CHAPTER I
INTRODUCTION

Liberalization of domestic financial market had been common characteristic in many countries which includes industrially developed countries as well as the developing countries. However, there is a substantial amount of debate in economic research regarding the benefits of deregulation. The theoretical rationale for industry deregulation is rooted in neoclassical economic studies beginning in the 1960s which questioned the merits of economic regulation (Oetzel J M and Sudeshna Ghosh Banerjee, 2007). Neoclassical economists tend to support deregulation and often argue that countries should rapidly deregulate industries and liberalize markets (Becker, 1983; Stigler, 1971). In theory, this will promote greater efficiency, greater professionalism in the market, introduction of more products and services and increase in the size of the market. It is argued that multinationals can also help to create more consumer confidence and improve market conduct practices. They can also enhance the stability and image of the industry by encouraging financial transparency and the adherence to internationally accepted disclosure requirements. In contrast, a growing number of economists are questioning the benefits of deregulation (Chang and Xu, 2006; Rodrik, 2001; Winters, 2004; Snyder, 2001). In the context of insurance services, deregulation generally leads to market liberalization. Countries are liberalizing their insurance market at different rates and to different degree. Additionally, each country has its own unique political and economic characteristics .Furthermore, the best route from monopoly to competition differs substantially in different setting. Therefore there is no single set of direction that can guide the challenging journey from monopoly to competition. And so outcomes of deregulation policy differ from country and country and need to analyze each of them separately to understand the end result of a particular liberalization and deregulation policy.

In India, New Economic Policy (NEP) was introduced in 1991 with the main idea of globalization, privatization, deregulation and liberalization. As a consequent, insurance market liberalization process was initiated in 1993 and was finally opened in 1999. Since then there has been changes in insurance market and in the basic structure of business. The life insurance market was opened to private players because of low penetration of life insurance, non availability of customer oriented products, low level of customer satisfaction, higher premium rates and lack of professionalism on the part of the insurer and a very low spread of life insurance in the country. In addition, signing of the GATT (General Agreement on Tariff and Trade) made way for the opening of the insurance sector to global players. The opening of the Indian insurance sector was aimed at fostering competition and innovation with greater variety of products and growth of the insurance business. This thesis will highlight the post liberalization scenario in the life insurance sector in India to see whether the objective behind the opening of the life insurance have been achieved or on the right direction towards achieving the objective laid down by the policy makers.

1.1-Liberalization and Deregulation Concepts:

Liberalization denotes a reduction of government or other barrier to market access, especially as relates to foreign insurers (Skipper, 1996) and deregulation relates to lessening of national regulation on existing firms in the industry. Liberalization and deregulation seek to improve economic welfare by bringing a more efficient allocation of the country's resources in the long run. A perfectly deregulated and liberalized insurance market would therefore means that the regulations are limited to indispensable minimum and concerns the questions such as (Sterzynski Maciej, 2003)

a) Who is authorized to operate an insurance business?

b) How many firms will be allowed to operate?

c) What products might be considered as insurance products?

d) What should be the price of insurance?

e) What should be prudential norms relating to capital, liquidity, quality of risk and service benchmarks?

f) What are the distribution channels?

Regulation means infringement of free competition on the markets. It occurs through legal limitations on the competition or by agreements among market participants. The deregulation is an occurrence opposite to regulation. It means a reduction of existing limits or controls of the state on a lower level. Liberalization results from the deregulation process. That means directions and magnitude of liberalization are determined by the actions of deregulation characters. Liberalization policies that remove barriers to entry and empower consumers to discipline industry suppliers typically are better methods for fostering vigorous long term industry competition (Armstrong Mark and David E. M. Sappington, 2006).

There are several potential benefits of liberalized regime as given by Skipper (1997). First, liberalization facilitates better customer services and value. It enhances competition in a wider geographical range and so creates stronger and more competitive local insurance industry. With increased competition there is further scope for greater motivation to generate new and innovative products, more responsible to customer needs and desires, better and broader range of quality goods and services and seek less costly means of marketing and servicing. Open markets also help firms tap into world markets, increase their sales potential, benefits from economies of scale, and spread the fixed costs of research and development over a wider customer base. Moreover liberalization allows insurers to diversify risks, in the sense that they can channelize resources to where returns are highest as well as secure access to capital at the lowest possible cost. To sum up, liberalization renders firms more competitive domestically and internationally.

Secondly, liberalization helps in mobilizing domestic savings. There are various studies suggesting a positive correlation between domestic saving and economic development. (Lean Hooi Hooi and Yingzhe Song , 2009; Suemegi Kjell and Peter Haiss 2008). Other things remaining same, the greater the number and variety of quality financial intermediaries within the market, the higher should be the national saving rate. Hence, a more liberalized market regime with greater foreign insurers involved in could contribute saving and so to economic development.

Thirdly, liberalization makes possible the transfer of technological knowhow. Transfer of ideas, bringing of new and better skills and knowhow, training programs, technology and managerial techniques to host country are facilitated in the liberalized market.

Lastly, liberalization promotes additional capital inflow. A domestic country benefits from liberality in that the foreign insurers bring an additional source of financial capital. The additional financial capital can be used to finance additional projects.

1.2-Purpose and Methodology of the Study

Life insurance sector is the major part of total insurance sector in India and so can be able represent majority of the reform's implication to the industry. The decision to introduce competition into an industry is only the beginning of a journey down a long and winding road that can represent many obstacles and detours. With the liberalization and entry of private companies in Insurance sector there are various changes brought in .There are changes in terms of efficiency of life insurance firms, market concentration level and product innovations which are generally attributable to liberalization and deregulation. So it is very important to evaluate and understand the impact in terms of growth and development and other future prospects in the sector and try to find out how the reforms have benefited the insurance sector in India. This thesis therefore, attempts to study the impacts of liberalization and deregulation processes in India, specifically in life insurance industry.

The impact of liberalization can be viewed as a two tier process; namely impact on financial performance as well as on the overall functioning of the market. In the context of overall performance, the growth in terms of volume of business, penetration and density, market share etc are examined. The necessity to study the financial performance of the industry arises from the fact that the industry suddenly had a paradigm shift and insurers seem to act efficiently resulting in growth of each insurer. Innovative distribution systems are employed as competition is fierce, which compels the insurers to price their products lower, resulting in lower profit margin. Therefore, this study takes into account the efficiency and productivity improvement in the life insurance industry in the wake of deregulation. To sum up, following research questions are examined in the thesis.

1) What is the present scenario of the industry? How different it is from the pre liberalization scenario?

2) The competition in the sector is expected to increase. So what is the present state and nature of competition? What changes have taken place in the market structure of life insurance industry?

3) Whether all firms are efficient or not? Whether or not the efficiency and productivity of the insurance market is improving after liberalization?

4) How did liberalization contributed in product innovation, risk management, customer service benchmark in life insurance industry?

5) What are the implications of liberalization on spread and coverage of social security measures?

There are 23 life insurers including LIC of India as on 31st August 2010. However number of insurers taken varied in the analysis, as the insurers which entered into the industry after 2005 are not considered for short of data. The analysis depends on the secondary data available with Insurance Regulatory and Developmental Authority of India (IRDA) and the Annual Reports of respective life insurance companies in India. Also text books, national as well as international articles and dailies are referred to collect relevant and required data. The statistical tools used in the research include Herfindahl Hirschman index (HHI), Entropy (E) and Data Envelopment Analysis (DEA). Other simple statistical tools were also used, as required. To examine the state and nature of competition, the Herfindahl Hirschman Index, Entropy and concentration Ratio of the industry are calculated using firm level share of total premium, equity share capital and total assets. To calculate the firm level technical efficiency, pure technical efficiency and scale efficiency, the technique of the data envelopment analysis was used. The productivity and its components technical efficiency change and technical change over the years were calculated for each firms using Malmquist Productivity Approach. Each of the statistical method used are explained in details in the respective chapter.

1.3-Importance and Limitations of the Study

The importance of the research lies in the fact that the liberalization is an important phase of insurance industry. The need for private entry has been justified on various grounds such as enhancing the efficiency of operation, achieving a greater density and penetration of life insurance in the country, greater mobilization of long term saving etc. However there are emerging issues in the light of liberalization which required constant monitoring of the policy programmes. And there is little research in these aspects. Present study will strengthen the knowledge and literature in the field and also helpful to policy programs, potential insurers, researchers, academicians and general readers who are interested in Indian life insurance sector. Overall, the thesis is expected to provide a brief overview on the overall impact of insurance sector reform measures on life insurance sector in India.

There are many other issues or effects of liberalization and all of them cannot be examined here. The main problem faced was the dearth of data. Due to time lag in publishing official data, the data considered was from financial year 2001-02 to 2009-10. Sometimes, there was lack of consistency and uniformity in the format of the data or annual reports published. Therefore the study has limited itself to analyze and interpret the impact of insurance liberalization on the topics of concentration, efficiency, productivity and innovation. In analyzing these topics, the methodology and variables used are also restricted to the available data. The results from this study need to be interpreted with some amount of caution as ten years may not be sufficient time for a complete overhaul of the industry, and many trends may only be indicative.

1.4-Chapter Outline

This thesis consists of seven chapters. Chapter two starts with a brief overview of the Indian life insurance industry during the pre nationalization and post nationalization period which had the monopoly regime of LIC of India. It follows the discussion on whole process of liberalization and the present industry scenario. Chapter three provides review of literature mostly related to the liberalization and deregulation related studies, its impact on various areas specially efficiency and productivity and in context to India. Chapter four examines the general impact of liberalization and estimates its impact on industry concentration. Chapter five is devoted to the efficiency as well as productivity of Indian life insurance industry. Chapter six discusses and analyses the innovations in the life insurance sector under various heads. Chapter seven gives important conclusions and suggestions.