signatories are being asked to open their insurance markets to foreign entry. Few are willing to open up to branches or wholly owned foreign subsidiaries, but many will allow partial foreign ownership. This is more acceptable in domestic politics where nationalist sympathies may be a powerful factor. Notable exceptions are the Philippines and Taiwan, where branches and subsidiaries, both wholly and partially owned by foreign companies, are permitted.

2.3.7.2 A joint venture may be viewed as the most favourable entry route, where the foreign life company has little or no familiarity with the operating environment in the target country. Key criteria in selecting a joint venture partner will include:

- brand name profile;
- government connections, which may be useful in the licensing process;
- distribution capability;
- willingness to undertake a long-term arrangement;
- shared vision and commitment; and
- common corporate culture.

2.3.7.3 Entering a joint venture arrangement obviously reduces the amount of capital required from the overseas insurer. A drawback is that the profits are also shared and ethical dilemmas might be encountered. It is common for the U.K. partner to provide most of the insurance expertise, particularly in the technical areas, and so there may be a need for a management services agreement, to allow them to be paid for this work.

2.3.7.4 A joint venture relationship adds an additional layer of complexity to a foreign undertaking. Reasons why a joint venture might fail include cultural differences and disputes over the use of policyholder funds and control. Further, holding a majority of the shares is not a guarantee of control, where the legal system may be less than transparent. Managing the partner relationship can be as important as managing the business. A clear division of responsibilities and areas of expertise is necessary.

2.3.7.5 The identity of the joint venture company will draw on that of the partners. Clearly the entity will share characteristics of both partners, but will usually develop its own culture. How rapidly this happens may depend on the extent of staff secondments from the parents. The name of the company will usually be a combination of both partners' names. As the local partner's name is more likely to be known in the territory in question, this may be given more prominence.

2.3.7.6 A joint venture, with the local company providing a distribution channel, may ensure that the new company's products get to market quickly.

2.3.8 *Acquiring part or all of an existing operation*

2.3.8.1 This route is often a short cut to establishing a business presence in a country. In countries such as Malaysia, where no new licenses are available, it is the only entry route. The transfer of shares to the foreign owner may also generally require a shorter approval process than applying for a license from scratch.

2.3.8.2 Buying into an existing operation can be less risky, as the original owners will have established staff and management structures, a market presence and relationships with the regulators. There will, of course, be a premium to be paid where this has been achieved successfully. Due diligence should be carried out to identify any problem areas with the potential acquisition. This would cover financial, tax and legal aspects of the company.

2.3.8.3 Buying an existing operation may mean buying existing problems and liabilities, such as poor systems, unproductive staff, hidden claims or emerging

financial liabilities. The latter can be very hard for a foreigner to identify, especially when accounting and reporting standards are not transparent.

2.3.8.4 A potential obstacle to establishing an operation with the identity of the parent is that the target company will already have an image, culture and presence of its own. Management practices may be difficult to change without wholesale changes in personnel, which might detract from the value of the acquisition, at least in the early stages.

2.3.9 *Marketing without establishing a physical presence*

2.3.9.1 Within the E.U. it is now possible to market insurance products cross border without having to establish a full presence in the target market. However, this route has not been very popular, although a number of U.K. insurers have set up offshore companies in other E.U. countries to sell tax efficient products into the U.K. and elsewhere in the E.U.

2.3.9.2 The advent of the internet and the existing capability to buy books, computers, arrange holidays and conduct certain financial services transactions 'on-line' might result in insurance companies reaching new markets by marketing their products over the world wide web. The regulatory issues and problems are, however, significant and complex. Web-based commerce might lead to the removal of middlemen from the supply chain linking product manufacturers and consumers (disintermediarisation), and this might force U.K. life offices to re-examine their distribution strategies. On the other hand, the world wide web might lead to a new generation of financial intermediaries who operate from the Web, rather than from the high street.

3. THE GERMAN LIFE INSURANCE MARKET

3.1 *Introduction*

Germany is the second biggest exporting nation in the world after the United States of America. It is the biggest economy in the E.U., and, with 82 million inhabitants (1997 figures), Germany is also the most populous country (25% of total E.U. population). Even before taking Austria into account, German is the largest language block of the E.U. Most significant of all for this paper, Germany also has one of the largest life insurance markets in the E.U.

3.2 *Savings Patterns*

Geographically, wealth and employment are unevenly split. The former East Germany has much higher unemployment than the former West Germany, and, West Berlin excepted, has less than 70% of the national average purchasing power per head. There is also a north-south divide, since the southern *Länder* of Hessen, Baden-Württemberg and Bavaria have had a consistently higher GDP per capita than the northern states.

Table 3.1. A comparison of German and U.K. economic statistics as at May 1999

	Germany	U.K.
Change in GDP	2.0%	0.7%
Change in wages & earning	2.6%	4.6%
Change in consumer prices	0.4%	2.1%
Unemployment rate	10.5%	6.3%
Yield on government bonds	3.90%	4.85%
Bank prime lending rate	4.15%	6.25%

Source: *Economist* (May 1999)

Table 3.2. Disposable income of German private households and the split between private consumption and savings

Year	Total disposable income (in billion DM)	Private consumption (in billion DM)	Savings (in billion DM)	Savings as % of disposable income
1995	2,226.4	1,973.9	252.5	11.3
1996	2,302.0	2,040.0	262.0	11.4
1997	2,339.6	2,084.0	255.6	10.9
1998	2,410.5	2,145.3	265.2	11.0

Source: Federal Statistical Office, Integrated Economic Accounts (17 April 1997), 1998 figures projected

Table 3.3. Monetary wealth of private German households by type of investment at end-1997

Asset type	Value in billion DM	% of wealth
Savings deposits	1166.5	21.9
Fixed-interest securities (bonds)	757.8	14.2
Investments in life insurance	825.6	15.5
Cash and sight deposits	461.0	8.7
Unit trusts	468.3	8.8
Time deposits	363.4	6.8
Claims against company pension funds	329.1	6.2
Investments in non-life insurance	337.4	6.3
Shares	443.0	8.3
Investments in building associations (<i>Bausparkassen</i>)	173.9	3.3
Total	5326.0	100.0

Source: *Deutsche Bundesbank*

Table 3.4. Comparison of German and U.K. demographics (1995 figures)

	Germany	U.K.
Inhabitants (millions)	81.5	58.4
Excess of births over deaths per 1,000 inhabitants	-1.4	2.1
Male life expectancy	72.8	73.6
Female life expectancy	79.3	78.9

Source: Federal Statistical Office

3.3 *State Benefits and Demographics*

3.3.1 Germany is one of a handful, but increasing, number of countries in the world with negative population growth (excluding net immigration and emigration).

3.3.2 State health insurance is compulsory for those earning less than DM76,500 in 1999 (DM64,800 in the East). The contribution rate in 1999 is on average 13.6% of gross salary (13.9% in East), of which half is paid by the employee and half by the employer. The contribution rate is independent of any cost or risk factors. A wage earner's contributions will also cover any non-working spouse and all children up to a certain age.

3.3.3 The public system is not run by the state, which simply specifies the minimum level of benefits to be offered, which includes dental and ophthalmic care. All doctors and hospitals are essentially private businesses. Their fees are paid by mutual-like health insurance societies (*gesetzliche Krankenkassen*). Each *Krankenkasse* is free to set its own contribution rate, but there are two provisos: no new member can be refused on risk grounds, and any over-spend (under-spend) by the society is then cancelled out by spreading the costs (benefits) amongst the other societies to an extent based on the risk structure of the portfolio. This system (the *Risikokostenausgleich*) ensures that the contribution rates are, in practice, almost identical. The weakness of this system is that a given society must share most of the benefits from its own claims cost control, but is also protected from the full consequences of its own over-spend.

3.3.4 The system is currently under strain, as all the other societies are subsidising the *Allgemeine Ortskrankenkassen* (the AOK — a large group of local *Krankenkassen*, which insure the bulk of blue-collar workers). The system also has another source of strain. Since premiums are expressed as a percentage of salary, the currently record high unemployment rate in Germany has reduced premium income for the *Krankenkassen*. This strain was met in 1998 with an increase in the contribution rate and the introduction of various small charges to be met by patients.

3.3.5 People earning above the limits given in ¶3.3.2 may stay in the public system, buy private health insurance, or else self-insure and pay medical expenses as and when they arise. Once someone has opted out of the public system, he or she may not re-enter as long as he or she earns above the limits given in ¶3.3.2. From the description in ¶3.3.2, the losers under the public system are clearly the

young and single, since they represent the best risks in terms of benefit costs. The disparity is such that private healthcare offers tremendous potential savings for this group. The market for private healthcare can be expected to grow as the contribution rate increases. That the contribution rate will increase seems certain, as a result of the factors outlined in ¶3.3.14.

3.3.6 Pensions in Germany are arranged around the so-called three pillars (*Säule*): the state pension, employer-sponsored pensions, and private pensions. Of these, by far the most important currently is the state pension. The average state pension in payment is around DM2,090 per month, which currently represents 70.1% of average net income.

3.3.7 Bismarck founded the state pension scheme (*gesetzliche Rentenversicherung*) in 1889. It is compulsory for all employees earning over DM 630 per month. It is a pay-as-you-go scheme, and the contribution rate in 1999 was 19.5% of gross salary. Contributions are made in respect of salary up to DM 8,500 per month. This contribution is split equally between employer and employee.

3.3.8 In recent years a number of measures have been introduced to contain or meet the cost of the state pension scheme. In April 1998 indirect taxes were increased from 15% to 16%, to avoid having to increase the contribution rate. The state retirement age has been equalised at 65 for both men and women. Benefits are being reduced from 70% to 64% of net income. From 1 April 1999 the newly formed German Government has introduced several more changes. An additional energy tax was introduced to subsidise the state pension scheme and the contribution rate was reduced to 19.5%. In addition, the Government extended compulsory social insurance to include people earning less than DM 630, which has led to problems in the labour market.

3.3.9 Pension benefits are based on a career revalued average salary, and the formula has been changed several times in the past to account for changes in demography, the labour market and the social security system. Time spent doing military service, in full-time education or raising children (capped at three years) is all credited without corresponding contributions. There is also the special case of ethnic Germans coming from Eastern Europe and the former U.S.S.R., who received full credit for their full working life without having paid anything into the system.

3.3.10 As with the state health insurance system, the administration of the state pension is in the hands of institutions incorporated under public law. Of these, the biggest is the BfA (*Bundesversicherungsanstalt für Angestellte*), which administers the pensions of white-collar employees. Blue-collar workers have their pensions administered by different regional institutes (*Landesversicherungsanstalten*). All of these various institutions are governed by so-called 'parliaments of the insured' (*Versicherungsparlamenten*), whose members are elected in equal measure by employers and employees.

3.3.11 Civil servants (*Beamte*) currently receive their pensions directly from the state, for which they do not have to contribute anything.

3.3.12 The self-employed are expected to make their own provision for retirement.

3.3.13 Germany has an ageing population, which is projected to shrink from 2000 onwards, as Table 3.5 shows. This has significant consequences for the various state sponsored pay-as-you-go insurance systems.

Table 3.5. Projected development of the German population

Year	Projected population (millions)	Proportion under 20	Proportion between 20 to 60	Proportion over 60	Ratio of 20 to 60 versus over 60
2000	83.2	21.2	55.7	23.1	2.41
2010	82.0	18.5	56.2	25.3	2.22
2020	78.6	17.0	54.2	28.8	1.88
2030	73.7	16.7	48.7	34.6	1.41
2040	67.6	15.9	49.1	35.0	1.40

Source: Eighth co-ordinated population projection by the Federal Statistical Office (variant 1)

3.3.14 The nightmare scenario for the German pay-as-you-go insurance system is:

- high unemployment (and thus fewer contributions collected);
- a lengthening life expectancy (and thus more benefits paid out); and
- a decreasing working population supporting an increasing retired population.

3.3.15 Unfortunately this is exactly the scenario that Germany now faces. The situation is exacerbated by politics. The system may have been mis-used in the past, and many politicians may be unwilling to face up to facts, thus delaying the necessary fundamental reforms.

3.3.16 The system is also coming under pressure from other, more subtle, sources:

- An increasing proportion of young people are entering tertiary education, thus delaying the start of their working life (and also their contributions).
- The role of part-time work has increased, and part-time salaries often fall under the limit for which contributions must be made.
- An increasing proportion of people are becoming self-employed, partly in order to escape the social taxes. Some of these may be employed, but with a contract to make them look self-employed.

3.3.17 The Government has introduced a new law to prohibit this latter custom, which makes it more difficult to avoid payment of social insurance contributions for employers and 'dependent self-employed' (*Scheinselbständige*). This will cause some problems for those insurance companies with tied agent networks. Currently, agents are considered to be self-employed, but this will

change, as the definition of self-employment will no longer cover their agency agreement.

3.3.18 Although the various options for reform are still being hotly debated, a decisive shift in favour of private pensions may be unavoidable in the longer term. This would represent an expanding market for the insurance industry, although unit trust companies are lobbying strongly to be allowed to provide what primarily may be investment products. It is unlikely that insurers will have this market to themselves. In autumn 1998 the mutual funds industry introduced a new type of mutual fund called the *Altersvorsorgesondervermögen (AS-Fonds)* (literally translated as ‘special fund for old age provision’), which is basically a managed fund with a minimum of 50% equity investment. These products are now marketed as an alternative to life insurance products as a vehicle for private pension provision.

3.4 The Size of the German Life and Pensions Market

The German market is already large and, for the reasons outlined in Section 3.3, it is set to grow even larger.

Table 3.6. Penetration of insurance and insurance density in 1995

	Germany	U.K.
Premiums as % of GDP	6.42	10.33
Total business (U.S.\$ per capita)	1,899	1,694
Life (U.S.\$ per capita)	763	1,079

Source: Statistical Yearbook of German Insurance 1997

3.5 The Regulatory Environment

3.5.1 The Insurance Supervision Act of 1910 formed the basis of ‘substantive government supervision’ against a background of a number of insurance company insolvencies. The federal supervising body is the BAV (*Bundesaufsichtsamt für das Versicherungswesen*), and, prior to the E.U. Third Life Directive, it was responsible for advance authorisation of all premium rates, products, policy conditions and underwriting standards. The BAV is not only responsible for monitoring the solvency of German insurers, but is also allowed to intervene if a product contravenes insurance contract law or other consumer protection laws.

3.5.2 The implementation of the E.U. Third Life Directive on 1 July 1994 was a massive cultural change for domestic German insurers. The change was most evident in the tumult in the motor insurance market, where the freedom to set prices has led to a sharp drop in premiums. A number of foreign operations have been very active in this area, especially via direct telesales. The sharp decrease in premiums means that these companies are far from profitable.

3.5.3 Change has been much slower in life insurance, where most of the domestic German insurers may have maintained a pre-1994 mentality. German insurers may not be well placed to react to innovation as and when it does

appear. A history of tight regulation has resulted in the development of a largely technical role for German actuaries. German actuaries have far less influence in life insurance companies than, for example, the salesforce does. German insurers are also handicapped by the local regulations, which restrict their ability to invest in equities — such restrictions may not apply to foreign-supervised insurers.

3.5.4 The asset valuation regulations require that property and shares are shown at the lower of the book value (purchase price) or the market value, if this has ever been lower. This rule (the *Niederwertprinzip*) is a major disincentive for an insurer to invest in equities. Should an insurer nevertheless decide to invest in equities, the law forbids it from investing more than 30% of its assets in equities.

3.5.5 A consequence of this was that German insurers had unreported (and as yet unrealised) gains on their equity holdings — the so-called ‘silent reserves’ (*stille Reserven*). Since 1997, these gains are disclosed as part of the new reporting requirements. The industry, in total, reported hidden reserves of 12% of the total assets. The level of hidden reserves ranges from 1% to 21%. Bigger, older companies have larger silent reserves than smaller, younger companies. Currently, the companies are using much of the hidden reserves to maintain bonus levels in the current low-interest environment.

3.5.6 The unnecessary conservatism of the *Niederwertprinzip* has led to unusual methods of releasing the value of such holdings. A number of German insurers have used derivatives to turn inadmissible capital gains into admissible income. However, not all of these attempts have been successful, as some reported losses show. Another popular method to overcome this problem is to use so-called *Spezialfonds* (a mutual fund especially designed for one investor). This vehicle allows asset appreciation to appear in the balance sheet without selling the underlying asset. This only helps to a certain degree, as there is a restriction concerning the maximum investment possible with one mutual fund company.

3.5.7 The usual E.U. solvency regulations apply in Germany: 4% of reserves for endowment assurances, 1% of unit linked reserves, 0.3% of sums at risk. In addition, 16-18% of premiums for supplementary contracts (normally for accident and disability) is also required. The capital sources to cover these solvency margins include:

- shareholder capital (*Eigenkapital*);
- terminal bonus reserves;
- free part of the reserve for future profit participation (*Rückstellung für Beitragsrückerstattung*, or RfB);
- silent reserves (*stille Reserven*, arising from the *Niederwertprinzip*); and
- future profits.

3.5.8 Up to 75% of the E.U. solvency margins can be covered by the RfB. The average solvency of a German life insurer in 1995 was 188% of the minimum, composed as shown in Table 3.7.

3.5.9 Future profits and hidden reserves did not play a significant role in

Table 3.7. Make up of average solvency of German life insurers

Source of capital	Percentage of solvency margin
Shareholders' capital	25.4
Terminal bonus reserve	96.5
Reserve for future profit participation	66.1
Total	188.0

Source: Tillinghast

solvency calculations up to 1995, although this may have changed in the last years, as the RfB has decreased for a lot of companies.

3.5.10 The RfB arises because of the conservatism of German premium rates. As insurers charge much more than is necessary to cover risk and capital benefits, the RfB is a reserve of these surplus premiums accumulated with interest and gradually released back to the policyholder. Life insurers, therefore, bear very little real insurance risk; almost all annuities are with-profits and even term assurances have, until recently, had terminal bonuses.

3.5.11 However, German insurers may be exposing themselves to some investment risks. For example, many of them may be declaring bonuses on their annuities which are not supportable by the market rate of interest. Contractually, these bonuses can be cut at any time, but the marketing problems involved in doing so may mean that they are exposed to risks as real as if they were contractually guaranteed.

3.5.12 The balance sheet of a German life assurance company is broadly as follows:

Assets	Liabilities
Immaterial assets	Shareholders' capital
Investments	Technical reserves:
	unearned premium reserve
	premium reserve
	claims reserve
	reserve for future profit participation
	other reserves
Investments for unit-linked life assurances	Reserves for unit-linked life assurances
Payments due from:	Pension scheme reserve
policyholders	Deferred tax reserve
agents	Reinsurance liabilities
reinsurers	Agents' liabilities
other parties	Policyholder liabilities
Other assets	Other liabilities
Deferred charges to operations	Deferred credits to income

3.5.13 Insurance company investment assets are covered in more detail in Section 3.7.

3.5.14 Shareholders' capital (*Eigenkapital*) is valued at nominal value. The technical reserves are the most important part of the liability side of the balance sheet, and the rules for their calculation are given in the *Rückstellungsverordnung*, based on Paragraph 65 of the *Versicherungsaufsichtsgesetz* (VAG — the Insurance Supervision Law). German companies are not able to value their technical liabilities using an interest rate linked to the yield on the assets that they actually hold. Instead, the maximum valuation interest rate allowed is 60% of the rate on government bonds, which, in mid-1999, would have implied a maximum valuation rate of interest of around 3%. In Germany bond yields have been falling steadily over the past few years, and there is currently little prospect of rates rising now that the European Central Bank has assumed responsibility for interest rate policy in the Euro zone. The maximum valuation rate of interest will, therefore, be reduced in the near future. The insurance association and the BAV are discussing whether this ought to happen from either 1 January 2000 or 1 January 2001.

3.5.15 The yield on 10-year government bonds has decreased significantly over the past few years to a low of 3.8% in October 1998. Therefore, it will be necessary for the BAV to reduce the maximum interest rate for valuing new business. For the year 2000 and onwards, this interest rate will reduce from the current 4% to 3.5%, or even 3%. This will lead to a corresponding decrease in the interest rate used for pricing, and will increase the cost of the guaranteed parts of a life insurance product.

3.5.16 The mortality rates and expense provisions are decided by the *verantwortliche Aktuar*, who has a role similar to that of the U.K.'s Appointed Actuary. Most actuaries use the mortality table DAV 1994, which was published by the German Actuarial Society (*Deutsche Aktuarvereinigung*) and is conservative enough to have been approved by the BAV for valuation purposes. Only a handful of companies use tables based on the assured life experience in their own portfolio. Future expenses are allowed for implicitly with regular premium contracts, while single premium and paid-up policies have an explicit expense reserve.

3.5.17 All technical reserves take reinsurance into account.

3.5.18 A further very important liability is the reserve for future profit participation, the *Rückstellung für Beitragsrückerstattung* (RfB). For business written before July 1994, 95% of the technical profits for the year had to be allocated to this reserve or distributed as a direct credit to policies. The rule for business written after this date is that 90% of the total technical interest earnings have to be allocated to the policy reserve, the RfB or have to be distributed as a direct credit. The main purpose of the RfB is to act as a buffer against profit fluctuations and to allow a stable bonus distribution policy. In addition, the German insurers lobbied successfully for the right to count the free RfB (the part

not already promised to be distributed to policyholders) towards the E.U. solvency margin.

3.5.19 The profit and loss account of a German life insurer contains the following:

- technical calculation:
 - premiums, including change in unearned premium reserve;
 - interest on the reserve for future profit participation;
 - asset returns and capital gains;
 - other gains;
 - claims and changes in claim reserves;
 - change in premium reserve;
 - allocations to the RfB;
 - expenses of administration and acquisition;
 - expenses for asset management and depreciation; and
 - other expenses;
- non-technical calculation:
 - profits from technical account;
 - expenses;
 - extraordinary profits;
 - extraordinary losses;
 - taxes;
 - dividends to shareholders; and
 - allocation to shareholders' capital.

3.5.20 German insurers must split their expenses into four distinct categories: acquisition, claims management, asset management, and other administration expenses.

3.5.21 The balance sheet, the profit and loss account, a management report and some statistical material are published annually, and are available to the public. Further reporting required by the BAV is not made available to the public. The purpose of this so-called internal calculation (*interne Rechnungslegung*) is mainly to enable the BAV to supervise the companies efficiently. In these internal accounts, the BAV requests a large number of reports on asset allocation, solvency, a split of the profit and loss accounts by class of business and a breakdown of premiums into components for savings, risk and expenses. This latter report is used for the allocation of profit to the different business classes.

3.5.22 The distribution of the emerging profit for pre-1994 business is laid down in an operating plan, which must be approved by the BAV. The idea is to manage a fair bonus method by transferring the money to the policyholders' accounts, according to the product type. In the past, the BAV insisted on methods to distribute the profits in a 'natural and fair' way. This demand led to systems following the idea of the contribution formula. Compared to the U.K., the bonus systems are, therefore, relatively complex: a system with four or more rates is not uncommon. For example, it is common practice to allocate risk profits as a

percentage of the paid risk premiums, or else as a percentage of the sum assured. Expense profits are allocated as a percentage of the premium or sum assured rather than as a percentage of the fund value, as the expense loadings are normally related to the premium or sum assured only. Interest bonus is allocated as a percentage of the premium reserve and the policyholders' profit account. The calculated bonus will then usually be used as a single premium contribution to increase the sum assured, or else be directly transferred to the policyholders' profit account. For term assurances, the profit share will normally be distributed by granting a rebate on the premium, or else by increasing the sum assured.

3.6 *German Life Insurance Products*

3.6.1 The main product is the traditional regular premium with-profits endowment, often with occupational disability and accidental death riders. The importance of unit-linked business has grown substantially in the last two years, and accounted for 8.6% of the new regular premiums in 1998. Unitised with-profits is a largely unknown concept, and currently only features in products offered by U.K. insurers. Deferred and immediate annuities are growing in importance due to changes in the state pension system. Term assurance rates are now very competitive. There is very little critical illness business. There is growth in the disability insurance market due to the reductions in state benefits.

3.6.2 Employer-sponsored benefits play a distinctly secondary role next to the state pension. The tax laws favour the accumulation of book reserves for defined-benefit pensions in the employer's balance sheet. Increases in such reserves are offset against tax. Defined contribution pensions are taxed as a benefit in kind in the year when the contribution is made, whereas a defined benefit pension is only taxed in the year when it is received.

3.7 *German Life Office Investment*

3.7.1 The vast bulk of German insurance company assets are fixed interest securities. This is a consequence of the regulatory environment, which, as described in ¶3.5.4, penalises equity investment.

3.7.2 Registered fixed interest securities (*Namensschuldverschreibungen*) may be valued using yields current at the date of purchase, rather than the ruling market yields. The regulations do not force the lower of book and market values to be used, as is required with equities. German insurers offer comparatively high bonuses, a strategy which may be best served by a conservative investment policy. Historically, the excess return of equities over fixed interest securities has generally been lower than that seen in the U.K. or the U.S.A.

3.8 *The Sale and Distribution of Insurance Products in Germany*

3.8.1 There is no sales regulation of insurance products in Germany. The basic principle has been one of consumer protection via controlled products, tariffs and investments. However, with the introduction of the Third Life

Directive, the BAV can no longer enforce a system of prior approval on insurers. The rules for selling investment products were, however, tightened in early 1998.

3.8.2 As shown in Table 3.8, over 50% of 1996 sales were via direct salesforces and tied agents. The deep penetration of the traditional German insurers (practically every village has an Allianz office) makes the entry of a new insurer very difficult. Every major bank and *Bausparkasse* (building society) has a strong tie to a domestic insurer. The broker market in Germany is very small, but growing, while telesales and direct marketing offer some potential.

Table 3.8. Distribution of new life insurance business by channel in 1996

Tied agents	48%
Brokers/agents*	21%
Banks	15%
Non-independent pyramid salesforces	8%
Direct response	8%

Source: Insurance Pocket Book 1998, Tillinghast-Towers Perrin

* Multiple agents, including independent pyramid salesforces

Table 3.9. Investments of life assurance companies in 1996 by type of investment

Type of investment	Value (in billion DM)	% of assets
Land and property rights	30.9	4.0
Shares in affiliates	15.7	2.0
Loans to affiliates	2.3	0.3
Participating interests	7.2	0.9
Loans to linked undertakings	2.9	0.4
Shares	18.6	2.4
Shares in pooled investments	86.7	11.3
Other non-interest bearing investments	4.6	0.6
Bearer bonds and other fixed-interest securities	84.8	11.0
Loans secured by mortgages	107.1	14.0
Registered bonds	252.6	33.0
Debentures and loans	136.7	17.8
Policy loans	10.0	1.3
Other loans	1.7	0.2
Deposits with credit institutions	4.3	0.6
Other investments	1.7	0.2
Total	767.7	100.0

Source: Federal Supervisory Office (BAV), annual report

3.9 Taxation

3.9.1 There are no tax duties levied on life insurance premiums, although a draft of the recently shelved tax reforms proposed a stamp duty of 3% on

premiums for endowments and unit-linked policies. The new government has shown no signs, as yet, of revisiting these plans.

3.9.2 Provided that a policy meets the qualifying rules, policyholder funds receive gross roll-up. To qualify, a life insurance contract must fall into one of the following categories:

- Endowment assurances must have a sum assured equal to at least 60% of the premiums payable. The premiums must be regular and be payable for at least five years. The period of life cover must be for at least 12 years.
- Term assurances always qualify.
- Deferred annuities without a lump sum option always qualify.
- Deferred annuities with a lump sum option qualify if they are regular premium annuities and the lump sum option is not exercisable within the first 12 years of the contract.
- Long-term care insurance always qualifies.

Table 3.10. Fiscal comparison between Germany and the U.K.

	Germany	U.K.
Top marginal rate of income tax in 1998 (%)	53.0	40.0
Taxes as % GDP in 1994 (OECD criteria)	42.6	33.8
Public expenditure as % of GDP in 1997	49.0	42.1

Source: Federal Statistical Office, *Statistisches Jahrbuch für das Ausland* (1996)

3.9.3 Lump sum benefits are tax-free if the policy follows basically the same rules as set out above. Life annuities in payment are taxable on an income component based on the age of the annuitant at inception. Annuities certain are fully taxable.

3.9.4 Benefits paid other than to the policyholder are taxable, mainly according to the rules of inheritance and gift tax. This tax is due when there is a claim if the claim amount is greater than certain limits. These limits are set especially high for spouses and other relatives.

3.9.5 There is limited tax deductibility of qualifying premiums for health and life insurance. Premiums are only deductible if:

- they are payable to a life insurer which has permission to conduct business in Germany (i.e. practically all life offices in the E.U.); and
- they are not linked, directly or indirectly, to the taking of a loan.

3.9.6 Premiums for unit-linked life policies are not tax deductible. Although this might seem a big disadvantage, the tax deductibility limits are, in practice, set so low that tax deductibility is not a big selling point.

3.9.7 If a policy is non-qualifying, withholding tax is payable on interest and dividends when the policy proceeds are finally payable. This can lead to a high tax burden in the year of payment. There are also a number of test cases before the courts to establish if an endorsement renders a policy non-qualifying. This

applies to any non-planned endorsement, such as a premium increase/reduction or even, according to some opinion, a fund switch in a unit-linked policy. Policy changes planned at outset, such as automatic yearly premium or benefit increases, are not affected. As the tax rules are very inflexible, they have contributed to the relative lack of product innovation in the German market.

3.9.8 Life insurance companies are taxed on the profit, calculated according to certain commercial and legal rules, allowing for allocations to the RfB (see ¶3.5.9). Allocations are only fully deductible if the remaining surplus is greater than the net income on the company's operating assets. There is no taxation on technical reserves, and there is also no separate taxation of interest and dividend income. The tax reforms planned for the year 2000 will have a minor impact on the ability to build up hidden reserves.

Table 3.11. Annual income tax bands for single people (bands are double for married people)

Year	Band II start DM	Band III start DM	Band IV start DM
1996	12,095	55,728	120,042
1997	12,365	58,644	120,042
1998	12,365	58,644	120,042
1999	13,067	66,366	120,042

Source: *Versicherungskaufmann*, according to §§32a, 52 EStG

Table 3.12. Current income tax rates

	Band II	Band III	Band IV
Tax rate	25.9%	33.5%	53.0%

Source: *Versicherungskaufmann*, according to §§32a, 52 EStG

3.9.9 People with a taxable income in band I (the so-called *Existenzminimum*) pay no income tax.

3.9.10 With the band limits marking time, this represents a creeping increase in taxation. On top of the recent rises in social security deductions (for the state pension and health insurance schemes) and salary increases below inflation, the net income of most Germans has been reducing.

3.9.11 In addition, every income tax payer must pay a 'solidarity surtax' (*Solidaritätszuschlag*) for the rebuilding of former East Germany. Although originally scheduled to stop in 1997, this will now only drop from 7.5% of income tax paid to 5.5%. A church tax of up to 9% of income tax is also payable for members of a recognised church.

3.9.12 Neighbouring Luxembourg offers lower tax rates and absolute banking secrecy, and the amount of German assets accumulating there has increased significantly over recent years. This has become a source of considerable friction

between Germany and Luxembourg, as many high net worth Germans seek to protect their assets from the German tax authorities (*Finanzamt*).

3.9.13 Capital gains are tax free in Germany after a twelve-month ‘speculation period’. This period used to be six months, until it was changed as part of the 1999 tax reforms.

3.9.14 To put the German system of income taxes and deductions into perspective, the tax position of an unmarried recent university graduate, earning a typical entry-level salary in the 1998 financial year is given in Table 3.13.

Table 3.13. Year-end tax and deductions statement

Description	DM in year	% of gross salary
Total salary	70,000	100.00
Income tax	15,817	22.60
RV — State pension insurance	7,105	10.15
KV — State health insurance	4,760	6.80
AV — State unemployment insurance	2,275	3.25
Solidarity surtax	870	1.24
PV — State long-term care insurance	595	0.85
Church tax	0	0.00
Net salary	38,578	55.11

Source: Research Group’s own calculations

3.9.15 The various state insurance premiums are deducted from gross salary to calculate the taxable income for income tax purposes. The maximum limit for insurance deductions is DM3,888 p.a., which is already used up by the state pension insurance in the example above. The marginal rate of tax for the graduate in Table 3.13 is therefore 44.89%. The recent reduction in the solidarity surtax has been more than offset by the increases in the contribution rates for the state health and pension schemes. An increasing number of Germans are de-registering themselves as church members as a means of reducing their tax burden.

3.9.16 Although the burden of taxation is very high in Germany, there exist a large number of exemptions through which the state directs private saving. These are made highly attractive by the high marginal rates of taxes and by deductions. For example, the building of a new house, which is very common in Germany, attracts special tax breaks.

3.10 *The Main Players, Foreign Players and Ownership Structures*

3.10.1 In addition to the usual mutual-proprietary split, Germany also has some institutions ‘incorporated under public law’. These insurers are usually owned by the federal state in which they operate or by publicly owned savings banks.

3.10.2 There are some U.K. insurers active in Germany via different entry routes:

- subsidiaries (CGU owns Berlinische Leben and Assecura, Royal and Sun Alliance owns Securitas and Guardian owned Albingia, now sold);

Table 3.14. Life assurance companies under federal supervision in 1995

Type	Number of companies	% of total premium income
Proprietary	86	71.6
Mutual	25	18.0
State-owned	10	8.0
Foreign	4	2.4
Total	125	100.0

Source: Federal Supervisory Office (BAV) annual report

- branches (Standard Life and Equitable Life); and
- selling into Germany from elsewhere in the E.U. (Scottish Amicable from Dublin, Clerical Medical and Scottish Equitable from Luxembourg).

3.10.3 It is very common to find cross-shareholdings between banks and insurance companies, and this makes penetration by foreign insurers even more difficult. It is also very common for insurers to be substantially owned by another insurer. For example, Allianz and Munich Re own about 30% of the German insurance market via their shareholdings in other direct insurers. The latter company has been consolidating these shareholdings with the formation of ERGO, the second biggest direct insurer in the German market.

3.10.4 The top 30 insurers make up 76.6% of the total German life and pensions market (Source: *European Life Insurance*, Alan Leach).

3.11 *The German Actuarial Profession*

3.11.1 The German actuarial profession is the DAV (*Deutsche Aktuarvereinigung e.V.*), and the examining body is the DGVM (*Deutsche Gesellschaft für Versicherungsmathematik*). The rules of the professional body specify three types of member: ordinary, honorary and associated. All members have the same rights and duties, with the exception that associated members have no passive voting rights and honorary members do not pay membership fees.

3.11.2 Ordinary membership is attained by passing examinations following the syllabuses described below. Honorary membership can only be conferred by the members voting on the suggestion of the executive. Associated members are those who work in Germany as actuaries and are full members of other actuarial associations in the E.U. A precondition of membership is a university degree in mathematics or a similar science and three years' professional actuarial experience.

3.11.3 There is a further internal body for pensions actuaries, and there are further examinations required to enter this body.

3.11.4 The executive can expel a member from the professional body. There are three possible grounds for expulsion: non-payment of fees, damaging the interests of the profession, and violation of professional rules or guidelines.

3.11.5 Paragraph 3.11.6 describes the examination system for prospective German actuaries. Comparing this with the U.K. syllabus, one difference is apparent: the Germans train and examine their actuaries in information technology. Given the ever increasing importance of information technology in modern business, the U.K. actuarial profession may consider following the Germans in this regard.

3.11.6 The examination system for prospective German actuaries is divided into three areas:

- basic knowledge I:
 - mathematics of life insurance; and
 - mathematics of general insurance;
- basic knowledge II:
 - mathematics of finance;
 - mathematics for building societies (*Bausparmathematik*);
 - mathematics of health insurance;
 - information processing (IT/IS); and
 - mathematics of pensions;
- specialised knowledge:
 - mathematics of life insurance;
 - mathematics of general insurance;
 - mathematics of health insurance;
 - mathematics of pensions;
 - mathematics of finance; and
 - mathematics for building societies (*Bausparmathematik*).

3.11.7 The subjects listed above contain the following syllabus items:

- mathematics of life insurance:
 - probability basics (random variables, discrete and continuous distributions);
 - compound interest;
 - insurance calculations (mortality tables, dependent and independent rates);
 - expected present values (commutation functions);
 - premium calculations (net and gross premiums, Zillmerisation);
 - reserve calculations (Zillmerisation, splitting into savings and risk elements); and
 - bonus (sources of surplus, distribution systems);
- mathematics of general insurance:
 - basics (data, individual and aggregate loss distributions);
 - insured risk (risk components, solvency regulations);
 - premium calculations (premium components and margins on expected costs);

- reserves (run-off); and
- risk division (direct insurance and reinsurance);
- mathematics of pensions:
 - discrete probability spaces (independence, expected value, variance, estimation);
 - Markov chains (Markov property, renewal processes);
 - population models (multiple modes of decrement);
 - premiums and reserves (commutation functions, pensions reserving); and
 - pensions financing and balance sheet calculations;
- information processing:
 - computer architecture and software (hardware, programming languages, databases);
 - information processing in insurance (modelling business processes, applications);
 - methods of software development (modelling data and processes, industry standards);
 - development of software (phase model, quality assurance, testing, project management); and
 - future developments (object orientation, knowledge-based systems, expert systems);
- mathematics for building societies (*Bausparmathematik*):
 - basics (contract, credit);
 - regulatory basics (building society law);
 - tariffs (contract charges);
 - special cases (valuation and allocation, cancellation, simplified development); and
 - basic mathematics.

3.12 Assessment of the Attractiveness of the German Life Insurance Market

3.12.1 Germany is the largest economy in the E.U.

3.12.2 Demographic pressures are likely to result in state sector benefits being contracted out to the private sector. This may represent a huge opportunity for insurers, as the market for private savings and protection may expand considerably.

3.12.3 After years of tight regulation, German insurers may find it difficult to respond to new entrants who may bring more innovative products to the market.

3.12.4 The Third Life Directive facilitates market entry, and may allow U.K. insurers to offer products with a higher equity backing, and hence higher returns, than German insurers.

3.12.5 On the downside, building distribution is likely to be difficult and expensive, and further consolidation may result in a more competitive market.

4. THE INDIAN LIFE INSURANCE MARKET

4.1 Introduction

4.1.1 In April 1993 the Government of India appointed the Committee on the Reform of the Insurance Sector, better known as the Malhotra Committee, under the Chairmanship of Mr R. N. Malhotra. The following summary is based on that in Chapter 2 of the report produced by the Committee.

4.1.2 Life insurance came to India in 1818 with the founding of the Oriental Life Insurance Company in Calcutta. This was followed by the establishment, in 1823, of the Bombay Life Assurance Company and, in 1829, of the Madras Equitable Life Insurance Society. At first Indian lives were subject to an extra premium of 15% to 20%. The Bombay Mutual Life Assurance Society, an Indian insurer, established in 1871, was the first to offer cover at normal premium rates.

4.1.3 The first statutory measure to regulate life insurance business was the Indian Life Assurance Companies Act 1912. The Indian Insurance Companies Act 1928 enabled the Government, among other things, to collect statistical information from Indian and foreign insurance companies.

4.1.4 The Insurance Act 1938 consolidated and amended earlier legislation. Its aim was to protect policyholders, and it had “comprehensive provisions for detailed and effective control over insurers’ activities” (Malhotra Report). Regulation was split between two bodies. Policy matters were attended to by an insurance wing, attached initially to the Ministry of Commerce and later to the Ministry of Finance. Operational matters were initially the responsibility of the Actuary to the Government of India, though they later came to rest with the Controller of Insurance.

4.1.5 The Insurance Act was amended in 1950. Significant changes included:

- a requirement for equity capital;
- ceilings on shareholdings in insurance companies;
- stricter controls on investments;
- submission of periodical returns;
- the appointment of administrators to mismanaged companies; and
- ceilings on expenses of management and agency commission.

4.1.6 The Indian life insurance industry was nationalised in 1956. The Life Insurance Corporation of India (LIC) was established by the LIC Act 1956. It took over the management of the life insurance businesses of 245 Indian and foreign companies. The general insurance industry was nationalised with effect from 1 January 1973.

4.1.7 Over the following few years, most of the Controller of Insurance’s powers relating to life business were gradually transferred to the LIC. “Presumably it was considered either the nationalised companies themselves or, where necessary, the government could regulate and supervise the industry... This dispensation was flawed even in the context of a state monopoly and would in any case have to change in a competitive environment” (Malhotra Report).

4.1.8 The LIC's objectives were stated when it was set up. They were reformulated in 1974, following the recommendations of the Administrative Reforms Commission. Though its primary obligation is to its policyholders, it also has a social function in spreading insurance into rural areas and in deploying its funds "without losing sight of the interest of the community as a whole, ..., keeping in view national priorities."

4.1.9 The Malhotra Committee's characterisation of the state of the Indian insurance industry is summarised in 'Liberalising India's Insurance Industry' by Malhotra, a public lecture delivered under the auspices of the A. D. Shroff Memorial Trust, 13 September 1995:

"Over the years, the nationalised insurance companies have expanded their business and established an extensive presence throughout the country. They have developed financial strength and large reservoirs of trained manpower. However the lack of competition has engendered complacency in the insurance industry which is reflected, among other things, in insufficient responsiveness to customer needs, high costs, instability of marketing networks, excessive lapsation of life policies, over-staffing, growth of restrictive practices and serious lags in technology. Despite overall growth of insurance, several lines of business have not been sufficiently developed and there is vast untapped potential. Since nationalisation, regulation of the insurance industry has atrophied. High levels of directed investment of the funds of insurance companies have affected rates of insurance premium, as well as bonuses on most life policies."

4.1.10 The Malhotra Committee concluded that the insurance industry should be opened up to competition. The reasons it put forward were:

- to provide better customer service;
- to help improve the range, quality and price of insurance products;
- to increase insurance penetration which is low, though business volumes are high; and
- there was little reason for maintaining a monopoly of the life insurance business when the rest of the financial services industry was being opened up.

4.2 *Savings Patterns*

4.2.1 The Indian insurance market has great potential, with a large population and a growing affluent middle class. Gross domestic savings (GDS) as a percentage of GDP are estimated to be 23.1% in 1997-98. In the previous year they were 24.4%. In absolute terms, however, GDS have risen from Rs3,444 billion to Rs3,615 billion. Most of this has been contributed by the household sector, where financial saving has gone up to Rs1,612 billion from Rs1,375 billion, while household saving in physical assets has remained broadly stable. (Source: Central Statistical Organisation, Department of Statistics, Ministry of Planning and Programme Implementation.)

4.2.2 Provident funds, similar to defined contribution pension schemes, exist to provide retirement benefits. They are subject to a different set of investment restrictions from life assurance, but benefit from the same system of tax rebates

(see ¶4.9.2). Membership is compulsory for the organised sector of the workforce. The Central Statistical Organisation defines the organised sector to be:

“generally all enterprises which are either registered under the purview of the Indian Factories Act, 1948, Mines and Minerals (Regulation and Development) Act, 1957, the Company Law, the central/state sales tax acts and the Shops and Establishment acts of the state governments. Also included are all government companies, departmental enterprises as well as public sector corporations, forestry, irrigation works and plantations. The organised sector includes all activities coming under the industrial heads of electricity, gas and water supply, railways, passenger transport by tramways and buses, freight transport by road in the public sector, ports and pilotage, lighthouses and light ships, air transportation, flying and gliding clubs, airports, warehousing corporations, cold storage, registered trade, hotels and restaurants, banking and insurance other than those relating to money lenders and pawn brokers, joint stock companies engaged in the real estate business and other business services, public administration and defence, community and personal services operated by recognised educational institutions, public sector medical and health services, sanitary services, research and scientific services and joint stock companies.”

4.2.3 Occupational pension schemes enjoy certain tax advantages, although their investments are restricted principally to Government bonds. Equity investment is generally not permitted. The funds may be managed by the LIC or by the employers themselves during deferment.

4.2.4 In addition there are gratuity benefits. These are statutory lump sum benefits payable on death, retirement or resignation, with the liability for providing such benefits falling on the employer. Companies in the organised sector are statutorily obliged to provide gratuity benefits to their employees.

4.2.5 Table 4.1 shows how gross domestic savings are split between different media. Of particular interest is the performance of the Unit Trust of India (UTI). The UTI has recently run into problems with its flagship US-64 Scheme. The Government appointed the Deepak Parekh Committee to investigate these problems. The UTI's main problems are as follows:

- Unit prices did not reflect the net asset value of the underlying assets.
- For many years the UTI paid dividends that were not supported by the income on the underlying assets. Assets have been sold to pay for these dividends, with the sales not being reflected in the unit prices.
- The UTI had funds that offered substantial equity backing and high guaranteed returns. Such funds distorted the market, and it is likely that the UTI made large losses on these funds.
- US-64's liabilities exceeded its assets by more than U.S.\$1 billion.

4.2.6 As one would expect, life assurance sum assured has a strong positive correlation with income. However, with increasing income, the percentage of savings invested in life insurance decreases. Among affluent people, life insurance tends to be used only as far as the tax rebate can be utilised (see ¶4.9.2).

4.2.7 Policies sold in rural areas are, on average, slightly smaller than those sold in urban areas: 51% of new policies are written in rural areas, but only 43% of new sum assured (LIC Annual Report 1997-1998). Other notable features of policies sold in rural areas are that they suffer higher lapse rates because agricultural incomes tend to be volatile. Premium collection costs are higher in rural areas, since a larger proportion of rural policyholders do not have bank accounts. However, a significant proportion of policies sold in rural areas are sold in the organised sector, particularly in the mining industry and on plantations.

Table 4.1. Distribution of household assets by financial product
(billion rupees)

	1980-81	1990-91	1992-93	1993-94	1994-95	1995-96
Currency	16.2 (13%)	60.4 (11%)	65.6 (8%)	133.7 (12%)	159.2 (11%)	163.8 (13%)
Bank deposits	55.5 (46%)	187.8 (32%)	295.5 (37%)	363.8 (32%)	561.6 (40%)	352.8 (28%)
Non-bank deposits	3.8 (3%)	12.9 (2%)	60.4 (8%)	116.5 (11%)	117.4 (8%)	170.8 (14%)
Life insurance funds	9.1 (8%)	56.0 (10%)	71.1 (9%)	95.5 (9%)	113.4 (8%)	134.8 (11%)
Provident and pension funds	21.2 (18%)	111.6 (19%)	147.2 (18%)	182.5 (17%)	206.2 (15%)	254.4 (20%)
Claims on government	7.1 (6%)	79.4 (13%)	39.5 (5%)	67.8 (6%)	132.2 (10%)	108.7 (9%)
Shares and debentures	4.1 (3%)	49.7 (8%)	82.1 (10%)	100.7 (9%)	84.6 (6%)	58.8 (5%)
Units of UTI	0.3 (0%)	34.4 (6%)	56.1 (7.0%)	47.0 (5%)	39.1 (3%)	2.6 (0%)
Trade debt	3.7 (3%)	-4.5 (-1%)	-14.0 (-2%)	-11.9 (-1%)	-16.0 (-1%)	3.0 (0%)
Gross savings	121.2 (100.0%)	569.7 (100.0%)	804.5 (100.0%)	1,095.6 (100.0%)	1,397.8 (100.0%)	1,249.7 (100.0%)

Source: Reserve Bank of India, currency and finance 1995-96 (vol. 11)

4.2.8 India is a country of considerable linguistic, cultural and economic diversity. Economic development has been far from uniform, so the nature and size of the market differ widely between regions.

4.3 *State Benefits and Demographics*

4.3.1 State benefits are minimal. There are some subsidised group schemes for low-income groups such as landless agricultural workers. These schemes are subsidised by LIC and funded in part by the Government. They cover a total of only 4 million lives under 23 occupations. They provide death and unemployment benefits.

4.3.2 India's population in 1991 was estimated at 975 million (Census of India).

4.3.3 The number of females per 1000 males was 927. (1991 Census of India)

4.3.4 The population of India is expected to reach 1.528 billion by 2050. To put this into context, China's population is expected to be 1.478 billion by the same date. (Source: Department of Economic and Social Affairs, Population Division, United Nations)

Table 4.3. India's 1991 population by age band and sex

Age band	Male %	Female %
0-6	17.8	18.1
7-14	19.3	19.2
15-59	55.5	55.4
60+	6.8	6.8
Not known	0.6	0.5
All	100.0	100.0

Source: 1991 Census of India

Table 4.5. New business in India — individual assurances

Year	Number of policies (millions)	First year's premiums (billion rupees)
1958*	0.95	0.13
1966/7*	1.41	0.31
1976/7	2.05	0.99
1986/7	3.87	3.72
1996/7	12.27	28.78
1997/8	13.31	32.84

* Figures include group business, since separate figures are not available.
Sources: Malhotra Report, LIC annual reports 1996-1997 and 1997-1998

4.4 *Size of the Indian Life and Pensions Market*

4.4.1 LIC's growth since nationalisation is shown in Tables 4.4 and 4.5.

4.4.2 The pensions market is dominated by provident funds, which are discussed in ¶4.10.2.

4.5 *The Regulatory Environment*

4.5.1 The Acts of 1938 and 1956 defined the current regulatory environment. Assets are valued at the lower of book and market value. The LIC values its liabilities using a gross premium method, although there are no specific regulations on how to value life insurance liabilities.

4.5.2 There are no conduct of business regulations. The selling and marketing of life insurance is, therefore, unregulated.

4.5.3 In the Malhotra Report, published in January 1994, the Malhotra Committee recommended that the insurance market be opened up to competition. The report included the following recommendations regarding regulation:

- a capital requirement for new entrants to the insurance market of Rs1 billion;
- no company should be allowed to transact both general and life business;
- the number of new entrants should be controlled;
- the promoters' equity stake in private insurance companies should not exceed 40% of the total equity of the company, although the holding may be higher initially;
- foreign companies entering the market should be required to float Indian companies, preferably in joint ventures with local Indian companies;
- before opening up the industry, an effective regulatory authority should be put in place;
- a level playing field should be created for new and existing companies;
- new entrants might be required to transact a certain amount of rural business; and
- insurance companies should have more freedom over investment policy (see Section 4.7 for current restrictions on investment).

4.5.4 The requirement for capital of Rs1 billion is intended to keep out small companies. As for the limit of 40% on the promoter's equity holding, a similar limit applies to new private sector banks. It is intended that the remaining equity will be widely dispersed, so that the promoters are able to maintain some level of control over the company. The Committee's recommendations are widely expected to be implemented eventually.

4.5.5 Over the last 10 years a strong consumer movement has developed and a Consumer Protection Act has been passed. District level courts have been established to deal with claims under this Act. It has been used in cases where claims are disputed, including a challenge to surrender scales. It may be used, potentially, in cases of mis-selling.

4.6 *Indian Life Insurance Products*

4.6.1 The LIC offers a wide range of products, but only a small number of these are important in today's market. These products fall into two main categories: protection and savings.

4.6.2 Approximately 95% of new business is with-profits. However, paid-up policies automatically become non-participating, so the LIC has a large portfolio of non-profit policies.

4.6.3 The LIC offers an equivalent of the typical U.K. protection contract, the conventional non-profit term assurance. However, this contract is not popular in India, because Indians are accustomed to receiving tangible benefits for their premiums, and the term assurance has no maturity benefit. Thus, the *Bima Kiran* contract is much more popular. This is similar to term assurance, but offers a return of premiums, plus interest, on survival to the end of the term.

4.6.4 The main savings contracts are variants on the U.K. conventional endowment contracts. Many options that are familiar in the U.K. are available (for example, non-profit or with-profits, limited premium paying term and single life or joint life). Other variations are also popular. The *Jeevan Mitra* ('double cover') endowment plan pays twice the basic sum assured on death, but only the basic sum assured on maturity. Another popular contract is the 'money back' endowment. In this case the sum assured is paid in instalments, with each payment made at a predetermined time in the life of the contract. The final, and largest, instalment is scheduled for the maturity date. If the policyholder dies during the term of the contract, the full sum assured is paid (i.e. no deductions are made for previous instalments).

4.6.5 The LIC is the only company in India permitted to provide annuities. Thus, annuities are purchased, not only by individuals, but also by pension schemes when members retire. These immediate annuities are sold on unisex rates, with a variety of guarantee periods and payment frequencies. All such annuities provide a level income: no escalating annuities are available, since there are no suitable matching assets.

4.6.6 Group products make up a significant part of the LIC's business. The LIC's three main group products are:

- group insurance (group term assurance);
- group gratuity (used by employers to cover their statutory gratuity liabilities); and
- group superannuation (group pensions).

4.6.7 The total sum assured on in force group business at 31 March 1998 was Rs748 billion. This compares with total sum assured of Rs4,007 billion of in-force individual assurances (Source: LIC, annual report 1997-1998). Group term assurance, including the social security schemes mentioned above, covers the largest number of lives, but group gratuity schemes provide the bulk of the premium. Although the LIC offers group pensions products, some of the larger employers operate their own pension funds.

4.6.8 The LIC has launched two important new products recently. The first was *Jeevan Asha*, which provides hospital cash benefits and income benefits on an endowment assurance. The second was *Jeevan Suraksha* which is a personal pension plan. The benefit is a with-profits deferred annuity, but, at retirement, the investor has the option to buy an annuity at current market rates. As discussed in ¶4.9.6, *Jeevan Suraksha* enjoys a preferential tax treatment. It was given this preferential treatment by the government of the day to help promote the development of a personal pensions market.

4.7 *Indian Life Office Investment*

4.7.1 Existing legislation imposes considerable restrictions on the LIC's investment freedom. The legislation affects both sector selection and concentration of individual assets.

4.7.2 Currently the LIC must invest certain specified percentages of its life fund in the following asset categories:

- central government securities;
- loans to the National Housing Bank;
- state government securities; and
- socially oriented sectors (e.g. house building by policyholders).

4.7.3 The remaining assets may be private sector investments, policyholder loans or property. Some government concessions have slightly diluted the original

legislation, but the rules remain very prescriptive. Because of these investment restrictions, unit-linked life insurance business has not developed in India.

4.7.4 The vast majority of the LIC's investments are in public sector assets.

4.7.5 There are also rules relating to individual investments, akin to the U.K. admissibility rules. These state that the LIC's investment in a single company may not exceed 2.5% of the LIC's total liabilities. Also, investment may not exceed 10% of that company's total share capital and debentures. Furthermore, the latter ceiling is reduced to 2% for an investment in a bank or investment company.

4.7.6 Features of the bond and equity markets further curtail the LIC's investment freedom. Until this decade the central government of India issued debt below market rates of interest. The LIC was compelled to subscribe to these issues, and, consequently, returns to policyholders were lower than they might otherwise have been. Government stocks were short term, mostly of only seven years, making it difficult for the LIC to match its annuity business. No secondary market in government securities existed. This decade, however, has seen the liberalisation of capital markets. The private debt market is becoming more developed, and the return on government issues is now approaching the market rate. As a result, a secondary bond market is now developing.

4.7.7 The equity market has shown strong growth over the long term, with capital growth since 1980 exceeding 20% p.a. However, as Table 4.7 shows, the stockmarket can be extremely volatile over the short term.

Table 4.7. Growth in the Bombay Stock Exchange 30 Index

Year to end	Capital growth
1990	34.6%
1991	82.1%
1992	37.0%
1993	27.9%
1994	17.4%
1995	-20.8%
1996	-0.8%
1997	18.6%

4.7.8 This volatility poses a significant challenge to any company writing equity-backed savings products with high guarantees.

4.8 *The Sale and Distribution of Insurance Products in India*

4.8.1 For individual policies the LIC has only one distribution channel: its 550,000 agents, many of whom are not active. Each agent is attached to a branch of the LIC. These agents are rewarded through non-indemnity commission payments. There is no IFA distribution channel, and expert opinion is that none will be permitted to develop, at least in the short term. Rather curiously, commission rebating is illegal, although widespread.

4.8.2 While approximately 10% of these agents report directly to their local branch, the vast majority of agents report to their 'development officer', who, in turn, reports to a branch manager. Development officers are responsible for recruiting, training and supervising agents in their area. In return, they receive a salary from the LIC as well as incentives based on the first year's premium from each contract.

4.8.3 The nature of the incentives is such that increasing new business is given priority over servicing existing policies. In practice, many development officers will recruit people who can quickly sell a few policies to their immediate contacts.

4.8.4 The LIC runs 26 sales training centres, and also contracts out training to private centres. Nevertheless, the training of these new agents is often neglected. As a result, the turnover of agents is high, with approximately 25% of agents leaving each year, to be replaced by new agents. Consequently, there is little continuity of service for the policyholder.

4.8.5 Furthermore, in order to meet their performance target of bringing in twelve new lives each year, agents will sometimes sell policies and pay the premiums themselves on policies that the policyholders have no intention of continuing.

4.8.6 When, in addition, we consider that a large percentage of the LIC's business is sold in rural areas, and that rural incomes fluctuate, it is perhaps surprising that only 29% of all policies lapse within the first three years. (Source: LIC annual report 1997/98)

4.8.7 Distribution of group policies is mainly through LIC officers at divisional 'Pension and Group Centres'.

4.9 *Taxation*

4.9.1 The effect of taxation on insurance is shown through its impact on four main parties: individuals, the LIC, employers and pension schemes.

4.9.2 Individuals are given tax breaks via the 1961 Income Tax Act. This states that premiums paid in respect of certain financial products will qualify for an income tax rebate of 20% on all premiums paid. The maximum annual aggregate premium rebate is Rs14,000. LIC products qualify for this tax relief.

4.9.3 Individuals also receive other tax concessions in respect of life insurance policies:

- payments received under life assurance contracts are exempt from tax;
- the value of an in-force policy does not constitute a wealth tax liability; and
- any sum received in respect of commutation of a pension is exempt from tax.

4.9.4 The new personal pension product, *Jeevan Suraksha*, is written in its own fund, and this is not taxed. Contributions up to Rs10,000 each year in *Jeevan Suraksha* are fully deductible against the policyholder's income tax liability. The *Jeevan Suraksha* allowance is in addition to the general Rs14,000 allowance mentioned above.

4.9.5 The LIC is taxed at 12.5% on its disclosed actuarial surplus.

4.9.6 An employer may treat its contributions to an approved employees' pension fund as a business expense for tax purposes. It may do so, however, only up to certain limits.

4.9.7 Employer sponsored private group pension funds in deferment are exempt from tax on investment income, unlike the corresponding LIC funds.

4.10 *The Main Players, Foreign Players and Ownership Structures*

4.10.1 Since the nationalisation of the Indian life insurance industry in 1956, the LIC has been the principal life insurance company. The only other player is the Postal Life Insurance Company. This is owned by the Post Office, and is authorised to sell to public sector employees. In spite of competitive premium rates, its business growth has been poor because of poor distribution.

4.10.2 Apart from life insurance, the principal vehicles for long-term saving are:

- public provident funds, which cover the statutory benefits of most employed persons;
- voluntary membership of public provident funds, which is also open to the self-employed;
- gratuity funds set up by employers to fund their statutory gratuity liabilities; and
- pension funds set up by the larger employers.

4.10.3 Currently the Indian life insurance industry is nationalised, and the only companies that are permitted to operate are the LIC and the Postal Life Insurance Company. At the time of nationalisation there were 16 foreign life insurance companies operating in India.

4.10.4 The decision to open up the Indian insurance market to foreign companies is closely linked with Indian politics. Since Indian independence in 1947, the Congress(I) party has dominated Indian politics and the governance of India. It was the Congress party which, under Prime Minister Narasimha Rao and his Finance Minister Manmohan Singh, first put the liberalisation of insurance on the table in the early 1990s, as part of a much wider reform of Indian financial services and capital markets. However, over the years the Indian electorate has gradually withdrawn support from Congress, mainly due to alleged rampant corruption within its ranks. The main beneficiary of Congress's fall from grace has been the pro-Hindu Bharatiya Janata Party (BJP) which has gained a lot of popularity. Consequently, India has reached a stage where no one party is large enough to form a Government on its own, and, moreover, Indian regional political parties have now become very influential.

4.10.5 The only political party which actively opposes the opening up of the Indian insurance markets is the Communist Party of India (CPI). The trade unions associated with the CPI are very strong within the LIC, and most LIC workers are fearful for their jobs in the event that the life insurance market is opened up.

Consequently, the CPI has been very pro-active in opposing the opening up of the insurance markets. The CPI is, however, a relatively small party. All of the other main parties are generally in favour of the opening up of India's insurance markets.

4.10.6 It seems most likely that, for the foreseeable future, coalition governments of varying colours will govern India. The current BJP Government, which has placed a very high priority on the opening up of India's insurance markets, recently lost a confidence motion by one vote, and is now not able to implement the economic reforms that it had promised. Fresh elections are due in September 1999, and this has inevitably meant that the opening up of the insurance market to private companies has been delayed. However, if only for the sake of the consumer, the Indian life insurance market should open up eventually.

4.10.7 With the prospect of the opening up of the Indian life insurance market, a large number of foreign companies have expressed an interest in entering the Indian market. In fact, many foreign companies have already made strong commitments to India by forming joint ventures with local Indian companies, investing in Indian infrastructure and setting up representative offices. The list of foreign companies interested in India reads like a who's who of world insurance, and U.K. companies are particularly well represented.

4.10.8 The LIC is a proprietary company, 100% owned by the Government of India. A distribution to the shareholder of 5% of the disclosed surplus is made each year. Both shareholder and mutual companies existed prior to nationalisation.

4.10.9 It is most likely that, once the Indian life insurance market is opened up, all of the new companies will be shareholder companies. A number of Indian co-operative societies have expressed an interest in entering the life insurance market, and their preferred ownership structure would be mutual. However, there are a number of technical issues associated with forming a new mutual, e.g. are joint venture mutuals possible, and how does one initially capitalise a new mutual? Because of these issues, it does not seem likely that new mutuals will be formed once the Indian life insurance market is opened up.

4.11 *The Indian Actuarial Profession*

4.11.1 The professional body representing the actuarial profession in India is the Actuarial Society of India (ASI).

4.11.2 Over the years since nationalisation the actuarial profession withered away, and, in fact, the production of new actuaries almost disappeared completely. The profession is not perceived as high status, and the rewards, both financial and otherwise, for qualifying as an actuary are negligible. There are no statutory duties falling on Indian actuaries. Moreover, until recently, the ASI did not offer actuarial examinations, and prospective Indian actuaries studied either the Faculty or Institute courses by correspondence, sitting the examinations in India. For these reasons, very few Indians were prepared to embark on a career

as an actuary in India, although, obviously, there are many Indian actuaries working outside India in the U.K., the U.S.A. and other parts of Asia.

4.11.3 However, with the prospect of the liberalisation of the insurance markets, the ASI has re-activated itself. It now offers its own examinations, which are of an equivalent standard to the Faculty's and Institute's examinations up to Fellowship level (the ASI does not offer general insurance or Fellowship papers). More importantly, however, there are now a large number of trainee actuaries enrolled with the ASI who are actively taking the ASI examinations, and fully qualified Indian actuaries are now beginning to emerge again. Nevertheless, there is a real shortage of experienced actuaries in India. Whilst the market remains closed and there is no real competition, this may not be a problem, but, as the market begins to liberalise, experienced actuaries will clearly be at a premium.

4.11.4 The Faculty and the Institute have helped the ASI to get up and to run, by providing it with complimentary training material, and they have also reduced their professional fees for Indian trainee actuaries. The U.K. companies interested in India have provided the ASI with useful financial support.

4.11.5 Clearly, it is highly laudable that the ASI has managed to bring the profession back to life in India. However, until the market liberalises and competition is introduced, actuaries are not likely to realise their full potential.

4.12 *Assessment of the Attractiveness of the Indian Life Insurance Market*

4.12.1 In our view, the Indian life insurance market is highly attractive to new entrants for the following reasons:

- It is a huge market with high growth prospects.
- There may be limited competition initially, implying relatively high margins.
- Foreign life insurance companies can add value simply by being experts in life insurance.
- The business environment is particularly attractive for U.K. companies (e.g. language, legal system, insurance products and regulation are essentially of U.K. origin).

4.12.2 There are, however, currently a number of drawbacks:

- political uncertainty and interference;
- slow pace of change, especially with respect to opening up the market to foreign insurance companies;
- infrastructure problems; and
- restrictive labour laws.

5. CONCLUSIONS

5.1 This paper has described some of the changes that are occurring within the U.K.'s retail financial services markets. Much of this change is also being

seen outside the U.K. in the world's other developed, and increasingly inter-dependent, retail financial services markets. As a result, U.K. life insurance companies, and other providers of retail financial services, are under more competitive pressure from domestic and international competitors than they have been in the past.

5.2 In order to continue growing profitably, one option open to U.K. life insurance companies is to identify and expand into overseas markets that may have more potential than the U.K. market. Two overseas markets are described in detail in this paper.

5.3 We anticipate that the next five to ten years will see considerable change in the U.K.'s retail financial services markets, and it will be interesting to consider the relevance of this paper, and its subsequent discussion, at that time.

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ABSTRACT OF THE DISCUSSION

The President (Mr C. W. F. Low, F.F.A.): The subject of the meeting is 'International Expansion — a United Kingdom Perspective', which has been produced by a Research Group of the Faculty. Membership of the Research Group numbers eleven, and this indicates the way in which research should be going. Seven, including the initial Chairman, are Fellows of the Faculty; two are Fellows of the Institute, one of whom is also a Fellow of the Actuarial Society of India and of its Council, and another is a full member of the actuarial body in Germany. Thus, we are co-operating with overseas actuarial bodies and enlivening our research groups by including some outside specialist views.

Dr D. J. Grenham, F.I.A. (introducing the paper): As Chairman of the Faculty of Actuaries International Research Group, I shall say a few words before handing over to two of my colleagues. First, I emphasise that the paper was the product of all eleven members of the Research Group; they were not just chosen as the result of political correctness.

The Working Party considered that the two sections covering the countries of Germany and India were the two most important sections of the paper. Nonetheless, the introductory sections were considered to be of importance to try to put the United Kingdom's insurance market in an international context.

Mr S. J. Richards, F.F.A. (introducing the German market section of the paper): Events in Germany have developed quickly since we wrote the first draft of the German market section in 1997. Three events are especially worthy of note:

- (1) The new left-of-centre Government has decided to tighten the entitlement rules for the state pension, while simultaneously declaring that individuals will have to make more private provision in the future. As predicted in the paper, the switch from public to private provision is now an idea with cross-party acceptance, albeit with reluctance amongst the trades unions and in certain circles of both the main parties.
- (2) The regulatory authority for German insurers, the BAV, is reducing the maximum valuation rate of interest from 4% to 3.25% for new business from July 2000. As outlined in the paper, this will tighten the screw for German insurers, none of which wants to be the first to reduce bonus rates (and hence projected maturity values, on which basis new business is mainly sold).
- (3) The new Government is pushing a radical reform of tax privileges, including those for life insurance contracts. The system of tax-free maturity benefits is to end for new unit-linked and endowment assurances, although both existing business and new deferred annuities will remain tax privileged. The playing field for savings has shifted suddenly from being substantially weighted in favour of life insurance to being tilted towards mutual funds and direct share investment. Faced with much-reduced sales of their bread-and-butter endowment policies, German insurers have two choices: either they can compete with banks and others for sales of shorter-term financial products; or they can switch sales to the still-privileged deferred annuities. Neither is particularly appealing: banks have a closer and more direct relationship with the consumer; while deferred annuities harbour considerable long-term longevity and interest rate risks. The insurers have lobbied, surprisingly ineffectually, against these changes, and, since the Government seems to have the consent of the opposition, the changes are likely to go through.

Times are set to become much harder for traditional German life insurers. Therefore, now is a uniquely accommodating time for innovative new entrants to the market.

Mr D. C. Chakraborty, F.I.A. (introducing the Indian market section of the paper): I shall first tell you a few things about the latest economic conditions in India, and about the state of play for the insurance industry's opening up there.

The domestic savings rate in India continues to grow, and a very important development has taken place during the last four or five years — the rapid shift of investment made by the household sector from physical assets towards financial assets. That is very encouraging for anybody who is trying to set up a financial services company in India. Insurance funds have shown remarkable growth. The year ending March 1999 was the best year for the Life Insurance Corporation of India in a decade, including the part of the business known as group insurance and pensions business.

India's GDP continues to rise, albeit not to the extent that it was doing earlier, in spite of political and other uncertainties. It has stayed remarkably unaffected by the turmoil in south east Asia. Of course, there was a setback internationally because of political instability, nuclear tests and a bit of a war. In spite of these, India maintains a degree of political stability which probably is not visible from outside. A new Government is in the process of being constituted. Even during the election campaign insurance liberalisation was a very important issue. Two major political parties, instead of being apologetic, are saying that this would be a priority as soon as they won the election. The existing finance minister said that the very first thing he would do after the election, if his party won, was to open up the insurance industry. This shows clearly that public expectation and the general climate in the country have changed very remarkably. The general public is waiting for more competitive and more efficient insurance services, which have been denied to them for a very long time.

One interesting thing that we found is that the performance of the Life Insurance Corporation of India seems to have an inverse correlation with that of the stock market. If the stock market does not perform well, it seems that life insurance sales do very well. Public pressure is also growing for privatising a large chunk of the pensions business currently run by the Government. Again, we have a very positive development for a prospective new player in the Indian market.

Another interesting subject is the problem of setting up a proper regulatory environment, including an authority, in a newly liberalised market, or in a closed market which is going to open up. Some Faculty members have played, and probably will be playing, very important roles in helping the Indian Government and the actuarial profession in India to set up a proper regulatory environment.

The actuarial profession in India has been in very much of a dormant state, because there is hardly any demand. The number of qualified actuaries is declining at a very rapid rate, but a revival has also started there. A Scottish life office has made a donation to the Actuarial Society of India, and provided some educational support to Indian students. Doing business in a country also helps to raise the international profile of the actuarial profession. Actuaries are particularly valued by the Insurance Regulatory Authority of India.

Setting up an appropriate regulatory environment, the problems faced, and how to overcome them, can be the subject of a future Faculty paper. It is interesting and very challenging. There are, not only actuarial challenges, but also political, social and other dimensions. Actuaries can help because of their professional training and the standing of the profession. In a politically charged situation they can probably contribute even more.

Mr R. J. Seymour-Jackson, F.I.A. (opening the discussion): Section 2 is the most important component of the paper, covering the issues facing U.K. life insurers which are familiar to us all, and the trends that will lead U.K. life insurers to examine their options for overseas expansions, such as: the blurring of boundaries between banks and insurers; strong retail brands entering the financial services market; and the European Union single market becoming more of a practical reality, albeit at different speeds (significant progress in life insurance, but slower progress, for example, in pensions funds).

In ¶2.1.4 the authors make the telling point that, after considering its options, the correct strategy for a company may well be not to expand overseas. The presence of attractive opportunities is not the same as it being right to seize all of them.

In Section 2.2 the authors move on to discuss the criteria used in selecting an overseas

market. It is interesting to note that, alongside the financial and macro-economic issues, are softer human ones. It is a very reasonable question for managers in life insurance to ask themselves whether they have the soft human skills, alongside their financial and actuarial skills, to assess properly the attractiveness, or otherwise, of an overseas opportunity. Following this is the discussion of the pros and cons of the various options available to a company on entering a new market.

In Sections 3 and 4 the authors look at two very different markets: Germany and India. They provide a useful summary of the structure, regulatory environment and economic background of each of the markets. In assessing the attractiveness of Germany, the following issues are highlighted: size of the market; potential changes in state benefits; demographic pressure; and the innovations that new entrants might bring. Such attractiveness could be applied, not only to Germany, but to many other markets across the world. This has to be balanced against the very significant entry costs and other barriers in Germany, particularly in the area of distribution.

In comparing this with the attractiveness of India, a quite different picture emerges. India is a large market, but a market with potential for huge growth. It has the potential for high margins due to lower competition, and the expertise of foreign insurers may be key. The business environment is one that might make it particularly attractive to U.K. companies, but this must be balanced against a very different set of problems in India: political uncertainty and interference; slow pace of change; infrastructural problems; and restrictive labour laws.

I finish with a question to the authors. They write about how the internet and the world wide web may change the rules of the game, and, in particular, the potential for disintermediation. On the grounds that anything written about the internet is out of date by the time that it is published, I would be interested to know how their view has changed, particularly with the rapid growth of e-commerce in the securities field in Germany.

Mr C. P. Startup, F.I.A.: In the paper I particularly liked the recognition of the need to consider the 'softer' issues as well as the harder financials. As the regional actuary for the Indian subcontinent in my company, I shall focus my attention on India.

One of the extra reasons for expansion into India is the ability to use your Indian operation to help with your U.K. operation. In particular, looking at low labour costs, there are opportunities for assisting, perhaps partially out-sourcing, your administration and I.T. operations from India. There is a wealth of talent in those two particular areas which could have a benefit for your U.K. operation.

In Section 4.5 the authors note the development of a strong consumer movement. It is fair to say that it is not as strong as the consumer movement in the U.K., but it is gaining momentum. In particular, a new development will be the introduction of insurance ombudsmen later in 1999. These ombudsmen will be looking at disputes over claims.

In ¶4.6.8 the authors mention *Jeevan Asha*. It is described as a hospital cash plan, but it could be more appropriately described as a surgical procedures plan, in that it pays out a percentage of the sum assured for either major or minor surgical procedures, depending on the severity of the procedure. However, it only pays out on certain listed surgical procedures, rather than just on a spell in hospital.

Also, it is worth noting, within Section 4.6, the existence of a critical illness plan. It is fair to say that it is a fairly limited critical illness plan, as it covers only four illnesses. Nevertheless, it has been one of the developments over the last ten years, and has been modified since its original introduction.

Looking at the advantages and disadvantages in Section 4.12, I would expect a little more 'prescription' when looking at pricing bases. In particular, I do not think that it would be either politically acceptable, or acceptable from a regulator's point of view, if insurers were making super-normal profits. The expectation is that there will be profit margins which will be reasonable, and, in particular, the combined effect will be a general lowering of prices without going as far as a price war. So, I would accept that, compared to the U.K., there would be higher profit margins, but, probably, these will not be quite as optimistic as the paper suggests.

Dr L. W. G. Tutt, F.F.A.: As the authors point out in ¶2.1.1, retail financial services companies are having to face rapid and fundamental changes in the business environment. Might some of such changes seem to relate to some modification in motivation? To exemplify, in ¶2.1.3 the authors refer to a U.K. life insurer in search of better returns for its stakeholders. Does such tend to reflect an attitude somewhat different in its emphasis from that which prevailed during past years, when Scottish life business was built up so valuably, and with such high efficiency, on the basis of mutuality?

Although changes, and potential changes, in the business environment should not be ignored, I too feel that ¶¶2.1.4 and 2.1.5 are particularly worthy of note. Implicit in them is the thought that, although expansion abroad may have some plus points, it may not necessarily be the best use of resources by a U.K. life office. It would seem, nevertheless, that as well as merger and acquisition activity between domestic operators, due to intervention by non-U.K. operators, the proportion of insurance and allied business transacted within the U.K., and remaining within U.K. control, is gradually decreasing. Might this suggest that there should be an even more active development of the home market by U.K. insurers — a point made by the authors in ¶2.4 — rather than leaving such development to an apparently increasing extent to overseas insurers, and might this be an issue suggestive of some priority attention? The intervention of overseas operators into the U.K. market might, of course, be considered by some to be advantageous to the industry as a whole, but is it self-apparent why such intervention, seemingly, should be predominantly one way? As just one example, why should an Australian life company be choosing to impinge on the U.K. scene when a U.K. life company, long established in Australia, should simultaneously be choosing to sever its operations in that relatively stable — indeed expanding — economy?

In ¶3.5.3 indication is given by the authors that German actuaries perform a largely technical role, and that they have far less influence in life assurance companies than, for example, the sales force. U.K. actuaries may feel that they are in a better position, although it may seem to be that the status of actuaries, as a whole, within some life offices in the U.K., may be declining; and, as far as the Appointed Actuary is concerned, C. D. Daykin states in ¶7.2 of his recent sessional paper on 'The Regulatory Role of the Actuary' (*B.A.J.*, 5, 529-574), "A growing concern ... has been the extent to which the Appointed Actuary post appears to have slipped in terms of seniority and prestige in a number of major life insurers."

I stress that I consider high technical ability and skills involving applied mathematics of a high order vital for the members of our great profession. The paper relates to matters of immense practical consequence, and decisions on international expansion, mergers, takeovers, and so on, need to give proper regard to those highly technical investigations for which actuarial practice is acknowledged to be so relevant, but they also fall within the sphere of business operations, ultimately calling for business decisions at board level. Is this broader business sphere, in addition to, and quite apart from, the technical sphere, one into which there is room for yet further intrusion by actuaries to the advantage of all? Further, from our own professional stance, there is the suggestion in the profession's publication 'Vision and Values', that, when looking to the future, it is the approach that we have in solving business problems by which we will be more defined.

Mr D. Paul, F.F.A.: I speak from the perspective of working for a health insurance company, and not a life insurance company, which has six overseas businesses. It is not a large, multi-national company working all over the world, but it is expanding overseas.

Concerning Section 2, it is very important to figure out why any company wants to expand overseas. The first pro for this is that it might protect a U.K. company from predators. I agree with the authors, in ¶2.1.5, when they say that it does not offer any great protection.

I think that the other argument is that, in a global market of global players, you also have to be a global player. I am not sure that such an argument works for life insurance, savings or pensions products. Its products are not like electronic goods or consumer goods, where you can just put a different plug with a different voltage onto the same basic product. If you look at the

realities, even in Europe, where there is some attempt to get a single market to operate, if you want to get into one of these markets, you have to set yourself up with a team that figures out the local regime, understands it, and designs local products. I do not think that we can argue that there is an automatic economy of scale. The reality of the insurance market globally is that it is a market of global owners, not necessarily of global players.

So, I am still struggling to see what the reason would be. I think that the obvious one is that you might believe that you can make some money. In ¶2.1.3 the authors refer to this as if it is a decision between whether you want to re-engineer your own business at home or get into mergers and acquisitions work, but, for me, it is a stand-alone decision. Can you make money? So, you then have to say why you believe that you could make money. You are probably going into a market where there are many other companies, privately owned, multi-nationally owned, or family owned, and all believe that they can make money. Therefore, you really have to have reasons why you can do better than them.

An important reason is the quality of your decision makers back at base: they have to be able to select the right markets; they have to be able to select the right strategy in the chosen markets; they have to possess the 'softer' skills; they have to be able to appoint the right people into these businesses; and so on. You also have to believe that you have skills that you can bring to the local market, and that you have people whom you can put there to apply those skills. You probably also have to believe that you can contribute something to the infrastructure of your start-up venture. If you end up with no advantage compared to local companies, then I do not see why you believe that you are going to be better equipped to make money. So, that is the only reason which stacks up.

If you look at the cons, there is obviously the downside risk on any venture where you try to make money — you might lose money. This is a bigger issue in setting up a foreign venture. You have to think about corporate governance, and there have been instances of companies where the venture is actually running quite well, but, at home, people decide that it is so small, and that the risks are so high, and therefore it is simply not worth the massive downside which might happen upon some remote contingency. The authors also mention that you may be spreading your management skills too thinly. I suppose that implies that there will be fewer things which you are going to do in the U.K.

One area which the paper did not tackle was whether, when it comes to making money, the mutuals have a different outlook, or whether the provident associations have a different outlook from a shareholder company.

On the reference to softer skills, I am uncertain about using the word 'softer'. I think that you have to have human skills, but I think that you have to have sharper human skills, rather than softer human skills, to deal in foreign markets.

One matter that could be covered by future research, although it is, perhaps, not obviously an actuarial issue, is that you have to consider how you are going to organise your head office to deal with ventures abroad — whether or not they are joint ventures is another matter. You have to look at whether your overseas operations are going to be significant enough to permit a divisional headquarters. You should not delude yourself that you are going to be able to get away with just board meetings, or your managers in your local U.K. business being able to do things in their spare time, and so on. Our own experience is that you need half a dozen people full time to look after even as few as five or six foreign subsidiaries. That can be overlooked. Large, established U.K. businesses, which may have been around, in my instance, for 40 or 50 years, forget just how much momentum they have built up. They forget how easy it is to organise a business when there is so much tradition, culture and experience of staff around.

Mr T. D. Kingston, F.F.A.: Becoming international is driven by several possible reasons, as the paper outlines. I have been involved for the last twenty years in international diversification from the base of a company with a large market share in a small market. This is different from operating out of a large market like the U.K., where scope in the domestic market is much greater.

Typically, companies, in the broad sense, have diversified internationally because their domestic product could be sold internationally. Mr Paul pointed out that retail financial services are different from other products. Conventional wisdom is that retail financial services products are peculiar to each domestic market, and are not easily sold into other markets. However, this has not always been true. There was a huge international expansion 100 years ago, when life companies took the same with-profits endowments to very many countries.

The assumption that retail financial services are domestic may well be changing again. If we look at financial services generally, we see that investment banking, for instance, has become very much more international; stockbroking in the U.K. is now largely controlled at the institutional end by United States companies; fund management is becoming increasingly international; and the mutual-fund business, too, is becoming international. Life insurance — which is essentially a savings business with some risk insurance attached — competes with mutual funds, and cannot be immune to these trends. Individual savings products are becoming more international, with increasing interest in international investment, common reporting and accounting standards, and increased need for greater scale and corresponding lower costs. If you can sell your mutual funds in twenty countries rather than in one, it is likely that your costs will be lower.

Costs are a huge issue for life insurance companies. Fundamentally, I believe that the great weakness of U.K. life companies expanding abroad is the cost base — particularly the cost of distribution. This has to be an underlying weakness of the whole business.

In areas where cost is less of an issue, the life insurance business has already become quite international. Single premium business is seeing quite a lot of international selling from off-shore environments — Luxembourg, Isle of Man, Dublin — and we are beginning to see E.U. based pension schemes being sold across borders. There has always been co-operation between life companies to pool risks; I think that we may now begin to see common pension products sold to multinationals to cover several European countries. I am also conscious of what has happened in Dublin in regard to the Italian life insurance market. The Italian unit-linked bancassurance market has settled largely in Ireland, due to a combination of expertise and tax advantages, combined with less restrictive regulation. In other words, companies, in the future, may well choose to base their operations in the country which suits them best for cost, expertise, tax and regulatory efficiency. For the present, marketing and distribution will remain domestic, but international barriers are breaking down here too.

This paper is, therefore, timely in looking at international markets — they will affect all of us, either by our competing abroad or by overseas companies competing in our domestic markets.

Mr D. G. R. Ferguson, F.I.A.: I confine my remarks to Europe, and, in particular, to Germany, and ask the question: “Why is it that U.K. insurers have not made more progress in the past ten years on the Continent of Europe?” It is very disappointing, and particularly so to those who were involved in getting the Third Life Insurance Directive and the Third Non-Life Insurance Directive framed in a way which was going to open up the market and make it attractive to a sector of the U.K. economy which, quite clearly, had competitive advantage compared with European colleagues.

If you ask the question why those opportunities have not been taken, undoubtedly the biggest one has been the preoccupation that managements of U.K. insurers have had with problems at home, for which the Government has been largely responsible — the Financial Services Act and the burden of extra costs and responsibility in protecting the home market. Of course, many of those burdens still continue. Life certainly has not become any easier.

The second reason is that, when you actually go and look at some of these attractive overseas markets, you find that they are not so attractive once you get there. They are very difficult. You have to come to terms with different languages, cultures, legislation, taxes, practices, distribution, and so on. So there are not quite the easy pickings that there may appear.

Thirdly, there has been the practice of insurers towards consolidation in local markets, and an approach of cross-border ownership of domestic companies rather than operating across borders through branches, and so on; the so-called think global, act local, philosophy.

This paper is particularly timely because of some changes which are taking place which could alter the climate, make some of the European markets more attractive, and give us another opportunity to realise the potential which is there:

- (1) There is, of course, the euro, which does change matters very considerably. You now have one currency for a large part of the European market.
- (2) There are reductions in the tax advantages which apply to local insurance companies. All of those are being eroded, and, as part of the euro trend, tax harmonisation is going to come, so again you are going to get more similarities across great swathes of the European continent.
- (3) The advances in electronics in communication are affecting the approach that people have to the way in which back offices are run, and the opportunities to get real economies of scale by operating across borders, wherever it is most effective. The back office does not have to be local. The era of the virtual office is here.
- (4) There are opportunities in distribution.
- (5) There is the experience that consolidation in local markets, moving to larger and larger companies, is not necessarily giving competitive advantage to the large companies. In all markets we are seeing, not a move to consolidation where a few companies are dominating the market, but there is a steady state developing, with new people coming in all the time, operating effectively. So there are opportunities for greenfield developments in all of these markets.

I hope that this paper will lead more actuaries to encourage their commercial connections to think again about Europe, and, generally, to expand internationally.

Mr P. K. Joshi, F.F.A.: I feel that it is particularly timely to have a paper on international expansion at a time of great merger and acquisition activity, both in the U.K. market and around the world, and also given the increasing trend of globalisation. I agree with Mr Paul that we should only expand overseas if we have the skills to do so, at a profit, but I suggest one particular reason for overseas diversification, and that is diversification itself. In particular, diversification helps things like distribution risk — we all have different concerns about the sustainability of different channels within the U.K. — and also the more obvious risks in an insurance context: mortality risk; asset liability management risk; and squeezes on planned profit margins in a given market.

On the German market, I agree that, although we now have the Third Life Directive, selling into other European countries is still not straightforward. We still have to comply with local insurance law and local sales regulations, and product designs have to meet local taxation requirements. I would also emphasise the cultural differences between different European countries, and particularly Germany. We have talked about the different approach of the actuarial profession and the different standing of the actuarial profession that we perceive in Germany relative to the U.K. The highly regulated product design environment which existed in Germany before 1994 is a large part of the reason for these differences, and for a great lack of comfort by German brokers, customers and regulators with discretion. The amount of discretion which the actuary and the board of directors have in the U.K. on setting bonuses, for example, is something which German actuaries are not used to exercising, and find quite difficult to understand and imagine.

Mr Richards talked about forthcoming tax changes, and said that he felt that insurance companies had been ineffective in lobbying for change. I think that is right. All I would add is that, given the political sensitivity within Germany, at the moment, to the package of changes which has been presented, it is perhaps not surprising that insurance companies have been ineffective. What has been proposed is quite radical; for example, a significant cut back in the

present, very healthy, level of state benefits. Technical arguments about how insurance companies are taxed are not going to attract the same degree of publicity as proposals to cut state benefits. That is not to say that insurance companies should not be trying to lobby the regulators.

Something that I find particularly odd about the proposed tax changes is that they are supposed to help tighten the German fiscal position. Having said that, the tax changes proposed are to tax policies on maturity, which is going to be revenue neutral for many years. I wonder if the present Government's proposals may be resurrected, which would have tax much advanced by comparison with the current proposals.

Mr J. Goford, F.I.A.: I was in Hong Kong for most of 1997, and was appalled at the quality of sales practices throughout South East Asia. This is a public interest issue. It was worse than it has been in the U.K., I have to say. Some of the origins are similar. In the unit-linked industry in the U.K. we had a large organisation with a very highly disciplined sales force which operated in a particular way. People copied it, but not quite as well, and the results of some of the sales practices that they indulged in have been seen.

The same is true in South East Asia. There is one large multi-national which dominates south east Asian countries, and it is very well disciplined. It has very good training methods and runs its organisation in a particular way, which many other companies try to reproduce, but not as well. It is a very similar situation. It is compounded by the fact that direct salesmen tend to go round in groups of 100, controlled by their lord and master. When they run out of their relatives, they move to another company and then go and see them again. I overstate just to make the point.

Unfortunately, there was no pressure for change to this situation that I could see. The regulators that I spoke to said: "If the industry wants to change and they come and tell us that they want to change, then we might put some regulation together to help them", but they were not going to initiate it.

I expected to see someone from the banks who might have a better attitude towards their customers, but there was none coming from there. You might think that the reinsurers might play a role. They did not seem inclined to do so either. On my last trip, a couple of weeks ago, I did find one company that said: "Enough is enough", and they are trying to play a different game in Hong Kong. It is nice to see, at last, someone starting to think that way.

There is a public interest role for the profession to point out the consequences to companies and to regulators of carrying on in the way that they are, and the consequences in poor value for money for customers, because of high turnover rates of policies. As a profession, and as influencers, we have a role to play.

The other public interest issue in S.E. Asia is financial reporting. The way that South Korean accounts are dealt with is quite laughable. I do not have a great love of deferred acquisition expenses, and they certainly have some of those. They also have the excess of book value over market value as an asset. Then they have the asset which the Government asks them to put in to make the thing balance.

The accounting profession must carry some responsibility for allowing this situation to occur. I do not think that the actuarial profession is tainted with this brush yet, and we do have a mechanism to bring this home, which is in the valuation of companies. You can start with whatever accounts you like, strip out the rubbish, and then build in the other components of value which are missed out.

So, we have opportunities to communicate the way in which these practices are carried on. I would not mind seeing some sort of truth and reconciliation accounting commission in S.E. Asia, but I am not sure that that is going to happen. The point that I want to make is that there are some public interest issues out there, over which we can have an enormous influence if we choose to do so.

Mr D. Paul, F.F.A.: I should like to reply to what Mr Ferguson said about his disappointment that U.K. insurers had not taken advantage of the Third Life Directive, and, in my case, the

Third Non-Life Directive. I think that we have probably been too automatic in our assumption that the single currency would mean single markets. Although I am not an expert on it, if you look at the U.S.A., which is effectively 50 states which have had a single currency for a very long time, you still have small banks who work at state level. It is not automatic that you become a federal bank in the U.S.A. So, perhaps, we have to be cautious on that front, and be more calculating about what the single currency does, or does not, mean — especially given that we are not quite sure whether we are going to be in it at any particular time.

The other point is whether the Third Life Directive has let us expand in this way. I wonder if we have under-estimated how much it is a case of 'out of the frying pan into the fire'. There is, perhaps, a hankering to get back to the deregulated free market in the U.K., with all things at the discretion of the company. The reality of most European markets is that they are more centrally regulated.

In health insurance, in particular, there is a fantastic mix of public and private provision, and governments will typically legislate how the two are joined up, so it is not automatic that you can just come in with a U.K. approach to any one of the other 14 territories.

Mr S. J. Bishop, F.I.A. (closing the discussion): I am an actuary based in Luxembourg, so I can claim to be an international actuary. I have three core themes: to cover regulatory and taxation aspects; to look at what the customer wants, mainly in Europe, but also in South America; and, a subject close to our hearts: "What is the role of the actuary in U.K. expansion?"

Concerning regulation and taxation, we have alluded to the fact that the Third Life Directive has made it quite difficult for us to expand into Europe. It should have made it easy. Different regulators within the E.U. interpret the Third Life Directive in many different ways. In my view it is getting more difficult. We see Finnish regulators putting up hurdles to entry into their market, and the Spaniards are making it very difficult for Dublin-based companies to sell mutual funds in Spain. So, protection of the domestic market is still very important.

In the more challenging markets, such as Italy and Spain, it is very difficult for us to find local expertise. Unit-linked products are intrinsically complicated as soon as you have mortality benefits or critical illness benefits. The regulators are not *au fait* with those kinds of products, and neither are accountants. It is a long, tortuous process to educate them on how such products work. Understanding such products is second nature to a U.K. trained actuary; it certainly is not to people in countries such as Italy or Spain.

One of the most important things is to build bridges with the regulators — something we all tend to be scared about. The regulators in Luxembourg are actuaries. They are reasonably easy to get on with, but make life reasonably difficult for me. Regulators in Belgium, for example, will not see anybody. You can communicate only by post. With the regulators in Italy, you can communicate over a bottle of Chianti.

Also, what may be strange for a U.K. trained actuary is the way in which the product structure works. Many European regulators require you to file product approvals with them. These are very detailed documents. In some cases you have to set out how the product works algebraically, how the charges are taken, how the acquisition costs, for example, would be recovered, etc. Valuation rules also vary enormously between different jurisdictions.

The asset diversification rules within the different territories are quite interesting. Luxembourg regulators are very strict in terms of what you are allowed to invest in. We have to submit every single internal fund to the scrutiny of the regulators. Certainly, some countries in the E.U. are becoming quite concerned about other off-shore jurisdictions (such as the Isle of Man, Guernsey and the Channel Islands) using insurance companies in the E.U. as passports to push non-regulated funds into their environments. They are clamping down, and hence the Spanish treatment of Dublin-based funds.

Finally, on the regulatory side, equities are bread and butter business to ourselves, but there are still untested, uncharted, waters within some areas of Europe. We have experienced difficulties with getting equity into some German funds. I had the interesting experience, last week, of meeting an Italian banker who was banging the table and getting excited, asking why

Italians do not invest in equities when their government bonds are only yielding 2.5%. It takes time to get that message over.

Now, considering some of the more cultural differences of working in Europe, first of all I give a word of advice: never use the expression: "In the U.K. we do it like this", because people will reply: "Well, you are in Italy or Belgium or Germany". Applying U.K. techniques and practices is perfectly acceptable. They are robust and will stand up against challenge. Then there are the language barriers. Most of the people with whom I deal speak very good English, but they always miss the nuances. I will explain in my normal English actuarial way, and suddenly see blank expressions. So I have to explain in a very simple way.

From the taxation point of view, in terms of reporting requirements, one thing that the paper underplayed is that, for companies which are subsidiaries of bigger multi-nationals, you have to report on many different accounting conventions. In my own company, I now report on five different accounting bases. The bases tend to be similar, but there are different nuances, especially in terms of deferred acquisition costs.

Moving on to products and markets, in terms of U.K. expansion abroad, there are two different strands: there are companies which have moved into offshore locations to offer tax advantaged products — companies in Dublin, the Isle of Man or Luxembourg, for example; and there are companies which have gone for a full domestic presence, and have tried to offer a wide range of products in terms of protection and investment. When you are trying to design products, people often omit the step of identifying the customer need. It is very easy to say: "Company X is doing this; company Y is doing that". What is actually in it for the client? That is something which actuaries will always bring to the table, and will actually have that conversation with the client. I have seen on many occasions, especially in the Italian market, where the tax benefits may not be that great, distributors asking for much higher charges to pay for their commission levels. Whether that product is meeting the reasonable expectations of the client is a very difficult judgement that an actuary has to make.

The second thing that you need to do on the product development side is to understand your competitors. Companies in Italy are very new to unit-linking, and new to what we would call advanced actuarial techniques, but they are catching up very fast. They are clever people, and are supported by consultants. It is easy for us to take a U.K. based mentality and say: "We, as actuaries, are much more business aware than our continental colleagues". I assure you that they are catching up quickly. Certainly, some of the consulting firms are out there making a great deal of money helping them to catch up.

The other things which always amuse me are policy conditions, and here I tell a little story about a company on the Isle of Man which was writing protection business to Colombia. It suddenly found a rush of claims. All their policyholders were lying decapitated by the side of the road. They had not built a definition of a death claim into their policy conditions. Many companies operating in South America will define a death, very strictly, normally as due to natural causes. Especially operating in these areas, it is very difficult to get a reliable mortality statistic.

On the product side we are aware, in the U.K., about how much attention we pay to charges, league tables in the financial press, and the calculations of reductions in yields. In most of the markets in which I have operated there is none of that. Everybody is still hiding behind charges, and there are many hidden charges, so that clients really do not understand what they are buying. There is a big education exercise for all of us.

So, what is the role of the actuary in international expansion? A colleague earlier said that he felt that the actuary in the U.K. could become slightly marginalised. I see quite the opposite. If you are a U.K. trained actuary working in the international marketplace, you are bringing much to any development. You are acting as a business person, a consultant, more than as a technical actuary. We tend to be quite fortunate, we have a wide overview of how an insurance company works from the marketing side, through its operations, even into IT. It is very important to try and keep focus in the insurance company.

Returning to a point to which I alluded earlier, on a policyholder's reasonable expectations,

and making sure that a policy is value for money for the client. I think that that is becoming an increasingly important role for us.

The actuarial role is about getting involved at all levels of business, understanding what your clerk is doing, up to the managing director, especially in a multicultural environment. We have 18 different nationalities in our office of 75 people. You need to understand your market, and you must not skimp on research and development. Looking at business failures of U.K. companies entering the Italian market, the reason for failure was because they simply did not understand the market, or understand the products. You also have to take a long-term view. You cannot expect immediate returns from these markets. It takes time to understand what is actually going on.

We have not mentioned distribution. It is usually the mantra of development into European markets — distribution, distribution, distribution. It has to come first. It is the most important thing in terms of selling into Europe, but, once you have distribution sorted out, the problems start.

Dr D. J. Grenham, F.I.A. (replying): There was one point about: “Why go abroad?” The question is: “Why do you want to do that?” It seems to come down to: “If it makes money”. That is obviously a necessary condition, but I do not think that it is a sufficient condition. A company will need to be satisfied that it has a product to offer which people will want, and that it will make money, but it also ought to have something which is going to add value to the lives of people overseas. Perhaps it is a slightly missionary mentality, but I think that, unless you go with that sort of mentality, you are going to be focused too much on the bottom line and perhaps too much on short-term returns.

As has been mentioned, you need to have a long-term view on overseas expansion. Mr Paul also mentioned that you need to look at it on a stand-alone basis. That may be true if you have sufficient capital to throw at a number of projects at the same time. Many companies which are capital constrained can only apply it to one or two projects at a time, and, therefore, to expand abroad is in competition with other projects, such as re-engineering, merger and acquisition or product development in the home market.

Mr Paul did make a very interesting point about the home office situation. It is very easy for a large organisation, with the culture of 40, 50 or 200 years, to view its own operation one-way, and wonder why an operation on the other side of the globe, with only three people working in it, cannot produce management information just as quickly.

A number of speakers commented on how U.K. companies had not done that well abroad. Europe having opened up, why are we not out there winning more business? Why was a U.K. company withdrawing from Australia at the same time as an Australian company is coming and playing in our backyard? I do not know the answer to that question. Maybe it is to do with the management of our insurance companies focusing on some of our local issues, such as pensions mis-selling or stakeholder pensions. Perhaps we could learn from some of the U.K. football teams who went through a period of not doing particularly well in Europe, partly because they were not allowed to play there in the first place. A number have recruited foreign managers to run the U.K. operation and foreign players, and, perhaps as result of that, are now doing much better abroad. Maybe we will be seeing more foreign managers in U.K. insurance companies.

The single European currency will, in time, assuming that it is successful, undoubtedly have a big part to play in the European economy and financial services. However, there will be barriers, such as taxation, to the extent that it is not harmonised, language and culture. These are not insignificant, and having a currency which is similar means that people may emphasise the differences that do remain. It cannot be taken as read that, so long as you have the same currency, you will be able to move into other countries more easily.

Mr Goford picked up a very important point about moving abroad: the reputational risk that could occur to a U.K. company that got involved with an overseas operation that went wrong. U.K. manufacturers involved in overseas manufacturing companies using child labour have suffered as result of those sorts of connections. I am not suggesting that overseas insurance

companies are using three-year-olds to administer their policies, but uncontrolled sales forces could give the company a bad reputation here if the word got around.

Mr S. J. Richards, F.F.A. (replying): I should like to take Mr Ferguson's question and the opener's question together, because both concerned distribution. Mr Ferguson wondered why so few U.K. insurers have actually tried to enter the German market. The opener asked a question about distribution technology. I think that one of the key reasons why so few U.K. insurers have tried to enter the German market is simply distribution. It was, and is, still true that Allianz has an agent's office in even the smallest German village. Thinking of the opener's point about distribution technology, I note that the previously high entry barrier in the shape of distribution has been somewhat lowered by the internet. Internet penetration in Germany is very high, and there has been very rapid acceptance of internet-based banking and share dealing. One of the most recently launched services, from one of the German internet-based share dealers, has been a self-invested personal pension, essentially a share dealing service in a tax-free pensions wrapper. If this does represent a lasting change in behaviour, then the internet will play a significant role in reducing some of the entry barriers to overseas markets.

Commenting on Mr Joshi's point on taxation, I agree that the current German Government's proposals of a 3% tax on maturities is revenue neutral for quite some time. The previous Government had a proposal to levy a 3% insurance premium tax, which would have generated revenue now, as opposed to revenue in 12 to 15 years' time. There is always, perhaps, the hope from the side of the insurers that the tax might actually be scrapped or changed before the first maturities. The problem with lobbying against the current tax is that it might actually be replaced with something less acceptable.

I now turn to the closer's point about style, and justifying something as: "That is how we do it in the U.K." I lived and worked in Germany for some time, and had many dealings with German insurers' sales agents and German actuaries. I discovered that something would be rejected out of hand if I justified it as: "This is how it is done in the U.K." However, it would be accepted if I described it as: "This is how it is done in Anglo-Saxon markets."

Mr D. C. Chakraborty, F.I.A. (replying): A number of life assurance companies which are owned by European parents are aggressively trying to build up business throughout S.E. Asia. One major company set a target of getting \$4bn premium income from the region. I was wondering what drives them. A representative said that, being a global player, it simply cannot afford to ignore any significant or growing market. These companies have grown very rapidly in the recent past by acquisition and merger. One company has taken over quite a few U.K. companies. Their drive seems to be to become large international players. How does that help them? Whether it prevents them from being taken over by others is a question to which nobody can give an answer. U.K. companies are generally more inward looking.

One side issue, so far as India is concerned, is that I know that some of these companies are looking to use India as a base for the operation of various other activities. Their life insurance operation is probably only a part of it. For example, a few life insurers started unit trust or investment management businesses, and a couple of companies are thinking of passing their pension fund administration to India.

Some American insurance companies do not have any operations in India, but have started doing some of their administration work there. When somebody sends something by e-mail in the evening from New York, it is received in the morning in India, and the response goes back by the next morning, giving a 24-hour opening. This sort of attitude, of building a global business, is one of the very important driving forces for many international companies to enter the markets in India or in Singapore. Is it valid for a U.K. life assurance company?

I agree that the public interest issue is vital. I compliment the actuarial profession in the U.K. The Faculty and the Institute members have played a very important role in highlighting some of the public interest issues on market deregulation. I also know that there are many questionable market practices in the insurance industry in various parts of S.E. Asia. Such issues

can be dealt with more easily if there is a strong actuarial profession locally, with connections to the international profession. Fortunately, even given the declining numbers in the actuarial profession in India, we continue to maintain international professional contacts. In the process we have been able to prevent some of the wrong practices which you will find elsewhere. I am not saying that bad practice does not exist in India, but the scale is less.

I now have a note of caution. Happenings like pension mis-selling scandals do not help the U.K. actuarial profession. When you say that India should have a specific practice, somebody says: "Why did you have a pensions mis-selling scandal, and what did you actuaries do to stop it from happening in the first place?" These are difficult questions. Having said it, the actuarial profession certainly has a strong role in highlighting public interest issues. In the process, they will be doing a service to the customers and to society at large.

The President (Mr C. W. F. Low, F.F.A.): We have had a very wide-ranging discussion which has not been confined to narrow technical details of the German and Indian markets. Some very important issues have been brought out, not least of which is the issue of public interest.

Insurance company accounts, like the accounts of commercial companies, vary greatly in their degree of disclosure and accuracy from one country to another. The International Accounting Standards Committee is already working on this issue, and is hoping to have international accounting standards in force around 2005. Our profession, through the International Actuarial Association, is working very closely with them in trying to develop acceptable international accounting standards which will remove accounting arbitrage between countries, and also, it is hoped, will be acceptable to international insurance regulators. This will greatly speed up the rationalisation of insurance business world-wide.

We also have had much discussion on how distribution and sales methods can be speeded up with electronic communication, website selling, etc. There has been mention of public interest issues, with actuaries being able to point out to their clients that prospective bad selling techniques can hurt their company retrospectively, not just from lapse rates, but also from regulators.

Pensions mis-selling did not arise because the product was badly designed, but because a product that was perfectly suitable to be bought by certain people was mis-sold to many others.

In the offshore life assurance market there are products which are suitable to be sold to certain third country nationals. Are these offices watching the sales practices of others, not necessarily their own employees, where such products may well be being sold into a country in which it is illegal to do so?

Dr Tutt brought out the fact that we have had a sea change from the time when U.K. companies expanded into large Commonwealth countries, a generation or so ago. We are finding the reverse. U.K. companies are finding that the European Common Market — to use an old-fashioned term — is still one where people are able to defend their own patch quite effectively, despite harmonisation of currencies in certain areas.

International trade was never supposed to be easy. It is certainly something that the Scots used to excel at in the last century, and I hope that we will get back to that level again. Many U.K. insurers see the trend towards globalising and consolidating financial markets as a threat. Whilst it is true that these are factors in the restructuring of the industry in the U.K., as has become so apparent over the last few years, this important paper has made it quite clear that there is cause for optimism, too.

One possible way of continuing to grow profitably is to invest sensibly in a foreign marketplace. While it is true that the U.K. life assurance industry has, in the past, been slow to grasp such opportunities, this paper makes it crystal clear that such openings undoubtedly exist. I would, therefore, urge Scottish and other U.K. life companies to give far more consideration to a significant overseas investment.

I now ask you to extend a vote of thanks to the authors for their paper.