



THE ACCOUNTABILITY OF INSURANCE IN FINANCIAL INTENSIFICATION AND DEVELOPMENT

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ABSTRACT

Insurance is a way of plummeting uncertainty of occurrence of an event. Insurance is an investment. Its basic purpose is to derive plans to counteract the financial consequences of unfavorable events. Insurance is a social device for eradicating the cost to society to certain types of risks. Insurance is basically a co-operative endeavor. It is the purpose of the insurance to protect the few against the heavy financial impact of anticipated misfortunes by spreading losses among many who are exposed to risks of similar misfortune. In this paper we review the previous work which has been done in the direction of determining the accountability of Insurance in financial intensification.

KEY WORDS: Insurance Sector, Financial Development, Domestic Capital Markets.

INTRODUCTION

The insurance industry in India has passed through a period of structural changes under the combined impact of financial sector reforms in general and insurance sector in particular. The market for insurance services previously was monopolistic while the market place was regulated and insurance companies were expected to receive assured spreads over their costs of funds and systematic demand for their products. This phase in insurance business was the result of sheltered markets and administered prices for various insurance products. Existence of entry barriers for new insurance companies meant that competition was restricted to existing public insurers. In case of life segment of insurance, Life Insurance Corporation of India (LIC) had a dominant role, while in non-life business segment, New India, United India, National and Oriental General Insurance Corporations were having monopoly. These companies were operating as cartel, even in areas where the freedom to price their products existed.

With the liberalization of insurance sector, the paradigm for Indian insurance industry has witnessed a sea change during the last decade. The emerging scenario has infused greater competitive volatility in the system, because the insurance sector has now entered into a competitive phase due to entry of more players in the insurance field. As a result there has been expansion and growth of insurance both in the life and non- life business. Hence, the larger cake is now being shared by the existing and new players. Further industry will become more professional and lowering the entry barriers and growing sophistication of customers will make insurance market oligopolistic.

Accountability of Insurance in financial intensification

Insurance is an important growing part of the financial sector in virtually all the developed and developing countries (Das et al., 2003). A resilient and well regulated insurance industry can significantly contribute to economic growth and efficient resource allocation through transfer of risk and mobilization of savings. In

addition, it can enhance financial system efficiency by reducing transaction costs, creating liquidity and facilitating economies of scale in investment. (Bodla et al., 2003)

Ward and Zurbruegg (2000) examine the casual relationship between growth in the insurance industry and economic development by recognizing that the economic benefits of insurance are conditioned by national regulations, economic systems and culture. Further, Ward and Zurbruegg (2000) argue that an examination of the inter-relationship between insurance and economic growth needs to be conducted on a country-by-country basis. Pesaran et al., (2002) have pointed out that it is important to accommodate the casual relationships to differences in size and direction across countries. The issue of "heterogeneity" is crucial in gauging the role of insurance in the economy across different countries.

Others (see for example Skipper Jr., 2000) highlight the role of insurance in individual and corporate risk management and their contribution to economic development. Webb (2000) investigated the mechanism by which insurance and banking jointly stimulate economic growth. Webb (2000) by adding banking and insurance to existing models asked whether it might explain economic growth. The more developed and efficient a country's financial market the greater will be its contribution to economic prosperity. Skipper (2000) argues for insurance as simple pass through mechanism for diversifying risks and indemnification. He highlights insurance as a fundamental contributor of prosperity and greater economic opportunities.

While the role of insurance as contributor to the process of economic development has not been properly appreciated and examined in economic literature. Among Indian authors Shrivastava and Shrivastava (2002) hold the view that there is dearth of material inter linkage between economic development on one hand and insurance services on the other, whereas role played by other services like banking, transport, communication, public administration, defense etc in accelerating the

national income of an economy has been properly highlighted.

To understand the relationship between the two it is necessary to have clear concept of insurance and more importantly the economic development, as the latter has undergone a paradigm shift. The definition of insurance, however, has been same without any ambiguity and difference of opinion. Insurance may be defined as a contract between insurer and insured under which insurer indemnifies the loss of the insured against the identified perils for which mutually agreed upon premium has been paid by the insured. The contract lays down the time framework within which the losses will be met by the insurer.

“If a country is going to restructure and liberalize its insurance regulatory environment, it should do so to maximize the opportunities for growth and development. Growth is consistent with certain structures for education, the public sector, savings and investment opportunities, private property rights, and proper fiscal and monetary policies (Skipper et al., (2000). These are the standards of IMF prescriptive for market development (IMF, 1996).

In most of the economic literature, the prosperity of nation was however measured through the yard stick of increase in the national income of the economy; measured through different variants such as Gross Domestic Product (GDP) or Net Domestic Product (NDP), at current or constant prices. Normally in order to assess the real pace of development, the growth of GDP at constant prices was taken into account (Shrivastava and Shrivastava, 2002). They observe that the writing did not consider the qualitative changes such as structural and institutional transformation of the productive system within the ambit of the concept of economic development. The issues such as alleviation of poverty, reduction in inequalities of income and un-employment were assumed to be taken care of the mere growth of the GDP (Shrivastava and Shrivastava, 2002).

Later writings on the subject questioned the concept of economic development solely based upon the qualitative changes in the GDP/Per Capita GDP, as it fails to reflect upon the qualitative changes in the life of an individual and the nation. The definition of economic development thus should incorporate both quantitative and qualitative changes. To incorporate both, economists distinguished the concept of growth from that of development; former being quantitative and the latter embracing qualitative changes in the economic institutions and organizations of the country.

In this description while examining the relationship between the two i.e., economic development and insurance, development has been taken up in the sense of growth, implying sustained increase in the GDP/Per Capita GDP of the country. The growth of GDP is a function of host of factors, both economic and non-economic in nature, which directly or indirectly subscribe to it. From an economic angle, these factors could be grouped into the following four categories.

- Human Resources. (Labour, Education, Discipline, Motivation, etc.)

- Natural Resources. (Land, Minerals, Fuels, Climate, etc.)
- Capital Formation. (Machines, Factories, Roads, etc.)
- Technology (Science, Engineering, Management, Enterprises.)

Accountability of Insurance in Financial Intermediation and Domestic Capital Markets

In developing economies, financial intermediaries play relatively larger role in supplying the funds and amongst these intermediaries insurers play an important role (Bodla et al., 2003). Shrivastava and Shrivastava (2002) highlight the advantageous role of insurance companies to co-operate banks, mutual funds and asset management companies, etc. They claim, advantage with insurance companies is that they are capable of deploying the funds in long term projects compared to banks and other intermediaries, who invest their funds mostly in short duration projects.

Carmichael and Pomerleano (2000) highlight contribution of insurance as a promoter of financial stability among households and firms by transferring risks to an entity better equipped to withstand them, it encourages individuals and firms to specialize, create wealth and undertake beneficial projects they would not be otherwise prepared to consider.

The insurance sector can also contribute to the development of capital markets, by making a pool of funds accessible to both borrowers and issuers of securities. This is due to the fact that insurance companies have long term liabilities than banks. Catalan, et al., (2000) studied the relationship between the development of contractual savings (assets of pension funds and life insurance companies) and capital markets. By analyzing Granger Causality between contractual savings and both market capitalization and value traded in stock markets for industrialized countries, they find that the growth of contractual savings Granger causes the development of capital markets.

In developing and underdeveloped countries, the most important factor, contributing to the process of economic development is the capital formation. The relationships between capital formation and insurance services in both developed and developing economies of the world has been quite pronounced and have greater significance. Bodla et al., (2003) laid down the three essential steps in the process of capital formation viz:

1. Real savings.
2. Mobilization and channelizing of savings through financial and non-financial intermediaries for being placed at the disposal of investors.
3. The act of investment.

Insurance can promote efficiency in the financial system by mobilization of scattered resources, creation of liquidity and economies of scale (Gupta, 2004). The features of insurance have been widely highlighted by Skipper (2001) with features overlapping the process of capital formation. The contribution of insurance in the process of capital formation is through all these stages.

Insurance plays an important role in channelizing savings into domestic investment (Skipper, 2000).

a) Insurance and Savings

The act of saving involves refraining from the present consumption and thereby placing a proportion of income for being consumed at a later date. The act of investment can only take place when there are savings in the economy (Shrivastava and Shrivastava, 2002). Historically a directly proportional relation has been established between savings and growth of GNP. Savings can be either financial or non-financial. Economists generally agree as to the positive relationship between saving rates and growth rates. "Countries that save more tend to grow faster. Further, skipper says "Of the world's 20 fastest growing economies over the preceding ten years, 14 had saving rates greater than 25 percent of GDP and none had a saving rate of less than 18 percent". In contrast, 14 of the 20 slowest growing countries had saving rates below 15 percent.

Shrivastava and Shrivastava (2002) and Bodla et al. (2003) have come up with relation between rate of growth of GDP, saving ratios and capital output ratio. The authors establish direct positive correlation between the rate of savings on the one hand and the rate of growth of GNP on the other. They define capital output ratio as the number of units of capital required for producing one unit of output. Authors categorize the source of generation of savings into three main heads:

- a) Household sector.
- b) Private Corporate Sector.
- c) Public Sector.

With the help of the share of all the above heads to GDP, actual figure of the share of the three heads to GDP reflect that household savings constitute the major proportion of the total savings in the country (Shrivastava and Shrivastava, 2002).

b) Mobilizing and Channelizing of Savings through Insurance

Insurance Companies also play a secondary but increasingly important intermediation role. They take funds from policyholders and invest them in financial and real markets. Shrivastava and Shrivastava (2002) highlight the role of insurance as a financial intermediary with specialized knowledge that place the savings of different units into most productive investment channels. The act of savings is performed by a large number of units scattered across the country (Shrivastava and Shrivastava, 2002). Insurers help mobilize savings in three ways. First, insurers lower transaction costs associated with drawing together savers and borrowers compared with direct lending and investing by policyholders. Second they create liquidity as they invest funds from customers to make long term loans and other investments. Whereas policyholders have ready access to loss payments and savings, borrowers do not have to repay their loans immediately. Hence, if individuals carried out the similar direct lending the proportion of their personal wealth held in long-term, illiquid assets

would be much higher. Third, by gathering small sums from large numbers of policyholders, insurers are often able to provide finance on a scale required for large infrastructure projects. This assists the national economy in expanding the set of feasible investment projects and encouraging economic efficiency (Webb, 2000). Insurers provide financing for one third of all corporate debt in United States and they are pivotal in promoting financial system efficiency in the economy (Skipper et al., 2000). He argues that insurers are main financial institutions in US who have been able to reduce in transaction costs, create liquidity, and facilitate economies of scale in investment compared to other financial institutions.

c) Investment

In meeting insurance needs, insurance companies also act as financial intermediaries. In collecting and managing a pool of insurance premiums, insurers are part of the group of institutional investors which have become key holders of financial assets and have an increasingly important role in today's capital markets.

CONCLUSION

In view of the above research literature, although various aspects of insurance industry have been studied and their impact has well been discussed. Insurance companies are not simply firms that specialize in risk. Rather, in a world of informational asymmetries, they are specialists in gauging, monitoring and most particularly managing risk. It is this expertise that enables insurance firms to cope with difficulties such as moral hazard and adverse selection. The ability of insurers to transfer risk facilitates the purchase of significant items, such as motor vehicles and real estate. As a result, insurance coverage can have 'positive externalities', including increased purchases, profits and employment. These arise not only from within the insurance sector but also outside it.

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