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Emerging Markets:

Opportunities,
Threats,
Implications
for Wholesalers

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INTRODUCTION

With low insurance penetration rates and rapid economic growth, emerging markets become attractive destinations for market expansion and diversification. Lloyd's CEO Inga Beale pointed out that new emerging markets generated 43% of commercial insurance growth in the last three years, and two-thirds of commercial insurance growth in the future could come from emerging markets (Louie Bacani). Some common trends within these markets, such as liberalizing business environment, rising middle class and increasing infrastructure investment bring abundant opportunities for wholesalers with specialist expertise to play a role.

OPPORTUNITIES

Market Growth Potential

From the regional perspective, Asian developing economies remain the dominant engine for premium growth in emerging markets. China alone, despite the slowdown of GDP growth rate at 6.7% in 2016, is expected to account for nearly 60% of emerging markets premium growth, followed by India for 11.5% by 2020. Africa, Latin America and Middle East, contributing around 9% altogether, still hold great market potential for low penetration rates and urbanization development boosting demand for insurance (Ernst and Young).

Liberalizing Business Environment

Instead of preventing capital outflow with rigorous restriction on foreign entry, government in some key emerging economies, such as China, Brazil and India, are pursuing the path of economic liberalization with the goal of absorbing foreign expertise and enhancing competitive advantage. On the demand side, trade liberalization stimulates the demand for marine, aviation and transport insurance (MAT). On the supply side, liberalizing policies on market access create business opportunities for non-admitted insurers. For example, China under the WTO commitments permits non-admitted insurers to write international MAT business without the requirement of a Chinese intermediary. In Mexico, non-admitted insurers from Lloyd's are allowed to write the risk declined by local market under the approval of Comisión Nacional de Seguros y Fianzas (CNSF). In Brazil, non-admitted placements are permitted when there is no insurance coverage available (Crystal Search, Lloyd's). Foreign non-admitted insurers can utilize these regulatory exceptions to write business in emerging markets.

Infrastructure Development

China's launch of One Belt One Road initiative in 2015 will present various opportunities for commercial lines. The large-scale program connecting 65 countries across Asia, Europe and Africa is expected to trigger a new wave of infrastructure construction and cross-border trade activities. The demand on coverage for manufacturers and massive infrastructures is enormous because of the infrastructure shortage in participating countries and high risks accompanied with trade and investment. The project could generate USD 7 billion in commercial insurance premium where property, marine and engineering insurance would benefit most (Swiss Re). Wholesale market, therefore, will benefit significantly from providing those high-risk and safety-critical products not only for China, but also for included

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emerging markets in Asia, Middle East, Europe and Africa.

THREATS

Despite the tremendous opportunities in emerging economies, however, insurers still confront a variety of internal and external challenges hindering their expansion. “The reality is harder than that. The penetration rates haven’t actually changed much in ten years”, CEO of AIG, Peter Hancock said (Peter Hancock). The reason behind low market penetration mostly comes from under-stimulated demand and restricted supply, constituting major source of threats.

On the demand side, challenges for foreign insurers originate from low customer awareness, misconception about insurance products and consumers’ home bias, especially in low-income areas where there is a dominant ratio of poor population and low level of literacy. In some emerging markets where there is a lack of enforcement of regulations against fraud and corruption, such as Russia and India, high administrative costs, fraud, adverse selection and moral hazard diminish the profitability of underwriting business (Allianz AG, GTZ and UNDP Public Private Partnership). Under such circumstances, it is critical for insurers to cautiously assess customer demand and risk exposures while designing products for target overseas markets. On the supply side, following factors may pose a threat on the profitability of foreign insurers:

Cost of Compliance and Regulations

Regulators in several emerging markets, such as Mexico, Brazil, Chile and China, are developing and synchronizing their regulatory framework around EU Solvency II . For example, China began the gradual implementation of its China Risk Oriented Solvency System (C-ROSS) in 2016. Under the tighter capital control in these markets, foreign insurers will face higher capital pressure. For foreign insurers, although geographical diversification reduces underwriting risk and thus reduces capital needed in the home country, the benefit may be offset when there is a higher capital requirement in the host country. Overseas branches have to undertake higher cost of capital including opportunity cost and agency cost, leading to less competitive pricing. Small or specialized insurers, in such situation, could suffer from mergers and acquisitions or exit the market (Swiss Re).

Local Competition

Given the market potential in emerging Asia and Latin America, foreign insurers face the threat from domestic players who benefit from market access restriction, discriminatory taxation, wide distribution network and familiarity with local markets. Compared to local insurers with those inherent advantages, underwriting expertise is the core competitiveness for foreign insurers to expand the market share. However, the joint venture for conducting a project, which is mandated by some regulators in emerging economies, may devalue the intellectual property through an imbalanced share of knowledge and techniques. Under this pressure, continuous product innovation is critical to outperformance the local competitors.

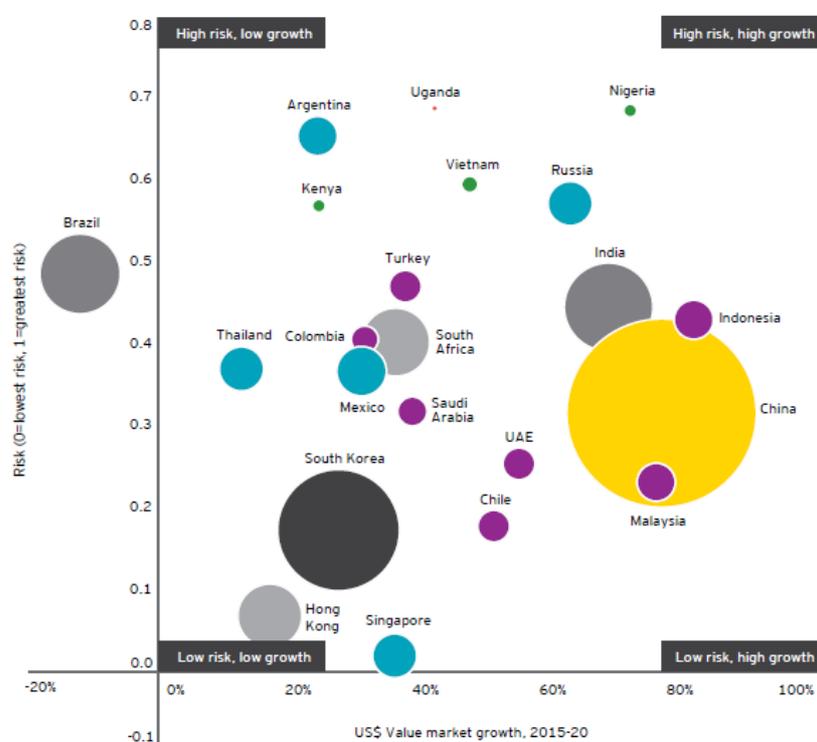
Technology growth in mobile and online service will compel wholesalers to rethink the distribution strategies and customer service. The giant e-commerce companies Alibaba in

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China cooperated with Chinese insurers to provide internet-based insurance programs through new online distribution channel. Mobile payment is also prevailing in Vietnam, Malaysia, South Africa, etc (Ernst and Young). These developments in digital technology will fuel the local competition in the future.

Unexpected Events

According to Risk-Opportunity Matrix created by Ernst and Young below, most attractive markets with high growth and low risk (China, India, Indonesia and Malaysia) is located in Asia, measured by opportunity index (market size, premium growth, penetration and macroeconomic environment) and risk index (macroeconomic risk, political/regulatory/corruption risk, sovereign and trade credit risk and underperformance in urbanization and technology) (Ernst and Young).



Source: Ernst and Young

But the reality is more complicated and increasingly unpredictable. The risk index defined by Ernst and Young merely revolves around economic and political environment at a national level. The risk dynamics affected by regional natural catastrophes and the loss severity within each country, however, are excluded in this matrix. The unexpected loss in emerging markets can be even more expensive with the urbanization raising the population and property density within urban areas. In fact, there are past records where insurers geographically diversifying in emerging low-risk zones suffered bigger loss than those in high-risk zones in 2011 (Guy Carpenter). For example, explosion in Port of Tianjin in China, fire and explosion in a drilling platform in Mexico and severe flash floods in India ranked among the 20 world most costly loss events in 2015 (Swiss Re). Besides, environmental triggers, for example global

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warming, will add to the correlation of insured events leading to increasing underwriting risk in emerging economies. Demanding enormous funds and strengthening the geographical economic and political correlation in most developing countries around Asia and Middle East, China's One Belt One Road initiative will also trigger trade and credit risk higher than expected. These uncertain factors alert wholesalers to develop unique business model and provide customized products based on assessment of loss frequency and severity in each target market through solid foundation of data and information.

Political and Economic Volatility

United States' withdrawal from the TPP and anti-globalization trade policies under the new administration could dampen the trade and cause currency volatility in some export-driven emerging economies. Geopolitical instability, including refugee crisis, terrorism and political turbulence, triggers currency risk in markets such as Brazil and Turkey. The volatility in exchange rates will complicate the repatriation of profits and capital if insurers choose to exit these markets given the rising global and regional uncertainty in the future.

Corporate Governance

Aside from external triggers threatening the diversification process, the operational failure may occur internally when the foreign insurers struggle to make a balance between market share and profitability. Lloyd's emerging market plan where 25% of its business comes outside of Europe and North America, was "positive, but brings risk", according to rating agency Fitch, "little understood, largely unmodelled but very expensive Asia Pacific risk exposures formed the bulk of a record catastrophe claims bill for insurance industry." (Benyon, D.). This was the consequence of chasing for market share with the cost of cheap pricing and lower underwriting quality, damaging not only the profitability but also the reputation, which is extremely vital to insurance business.

At the operational level, how to incorporate the management style, value or culture into the subsidiaries, branches or joint ventures overseas is challenging and takes time for adaptation. The language and cultural barriers in emerging countries also add to the difficulty of communication with multiple parties involved in complex events, posing new capability requirements for wholesale professionals.

RECOMMENDATIONS

Cooperation with Regulators and Stakeholders

Even for multinational insurers with years of experience and global presence, it takes high institutional uncertainties and transaction costs to obtain licenses and run business effectively in developing economies. The key is to seek win-win opportunities with regulators and stakeholders. "The regulatory challenge and the stakeholder challenge we face are many", said Peter Hancock, "what I feel the most important is not to feel regulators as your enemy. They have a duty to help the society to operate in a fair sustainable way. I'd like to meet with leaders, regulators and political leaders who often govern them to understand what their political priorities are and see how we can help them." (Peter Hancock, AIG). Apart from negotiations with government, cooperation with local NGOs or international organizations

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based on common goals and incentives helps reduce the amount of friction with stakeholders. For instance, Micro-Insurance Development Program, implemented by the World Bank and International Finance Corporation, provides insurers with advisory and technical assistance in terms of building public-private relationships, raising customer awareness and developing distribution channels (World Bank).

For wholesalers with a limited entry strategy, there are alternatives to access the emerging markets through participating in Lloyd's and other associations. Lloyd's of London, the largest wholesale specialty marketplace in the world (Fairfield), has obtained licenses and established overseas offices to provide specialist insurance in emerging markets such as India, China, South Africa, Brazil and Mexico, enabling wholesale members to access the developing markets and apply their underwriting expertise across national boundaries.

Technology and Talent

Entering new markets suggests reform in product design, distribution, customer service and marketing. As the digital technology develops in most developing markets, targeting at customer needs and improving customer-centered service can build competitiveness through big data technology. Internet-based insurance compels wholesalers and carriers to rethink the traditional distribution channel. Besides, wholesale professionals and human resource managers are faced with new requirements on talent: a) cross-cultural communication skills; b) specialized and localized knowledge; c) proficiency in advanced technical tools.

Risk Management

Given the growing uncertainty in emerging economies, it is crucial for wholesalers to continuously identify, evaluate and monitor the risk exposures and implement risk management tools from following aspects:

- a) Loss Control: Provide customers not only coverage, but also risk management advisory service to reduce the level of risk activity. This can also reduce fraud and moral hazard in countries with regulatory deficiency.
- b) Loss Financing: Reinsurance protection may mitigate the insolvency risk as well as reduce capital cost. Hedge currency risk in emerging markets by using forward or swap contracts and foreign exchange derivatives.
- c) Internal Risk Reduction: Invest in quality and accuracy of data for loss forecasting. Most importantly, increasing unexpected loss events call for advancing catastrophe modeling and customized pricing under sustainable growth strategies.

SUMMARY

Numerous opportunities and significant challenges in entering emerging markets require proactive adaption to the dynamic regulatory and competition environment for the wholesale professionals. Internally, customer-centered products, strong risk management mechanism, innovative talent with global market insights and advancing modeling techniques will help enhance the sustainability and profitability of the diversification portfolio. Externally, the ultimate success also relies on the networking and collaboration with multiple parties such as local stakeholders and professional trade associations.

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