RECORD, Volume 22, No. 1*

Marco Island Meeting
May 29–31, 1996

Session 37PD
International Product Development Market

Track: Product Development
Key words: Product Development, Reinsurance

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Summary: The panel discusses the insurance product development environment in various international markets with emphasis on both current and future trends.

Mr. Robert B. Lau: I'm the actuary for the Asian Pacific Division of Reinsurance Group of America (RGA), and I'll be your moderator. We're fortunate to have representatives from all of the Latin American, the Far Eastern, and European markets. We have Juan Punchin, who is vice president of international operations for Metropolitan Life based in New York. He has previous experience in Argentina, Spain, and Mexico. He's going to touch on changes to the Social Security system in Latin America and its impact on products and product development using Argentina as a specific example.

We also have David Rosier, who is regional vice president for RGA's Asia Pacific operations. He's stationed in Hong Kong. Prior to joining RGA, he was most recently at American Insurance Association (AIA) as head of operations for AIA's select operations in Asia Pacific. He'll touch on issues impacting the approach to product development in the Far East.

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We also have Nigel Silby, who's filling in for Phillip Brook who, unfortunately, could not join us. Nigel is a partner in the insurance practice of Watson Wyatt Worldwide in the U.K. His work primarily involves insurance consulting in Europe. He has been with Watson Wyatt Worldwide for 12 years. Prior to that, with Swiss Re. Nigel will be talking about product development with specific reference to the U.K. and France.

Mr. Juan F. Punchin: Bob asked me if I would talk about Latin America's insurance opportunities and product development environment? I think this part of the world has experienced significant economic growth and development during the past decade. Democratization is taking hold. Countries are adopting market-based capitalism. State industries are being privatized. Free trade agreements are being signed. Import tariffs are being lifted, and the list just goes on. As economies open up, and as political stability returns to the area, large amounts of foreign investments are flowing back into the region.

I want to focus specifically on Argentina where I have spent the past two years working with the life operations. I think that Argentina is a good example of the fast pace of change in development that we are seeing throughout the region, and the opportunities that open up as a result for the insurance industry. I will be focusing my presentation on the privatization of the Social Security system and explaining that in some detail. It was a very important development in Argentina, and it created quite a few opportunities for the insurance industry. We're seeing that happening throughout the countries in different degrees, but basically the same trends are happening. First, let me provide you with some background and mention some major recent changes that have affected the life industry.

Individual life insurance is untapped in Argentina, and this is not atypical of countries that have experienced fairly high inflation over long periods of time. For example, over the period from 1975 to 1986, inflation never fell below 80%. For most years, it was higher than that. The lowest was 82% in 1986 during that time period. And in 1984, it went up to 700%. In 1989, it went through a cycle of hyper inflation and inflation; inflation peaked in July 1989 at 200%. For the year 1989, it was over 5,000%.

Because of the unpredictability of these levels, it is still questioned whether long-term life insurance really ceased to exist in Argentina. During this time period, most Latin American countries had to cope with inflation. Some did it more successfully than others, perhaps because they had to cope at levels that were not quite as high as those levels that I have mentioned for Argentina.

For example, during the 1980s, Mexico's inflation ranged between 30% and 60% for most years; for two years inflation rose above 100%. In Chile, inflation has ranged between 12% and 30% in each of the last ten years. Inflation really has had a crippling effect on the life insurance business in those countries that experienced extremely high inflation rates. Although inflation will continue to be a challenge in this region, governments, I think, have begun to tame inflation and they are learning how to cope with it and how to manage it. As economic stability returns, I think that, the opening up of the economies is creating many opportunities throughout the area.

In 1989, for example, Carlos Saúl Menem was selected as president of Argentina. Under his presidency, and with the economic team led by Domingo Cavallo, Argentina has been on a steady path of recovery. Trade barriers have been lifted, markets privatized, and deregulated. Since 1991, currency stability has occurred. The Argentine peso was basically pegged to the American dollar under the so-called comvertibility plan. Under this plan, which was enacted by Congress into law, the monetary base has to be fully backed by the available international reserves at the central bank. The economy was effectively "dollarized." Since these reforms, I think inflation has been down to almost 6%. After reaching levels of 5,000% in 1989, inflation is now down to 6% and lower in the past few years.

Let's discuss some of the reforms that have impacted Argentina's insurance marketing outlook. With some of the economic stability returning and because of deregulation of the insurance industry, we have seen some major changes. The first step was privatizing the state-owned insurance company, which had the largest share of the market. Formerly a monopoly of the state, reinsurance is now open to international reinsurance companies.

The insurance regulatory framework was overhauled. Existing regulation was streamlined and consolidated. Premiums were deregulated. New solvency margins were established. The role of the state regulatory authority was redefined to overseeing financial solvency rather than setting premium rates.

The privatization of the Social Security system is perhaps the most important change that has affected the insurance marketplace and that has created opportunities in many areas. I would like to spend time describing in more detail this privatization effort. Some of the Latin American countries have already implemented some form of privatization, and many are far along in the planning stage. You might ask why privatize Social Security. Perhaps among the most important reasons are, one, the governments just have not been able to manage efficiently the public system; and two, many state systems are bankrupt; and, three it increases the level of private funds to support capital market development.

In 1981, Chile was the first country to privatize. Its efforts have proven so successful that it has become a model for other countries. In Argentina, legislation was enacted in October 1993 to reform the existing pension system, and it became operative around mid-1994. All active workers over the age of 18, employed and self-employed, are included in the new system. Current retirees continue to be covered by the existing pay-as-you-go system, and the state will continue to administer that system. The new system provides for retirement, disability, and death benefits, and I'll be describing these in a bit more detail later. Under the reforms, the state will continue to have a role, and the state system will co-exist alongside the private capitalization system.

Let's look at the contributions under the new system. Employers pay 16% of salaries to the state, which will continue to provide a basic universal benefit. Employees must contribute 11% of their salaries. Employees have a choice of contributing either to the state and increase their retirement benefits, or they can opt—and this was one of the major changes—for the private pension fund manager, the so-called Administradora de Fondos de Jubilación y Pensiones (AFJP), where the contributions will be accumulated in individual pension accounts. The AFJPs were specifically created by the new law for this purpose.

The self-employed contribute 27% of their salaries of which 16% goes to the state; the same alternatives, state or private, apply to the remaining 11%. For purposes of calculating all the contributions, salaries are capped. The maximum is determined by formula and its variable. The current maximum is $4,500 on a monthly basis.

Let's look for a minute at this entity that has been created by the law, the AFJP. The sole objective of the AFJP, the private pension fund manager, is to manage funds. Contributors are free to choose fund managers and to change them twice a year. The accounting is on an individual basis. The funds are segregated and they're separate from the equity of the AFJP, so there's protection for the contributor. Fairly strict investment restrictions apply specifying what a fund manager may invest in and what limits they could invest in. The responsibility for supervision is through the superintendent of AFJP.

Let's look at the benefits that are provided. The state will provide to everybody a basic benefit consisting of a flat amount. This amount is determined through a formula and it is currently about $200 a month. It will also pay a so-called compensating benefit to reflect amounts contributed to the old system, and this benefit is calculated as 1.5% of the final ten-year average salary per year of contribution to the old system.

If a contributor has chosen to direct his or her 11% to the state, he or she will receive an additional benefit equal to 0.85% of the final ten-year average salary per year of contribution. If the contributor chooses to contribute to the AFJP, he or she will be entitled to an annuity, the amount of which will depend on the funds actually accumulated at retirement. The contributor is provided with coverage under either the state or the private system in case of death or disability. There is a ceiling, or a cap on the salaries used for determining contributions, as I mentioned, and this also is used to determine the benefit amounts.

The experience has been interesting since it was launched. Basically, more than half of the contributors have chosen the pension system. There were incentives that were built in so that it was advantageous for the older people to stay with the state system. So most of the people who have joined the private system tend to be younger.

The model in Chile was slightly different. The state, initially, had a role. But the privatization proved too successful, and the role of the state completely disappeared a couple of years after it was introduced.

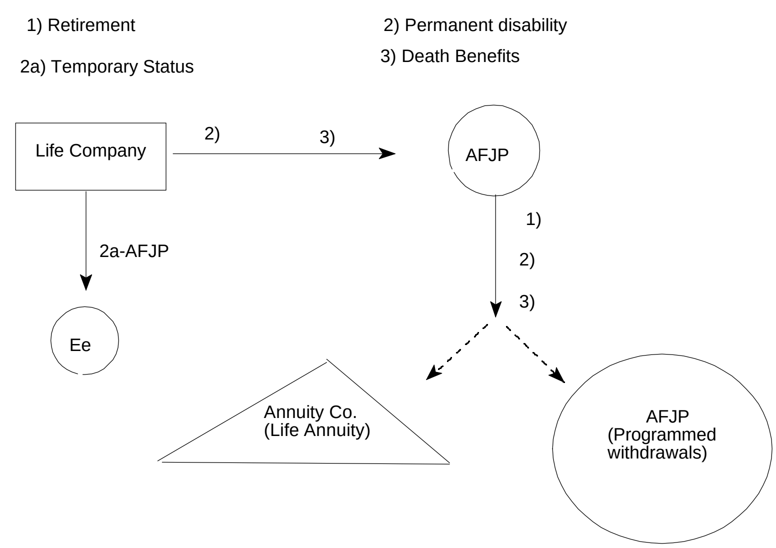
Let's take a look now at the death and disability benefits that are provided either through the AFJP or the state regardless of which contribution the contributor chooses to direct it to. Death and disability coverage is compulsory, and the AFJP is obligated to provide these benefits to its contributors. The coverage is provided by group insurance, which the AFJP purchases from an insurance company through public bidding. The AFJP is not obligated to choose the lowest bid, and there are a number of other factors that go into choosing the insurance company.

Death benefits consist of providing surviving spouses with a life annuity and an annuity payment to children until they reach the age of 21. If the child is disabled, the annuity is paid for life. The annuity benefits are specified in the law, and they are determined as percentages of average salary over the last five years. For example, the percentage for a spouse with no children would be 49%.

Benefits are payable on total and permanent disability. Qualifying disabilities are determined by a medical commission, and all qualifying disabilities go through a three-year temporary status, which can be extended for another two years. During this period the disabled employee will receive benefit payments. At the end of the temporary period, if the disability is still deemed to be total and permanent, the employee then is entitled to a life annuity. The annuity benefits are specified percentages of average salary over the last five years. So quite substantial, comprehensive, and significant benefits are provided.

Chart 1 shows how the funds flow from the insurance company to the AFJP to the employee. Basically, some events trigger the flow of funds: retirement, disability (which, as I have explained, can be on a temporary or permanent status), or death. On the left side of the chart, you see that when the disability occurs, it is in temporary status. The life company is liable for the payments, and it funnels these payments to the employee's account through the AFJP.

CHART 1
FLOW OF FUNDS



When the disability becomes permanent, or upon a person's death, a lump sum is paid to the AFJP. Although the beneficiary does not have access to a lump sum, he or she does have the choice of either purchasing a life annuity from an annuity company or letting the funds remain in the AFJP under a programmed withdrawal plan. The same thing occurs at retirement: the beneficiary will have the option of purchasing a life annuity, or leaving the money in the AFJP.

The opportunities that are created in insurance, I think, are summarized in Chart 2. First, of course, is the opportunity to be in the pension management business by participating in the AFJP itself. The second opportunity is setting up a life company and providing the pension fund related coverages that I have just mentioned, as well as traditional life insurance. This is also an area of opportunity for the emerging countries.

CHART 2
INSURANCE OPPORTUNITIES

AFJP	Pension Management
Life Co.	• Pension fund-related coverages • Traditional (Gp or individual)
Annuity Co.	• Pension fund related • Traditional (Gp or individual)

Latest (April 1996)

A.R.T. → Workers' Compensation

Future: (?)

HEALTH

With the high inflation that most countries have experienced, the life insurance business is untapped. As most economies become stable, and the people regain confidence in their governments, I think that people again are buying long-term life insurance and investing in their countries. The need for protection against premature death never really ceases to exist.

In Argentina, the annuity has to be provided by a separate annuity company. It can't be through the life company. As we saw from the flow of funds diagram, there's a tremendous market that is generated for annuities as a choice over the AFJP. The opportunities are pension fund related or they can be supplemental coverage. Remember that the benefits are capped; therefore individuals earning more than the maximum will need the supplemental retirement coverage. This creates a market for that type of coverage.

The latest privatization is really the enactment of a new law requiring employers in Argentina to insure their work force for work-related accidents and occupational illnesses. In special insurance companies, the Administradoras de Riesgos de Trabajo (ARTs) have been created to provide these coverages. As for the future, there is much discussion currently underway on the privatization of the health business.

Within the major Latin American economies, there is an area close to 400 million people. If you add the smaller countries, it's well over 400 million people.

Although I have focused my presentation on Argentina, this country is a good illustration of what is happening, or likely to happen, throughout Latin America and in emerging economies in other parts of the world as well.

As I mentioned, Chile was the first to privatize in 1981. Peru privatized in 1993. Incidentally, Peru's economy had the highest growth rate in the world in 1984. Colombia has instituted reforms. Mexico is currently revamping its existing system, and it's about ready to launch reforms worldwide. Mexico is in the midst of implementing their reforms, and it's privatizing. So far there has been a worldwide monopoly in the entire insurance business, but it's being privatized, and the Social Security system is being privatized as well.

From the spillover of the Mexican economic crisis at the end of 1994 and into 1995, Latin America has started to resume its long-term growth pattern. One by one, the major Latin American countries have made the necessary adjustments, and they are displaying, once again, strong signs of recovery. I think the whole area, with its population of over 400 million people, is vibrant with economic activity. Free-trade agreements continue to be established.

Chile is joining the Mercosur, the Southern cone trade composed of Brazil, Argentina, Paraguay, and Uruguay. Mercosur has established agreements with the European block. You see hundreds of Brazilian companies operating in Argentina and vice versa. Chilean companies are investing all over South America wherever opportunities arise. You can see transnational financial ventures and deals becoming quite common.

So I urge you to look globally. I don't think that we can ignore the opportunities that are offered to us in this part of the world.

Mr. David Rosier: We want to shift to another part of the world now and talk about the Asian markets. Many of the comments Juan has made about South America are equally relevant for the Asian markets.

When I looked at how to go about doing this presentation, my first instinct was to give you an overview of what's happening in each of the Asian countries, but that would be verging on the impossible in the time available. I also don't think that would be particularly useful. What I'd like to do is try to look at some of the issues that I think are common among those territories. One has an opinion that these issues are very common in any of the emerging markets and, perhaps, in some of the more mature markets.

I don't think it's relevant to talk much about Asia itself. I do recommend a book by John Naisbitt called *Megatrends Asia: Eight Asian Megatrends That Are Reshaping Our World*, Simon & Schuster, New York, 1996. He writes about what's happening in Asia and some of the trends that will be established as we go into the next century. I can't go through any of the points that he raises, but they are very relevant to the economic, political, and social development that's happening in Asia.

Just to start the talk, I think I need to put some of the markets into a little bit of perspective. I've categorized the markets into a number of different stages of maturity. Within the territory, you have, what I would see as mature and competitive markets. Now, when you talk about maturity, all things are relevant, of course, we mean maturity, in the sense that there's a substantial percentage of the population insured, a wide range of products available to them, and some well-established and rather fierce competition. Hong Kong, and Singapore are very much in that category. And markets like Japan and Korea are obviously in that category. Japan is the largest life insurance market in the world.

Then you have another tier of countries that are characterized by significant areas of development that can occur. But they've had very strong growth over the last 10–15 years. I'll put Malaysia and Taiwan into that category. Then, going down that stepladder, you have the rapidly emerging markets, and most of those are characterized either by many recent new entrants into that market—both local, but probably more, in most cases, foreign entrants—or where the country itself has set the regulatory environments such as there will be many new entrants coming into that market. The Philippines, Indonesia, and Thailand come to mind. Indonesia has already started that process. Many new joint ventures have been set up over the last five or six years. Both the Philippines and Thailand are right in the midst of a process of throwing their doors open to new entrants.

Then you have the markets that present huge potential. The market exists, but it's very difficult to get any real perception of what the market is going to be like in the next five to ten years. It's a very immature market by definition. Of course, China fits firmly into that description. A very large state company catering only to a very small percentage of the population and, on the life side, only American International Group (AIG), at the moment, currently operating as a foreign company.

Then you have the markets to emerge. That's why there's so much potential in this part of the world, not only in those countries where there's a low penetration of life insurance, but countries where the concept virtually doesn't exist: Vietnam, Cambodia, and Laos. They all really have to establish an insurance industry. I deliberately haven't mentioned India because I'm not actually sure where to put that country in those lists. It should be placed probably alongside China, although with the results at the last Indian election a few weeks ago, the whole issue of opening up to the financial services industry has been thrown on its head. No one is quite sure how that market will, if at all, emerge in the next few years. I won't go back and mention specific countries as we go through some of the points I want to make on product development.

I want to touch on a number of key issues. I will not talk about products per se. I want to talk about some of the issues that influence how a company looks to develop its product and, to a degree, distribute the products. I think it's very important to look at who the customers are, and how, in recent years, the attitudes of the customers have been changed and been influenced essentially by competition. I want to look at some cultural issues, and touch upon not just the culture of a particular country, but also the culture of the companies that are competing for business against each other. I also want to discuss some of the strategic approaches that new companies have taken to get into the market because that's obviously of greatest interest.

I also want to look at the issues that are very important to product development, but are not directly involved: regulation; the regulatory environment of the particular countries and what direction that seems to be taking; distribution, and methods of distribution. Probably even more important than the product itself is how do you get the product on the street and sold. Of vital importance is the administration capabilities of a company, particularly in an ultra competitive environment, and the company's ability to support existing business and use that information for the purposes of future marketing. Obviously, I can't resist some mention of reinsurance and how that is influencing the development of the various markets.

I want to talk a little bit about the cultural environment. Now, I talk from a perception of not being part of any particular culture in Asia, but having lived a number of years in that part of the world and being involved there for 12 years. I sit somewhere in the middle and I look at how companies coming to the region, particularly foreign companies, have to deal with the issue of culture when they're setting up branches or going into joint ventures and trying to be successful.

I think in several ways the foreign entrants into the markets, and this is probably true in any part of the world, probably are most scared of cultural issues. It's something that, perhaps, companies have the least understanding of, and sometimes the local player can throw up, I think, considerable barriers to the successful development of the business. What is culture? It was very difficult to define when I was thinking about this talk. I think it's basically the influence the people— those within the company itself or potential customers of the company— will exert on the company's ability to sell its products.

So within a company itself, the people that it employs, its management, and its general staff will exert a very strong influence on the character of that company, and, this has to be managed in some form or other. All too often, certainly from my experience, I've seen multinational companies coming to Asia that have a very clear understanding of what their culture is inside their own organization, and they are determined to try to replicate that in any and every country that they decide to enter. Now, clearly, that is fraught with dangers, and it will probably occur, as it has occurred in many cases, not just in the insurance industry where companies don't actually maximize the advantages of entering a new country, particularly with a joint venture partner. There has to be a balance between what a company sees as its own internal culture and the culture of the country in which it's entering. There has to be management of that.

Culture should never be a reason for inertia. I've seen, often from my experience, that it has become that way in the Asian markets, because change is happening so rapidly, far more rapidly than I have ever seen, say, in the U.K.'s markets. This creates the natural reaction of a greater degree of fear and uncertainty. What's the future going to be like? Is the job going to exist? Is the process that I've just learned suddenly going to be thrown out of the window? These are fairly alien concepts.

It's difficult for companies in the west to cope with it, but staff in some of the Asian countries get extremely concerned and use cultural issues. We call it the "we are different" syndrome. We are very careful when a local partner says, "you can't do that because we are different." Well, why are they different? How do we go about changing that from a positive point of view rather than a negative? On the other hand, as I mentioned earlier, the equally bad approach is for a company to come and say, "We know exactly who we are and what we do and how we want to do it and, therefore, we have no particular sympathy for the local culture."

Now this is a rather sweeping statement to make, but Asian companies' management have a few common features. Insurance companies very typically have them. I would call it a Chinese style of management, which is basically characterized by a very autocratic centralized form of management, which is sometimes very different from some of the management styles that we may be familiar with. There is often a very central figure within an organization who's all-powerful, who wants and actively encourages staff to look to him or her to make all of the decisions; decisions sometimes that we would find very trivial. You wonder why someone at that level would possibly want to make those sorts of decisions, but that's the culture. Below that person you have some incredibly competent staff.

In some of the jobs that I've been doing, I have found staff who had wonderfully good analytical minds, but who often didn't see the need or necessity or even the desire to be slightly more imaginative when putting forth solutions. Having analyzed the problem, what do we do about it? In looking at the capabilities of the staff, you have to try and understand the management culture that they have been used to. And it's all too easy to maybe make the assumption that these people are not as innovative and as smart as, perhaps, we think we are.

There's also the issue of face. Everyone talks about face and says this is the issue that will come up most frequently in the Asian markets. It is important, but I think it's equally important to all of us in this room. None of us likes to be embarrassed in front of our peers or our subordinates, and that's the basic issue. In the Asian markets, it's taken to, perhaps, a higher degree of refinement in the sense that there is a culture that avoids public conflict. I think that has to be remembered. Most contentious issues are taken care of in private. The ability to read meetings and discussions, and the ability to avoid unnecessary conflict can be a major success factor when dealing with a foreign partner in this part of the world.

If you're going into a joint venture, I think you have to understand the nature and the style of management and also where the power actually resides within a company. Some territories, countries like Thailand and the Philippines, are characterized by centers of power within organizations based on a fairly old system of patronage. Senior long-serving employees generate much loyalty with groups of employees below them, which sometimes is not reflected purely by the level of seniority that these senior employees have within a company. So that's a little bit of an insight into some of the cultural issues of inside a company.

Local culture is a much more difficult issue to tackle. The culture of a company is more manageable than the culture of a country. The ideal situation is that a new company coming into the market should work within a particular culture, and try and position products that don't challenge the basic beliefs of the target audience. I think there are two ways of looking at local culture: there are the local customs and practices that will influence how a customer perceives you and the products that you're offering to them, and then there are the more fundamental wants and needs of the particular customer. I want to make just a few comments about those two aspects.

There is my cultural influence on a customer. And we're talking about more general issues within a country. Religion is probably the most dominant factor, and that's very much true in some of the countries like Indonesia and Malaysia where the Islamic principles are very dominant in a large percentage of the population. You would see there a very practical approach being taken to address the religion factor, where a new division of life insurance is being developed to fit within the Islamic principles as people interpret the purpose of insurance. That's a good illustration of cultural issues that must be dealt with, and how we are finding a practical solution to them. Oftentimes, with most of these issues, there are practical solutions.

You also have to understand people's attitude towards death and their attitude towards the family. It's very important when we're looking at the development of products in this part of the world. A Chinese attitude lays far less emphasis on death. Death is not a good subject to talk about, to consider, or even to speculate upon. But savings is a very dominant feature. There's an incredible propensity to save in many of the Asian markets. So what you find is the major incentive to buy is some form of saving, and protection itself is an ancillary benefit. You'll see in the nature of the products, an incredible amount of packaging about a very sophisticated packaging of product concepts. That has really categorized much of the market developments that are occurring. Certainly in comparing it with my experience of the U.K., there is much more sophisticated packaging of product concepts.

You have the concept of the extended family. Often, as an instinctive reaction to insurance, people say, well, we don't like the concept of life insurance because it starts to erode the values of the extended family—that a family will largely take care of itself. Well, that's very true. But the counter to that, and what many companies that experienced opposition to their products said is these products don't change that extended family concept. What we're trying to do here is provide you with the financial means to keep the extended family concept together. We are providing you with the financial resources to have a fair degree of self-reliance.

I think that's a tremendous opportunity, and John Naisbitt refers to that in his book. The opportunities in Asia are so much greater because the general attitude of the people is one of self-reliance. In the western countries, we find that the economic problems are very much centered on the increasing burden of the welfare state. You don't see that in many of the Asian countries, and I don't believe that the development will go in that direction. So I think insurance companies, particularly because of the provisions for old age, have a tremendous opportunity in the Asian markets.

So when we're looking at the market itself, we have to understand a little bit more about how the customers think, what they think they want, and then we must try to identify what the customers need. These are two very different concepts that many of the successful companies have spent much time trying to understand and work with. What we think customers want is often very different than what they believe they need. So there has to be a balance between the two concepts. I think that across all the markets there are some very basic instincts prevailing. People want maximum value for their premium, and they want a good return on that premium. You have to understand that for many this is the first time that they've invested their money in this type of product.

AIG in China is demonstrating that even in a rapidly emerging environment, where disposable income has been very limited up until recently, there is a tremendous interest in this type of product. People have to feel that they are getting good value for their money. There must also be security of that money. Companies like AIG have traded very successfully on the international strength and security that they bring to the buying customer. And that's often traded off against more glamorous looking returns.

People will take fairly average looking growth on their premiums as long as it's secure, and that aspect shouldn't be ignored. Within Asia, the estimates are that by the turn of the century there will be half a billion people who, by western standards, would be considered as middle class and therefore have significant disposable income to buy the type of products that we sell. So a tremendous opportunity exists there.

As I said before, protection tends to be mostly of a secondary issue. Coupled with that, there is much more of an attitude of, if I buy protection coverage, I really want that protection to benefit me. Now, that sounds like a rather selfish approach, but, again, it's a little bit of a cultural issue of understanding the family unit where often—not in all the cases and it is changing—there is a single wage earner, which essentially is the husband. So there's a little bit of a more chauvinistic approach to selling.

The female market is only just starting to emerge. Some companies have taken products oriented to women, and they've had some initial success, but there's still a long, long way to go. In fact, more policies are sold to children than are bought for the wife. So you have to understand that as well. There is more of a selfish motive on the part of the buyer in terms of his thinking: I'll buy the disability benefits, but I might not buy double accident coverage because I want to see those benefits emerge I want to be able to control and manage them because I manage all of the finances for the family group.

I think a successful company uses common sense. When it looks at any particular market it will ask, what key issues do the people that I'm trying to sell to have? What are they most concerned about? And some of the more successful companies have gone out and asked. They've gone into the different target population groups and said, "What do you want?" What concerns you most? A very good example of a success story in the market is with National Mutual in Hong Kong. In 1991, the company did a huge perception study of the market. One of the questions was, what concerns you most? A few people said, 1997, but that's a long way away. One of the key issues was inflation. Inflation traditionally runs at 10% or 11% in that market, and people were concerned about that. The media was drawing much attention to the effects of inflation. So the company realized that it had to cater to that particular concern, and it introduced a very successful, very basic inflation option that suddenly captured the imagination of the market. This company had taken the very radical step of asking the potential customer, what exactly do you want? What are your major concerns?

The culture of any country in the Asian markets, and probably anywhere in the world, is an opportunity. It's not a barrier and never should be. But it can only be an opportunity if you have a clear understanding of it, and are prepared to, I think, invest much more time than the companies have historically spent doing in market research and market perception. The products that are going to be successful in the Asian markets have to be packaged as single concepts.

Now, it sounds very good, but you have to understand the nature of the buyer and also the nature of the distribution, which is essentially agency. You will not get that sort of service support that make these types of variable life, flexible life type policies successful. I think it will come, but it needs most of those markets to mature a little bit more, particularly in distribution.

When looking at how a company may strategically approach the market, I tried to think about how these markets are characterized. Clearly, in every market, we look at whether there is strong growth. In virtually every market we look at whether there is still great potential. There's one or two exceptions to that. We're seeing increased liberalization, not in the sense of deregulation, but in terms of the ability to enter the market. I think those are the main characteristics. On the other side, there's more and more regulation in terms of controlling the way the market operates. Access to many markets is opening up or has opened up.

I think another characteristic is the new entrants coming to the market that have a different perception on those markets than the local companies. They often bring products that the local companies felt, in their rather cozy environment, were just too radical to be even contemplated. New companies, many new entrants have just cut through that nonsense and have said, "We have a successful concept in Europe. We're going to sell that product straightaway in the Asian markets. We believe we can make it successful."

I think, generally speaking, that the customers in all of these countries are benefiting by this healthy competition. As I said before, the new entrants are ignoring previous buying trends. The successful entrants actually understand the trends, but they're generally tending to ignore them when they're talking about their product and distribution strategy. Companies are agonizing in most of these markets about whether to be proactive or reactive in product development issues And I think there's much fantasy about needing to be proactive.

In the last couple of years, the most successful companies, even looking at the new entrants, have generally been those that have the ability to be rapidly reactive. Generally, it's not the company that brings the concept to the market first. I think the key to this success is the word rapid. The more successful companies seem to be those that put together multidisciplinary teams that are empowered from the top of the organization. They have the ability and the power to respond very quickly to a development in the market.

Again, companies like National Mutual in Hong Kong and Great Eastern in Singapore have been successful. They are very good at seeing when a product hits the street, and the success of that product. They do not go in and replicate the product, but enhance it. They recognize that there is an underlying interest in that product.

Some of the local companies and international players that have been there a long time tend to be fairly inert and somewhat bureaucratic in the way they operate. Some are also getting fairly hamstrung by overinvolvement from the home office in a remote site around the world. If these companies are going to compete effectively in these markets, there has to be empowerment of the local team to make decisions and to react to developments in the market very quickly, because if they don't, there will be two or three other companies that will be doing that successfully.

I think there are a number of unknown issues in the market that few of us can really know what is going to happen. Will the market, as is happening, say, in Europe, eventually become dominated by mega players across border networks of companies? Certainly, the international players—AIG is probably the best example in that part of the world—have gone that way. But they seem to be more of the exception than the rule. If you look at the Asian companies, there really is only one company, Great Eastern, that has done anything about breaking out from the core original market in Singapore going to Malaysia, and it's now trying to enter other markets. I think you will see more of that. But I think the future rests with joint ventures that go regional rather than pure international companies or just a Philippine company going regional. I don't think that will work. But I think the joint ventures have significant potential.

As I said before, the success of product development lies very much with the creation of a broad-base-empowered internal marketing team. That marketing team has to include distribution, and it often doesn't. It has to include the administration side of the company, and it often doesn't. It has to include market research, and it often doesn't. So there's much to be done in just the infrastructure of the product development process.

A company has to know the market, other markets in the region, and the international markets. There's a great opportunity, obviously, for reinsurers in that part of the world. A company must also understand not only products, but distribution opportunities, because the agency distribution, which has tended to dominate these markets, is very much waning. It won't disappear in 10 or 15 years, but it probably will still be the most dominant. There will be many other viable alternatives to distribution—direct marketing, bank distribution, and a number of employee distributed products—that are starting to gain much attention.

People get somewhat scared looking at the regulations. This rapid pace of development in the country is just as challenging for the regulator as it is for the insurance company coming in. Probably more so because the regulator has to deal with a wider range of issues than an individual insurance company. Most of the regulators have a very pragmatic attitude towards products. It's less flexible, and there's much more concern about distribution. I think the regulatory environment is concentrating on the value of agency distribution, the value that the customers gets in terms of the products that are being offered, and the products themselves. There's a reasonably good environment.

I think one of the key issues in Asia is that often, in the past, regulators haven't created a level playing field. They have not looked at foreign companies the same as they have the local insurance company. I think the challenge facing the regulators is for them to get back to an even basis in saying, "I looked at the product, I approved that product, and it doesn't really matter what company is actually introducing that product to the market." There mustn't be active discrimination against foreign companies.

I mentioned briefly the impact of administration and technical considerations. It is of paramount importance to have the operation side of the company very actively involved in product development because even though individual policy sizes and premium sizes may be quite small in these markets, the actual physical volume of the business can be absolutely huge. It's not just the ability to turn around a policy document or process a claim; it also has to do with cost-effective risk control. That's another problem: when product development creates more protection- oriented products, there's often difficulty in trying to understand how much underwriting to do and how much claims investigation you can afford to do.

If companies study the markets, even some that you wouldn't expect, such as Thailand and the Philippines, successful companies have had excellent kinds of experience. They also got their expenses under reasonably good control. They know when they can spend money, where it's viable to spend it on investigation, and when it's not. The same applies to underwriting.

In going through all of that, I think it's very easy to see where a reinsurer can fit in. Clearly, in any part of the world, the reinsurer should be the focal point for product development and should be acting as a catalyst. I think a difference in this part of the world is that we see reinsurers getting much more involved in working with the regulators. That's quite an interesting change, but it is an important one. Reinsurers are working with the direct office and trying to help educate the regulator as to the nature of a product, what it provides, what the structure of that product is, and how it's priced.

Reinsurers are working very actively with many companies and helping them go into alternative distribution, particularly direct marketing, and looking at bank assurance. Reinsurers are really saying to a company, "How can we help you look at the customers and the linkages you already have because many of these companies have association with banks. How can we help you exploit the potential of the customer base you haven't previously looked at?" So there's tremendous opportunity both for direct writers and the reinsurance companies.

What can I say in conclusion? For the market, in general, there's no luxury of time. Time is passing very rapidly. Change is happening very rapidly. A company coming to any of the Asian markets must hit the ground running. They have to have a very good understanding of the market and its environment. They have to be very clear in what they want to sell. I believe that the only way a company, say, coming from the U.S. can do that effectively is to find a joint venture partner. But like a marriage, you have to be very careful in selecting your partner, because it often can be a very painful relationship.

Mr. Nigel Silby: I will talk a little bit about product development in Europe, its background and the way things are going. Then I will illustrate by talking about two particular markets: the U.K., principally because that still is the market where most product development is going on, and also France, which is another interesting market in Europe. And I apologize in advance if I use U.K. and European terms that may not coincide with your own particular technical language.

If there are any words that I use that you don't understand, I hope you can deal with them in the question session, or you can talk to me afterwards.

I think it's worth looking at where we started from in Europe. Basically, the European countries fell into two basic groups. You have the U.K. Island and the Netherlands, which were markets that were largely deregulated. That is, companies designed products that they thought would suit their particular market, and they could develop premium rates that they thought could make profits for their shareholders or with policyholders in the case of mutual.

Then you have a second group: France, Germany, and so on, which were highly regulated tariff markets. Premiums for all companies in those markets had to be calculated on the same basis, and product designs had to have prior approval by the state regulator. In those markets where everyone was charging the same premium, the competition tended to focus around bonus rates and distribution issues.

The European Union bureaucrats probably came to the realization that the highly controlled tariff market will provide a great deal for the consumers. And there was pressure to move towards deregulation. This came forward in the European Union third life directed in 1994. Basically, this moved the system across the European Union countries more towards the U.K. and the Netherlands. In other words, there was removal of prior approval for product development by your state regulator. This freedom allowed companies to price products on the basis that they wished. They introduced the concept of a single license.

That meant that insurers that were regulated, supervised, and authorized in one European Union state could sell in another European Union state without reporting to the regulator in that country. This is sometimes referred to as in-home country supervision rather than postcountry supervision. In theory, a German insurer could sell in Spain on the basis of supervision in Germany.

To tie in with that, of course, there was a need to introduce some form of common standard across the European union. A common statutory valuation system and the common system of accounting were introduced. The system of accounting had similarities with U.S. generally accepted accounting principles (GAAP) in that there were introductions of deferred acquisition cost assets. Previously, in some European countries, acquisition costs were written off straightaway. Also, within each state, countries were required to demonstrate minimum levels of solvency.

Since that time in Paris in 1994, we have increasingly deregulated markets, and increasing sales across different European borders. And within those markets where you had groups of highly regulated insurers, they're now moving towards more cost-effective product development cycles and more innovation as they fear competition from other more flexible countries.

I'll just talk briefly about two specific examples. First, the U.K., because, as I mentioned at the onset, this is probably the market that is still the most innovative. Starting from where they were, the traditional U.K. endowment products offered a smooth investment return to the policyholder. In other words, there was a guaranteed endowment benefit and guaranteed death benefit. Bonuses were declared annually depending on the results of the company. Bonuses tended to be in the form of reverse re-bonuses and additions to the sums insured rather than paying cash or in proportion to premiums. You also had terminal bonuses, amounts payable at maturity or upon death.

Those products tended to be very capital intensive to the insurers because of the nature of the guarantees involved. They were particularly popular until, say, about the mid-1980s. In fact, up until mid-1984, there were significant tax breaks for the policyholder, which meant that, in effect, £100 of premium matched the cost of the policyholder in £95 pounds. Companies made hay while the sun shined in that particular market. It also tended to be used quite actively by banks and building societies, which I think over here are called thrifts in the U.S., to fund mortgage loans.

In the 1970s and 1980s, we saw the introduction of unit-linked products, which I think are equivalent to what you would call universal life products. Perhaps it's somewhat different in that the unit link would be a mutual fund. The typical feature is the premium will be paid, charges will be taken off, and the balance will be invested in a mutual fund. It's more efficient in capital terms for the insurer simply because the investment risk is, in fact, transferred to the policyholder.

Also, in terms of European units solvency margins, and because of that transfer, the solvency margin requirements for the linked products were considerably lower than they were for the traditional policies. The traditional policy and the solvency margin requirement is 4% of the reserves, plus 0.3% of the sum at risk. On a linked policy, you can eliminate entirely the type of design where you reserve the related components at the solvency margin. Your solvency margin that you're required to put up can be reduced to 0.3% of the sum at risk. In capital terms, you can design some quite efficient products.

What had been the more recent developments? Well, probably near the 1980s, we've seen the introduction of so-called dread disease products. They tended to start off with a fairly limited shopping list of conditions on which a lump sum will be paid. Recent trends have been to extend the list of disabilities on which a lump sum will be paid.

The unit link tie has been extended by traditional with-profit offices into so-called unitized with profits. Typically, under the U.K. unit-linked products, a choice of funds was offered where premiums could be directed, perhaps in equity funds, a bond bonus, or an overseas equity. What companies have done is to create a so-called with-profits fund where, in effect, premiums are put into that fund, and then the monies just accumulate at a guaranteed rate of interest, plus additional amounts reflecting bonus. So there was a guarantee of stability compared to the volatility of the investor's holdings in the equity and bond markets.

About three or four years ago, unit-linked products with guarantees were introduced. These were typically single-premium five-year savings plans, where the single premium would grow over five years in line with the suitable index, typically the Financial Times Stock Exchange Index of the hundred top companies. But underneath that, there is a guarantee that if the index hasn't risen by a certain amount over five years, a minimum benefit would be paid at the end of five years. This product really works by the company taking out derivatives to provide the maturity guarantees.

Typically, you could think of it as a company taking your lump sum, investing it in cash, which provides the guarantee, and then taking a certain amount out and providing a suitable derivative contract to cover the outside risk on the index. The other way some people do it, of course, is to invest in the index and then take out a suitable derivative to get the downside protection. They've actually proved quite popular, although I have some doubts as to whether they were a great deal for the consumer.

Related thinking in the U.K. currently is long-term-care products: either persuading people to take out funds to fund long-term care in advance of their need for long-term care, or point-of-need funds, or impact life annuities. Many of those developments are still very much in the embryo stage, and it's still quite a small market. But perhaps with the most extensive experience of this sort of product in the U.S., that might be a thought.

That's a lightning overview of what's happening in the U.K. I said I'd mention France because that's also an interesting market. In France we've seen much development in the so-called bank assurance concepts: banks using their customer relations to distribute insurance-based products. The products they've been successful in selling have tended to be single-premium policies that look, for all intents and purposes, very much like regular bank deposit accounts. Typically, they'll have some form of interest rate guarantee, plus an outlet reflecting annual bonuses.

An issue that is causing concern to many bank insurance companies (bear in mind that many of them have been relatively recently formed and some might be capitalized), is the fact that they have to offer guaranteed surrender values. And that does lead to some serious concerns over asset/liability issues. Typically, these insurers will invest a mix portfolio, often with a high or a significant real estate property content. And the issue here is that if the interest rates that are being offered by a particular provider become uncontested, where does that leave the company if a large number of these policyholders start to exercise their guaranteed surrender values and leave the company in a critical bind?

When looking at my crystal ball to determine what developments there will be in Europe in the future, I see the move will continue to be one towards continued deregulation, and continued freedom within the various markets with the companies designing and pricing the products that they believe will meet their customers' and shareholders' needs. I think they'll see increasing pressure from alternative savings media. There's pressure to unbundle the pricing of the products, and, of course, that leads the traditional insurer open to the idea of the mutual fund manager who just provides you with your investment service and suggests that for protection you just use the insurer. That will lead to considerable cost structures.

I think we'll see more direct selling. We're already seeing, to a limited extent, some new entrants to the market operating on the basis of direct sales and telephone sales. I think that trend will continue. Those new entrants often start with a low-cost base and the more traditional established insurers.

Finally, I think one of the issues with deregulation will be determining what opportunities exist for the larger player and the larger multinational insurer. I think that the way the market is deregulating does offer considerable scope for the large company, particularly one that can achieve economies of scale. I think it's important to bear in mind, from an American perspective, if I may be so bold just to offer a comment, that the countries in Europe do tend to be very different culturally, and language barriers are very much an issue.

Foreign insurers or non-European insurers do need to be sensitive to that, and do need to be sensitive to the different cultures in the different European countries. But I do believe that they're continuing harmonization in regulation. It will lead to more opportunities for the prime European operators even though there will still be opportunities in niche markets for the local players.

From the Floor: There's a question for Mr. Silby with particular reference to the most recent regulation in the U.K. about qualifying policies. I understand that's very parallel to our Section 7702 requirements here. Could you, very briefly, describe what makes a policy a qualified policy in the U.K.

Mr. Silby: Forgive me if I don't have the reference to the U.S. legislation. In the U.K., policies are described as qualifying or nonqualifying. Qualifying policies basically are policies that run for ten years, and basically have level regular premiums. So a traditional endowment will be a qualifying policy, and a single premium policy will be a nonqualifying policy.

The consequences of a policy being qualifying or nonqualifying have actually diminished significantly. For a qualifying policy, the proceeds are entirely clear of tax in the hands of the policyholder. For a nonqualifying policy, the proceeds are entirely free of tax in the hands of the policyholder, if the policyholder is a basic rate tax payer. And that covers 90% to 95% of the population.

For the 5% wealthiest individuals who pay a higher rate of tax, on the nonqualifying policy they pay tax at the difference between the high rate of tax and the basic rate of tax (the current difference is 16%) and the gain on that policy. In practice, the qualifying and nonqualifying is much less of an issue than it used to be.