

## **Emsley D Tromp: Insurance regulation in a globalizing world – challenges and opportunities**

Address by Dr Emsley D Tromp, President of the Bank of the Netherlands Antilles (Bank van de Nederlandse Antillen), on the occasion of the 2008 IAC Conference, Willemstad, Curacao, 1 June 2008.

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Ladies and gentlemen, good evening.

It is with a great deal of pleasure that I accepted the invitation to speak at this Annual IAC. I would like to congratulate the NAVV for bringing this prestigious conference to Curacao. It makes a welcome contribution to not only our tourism sector, but also our financial sector and our economy through the various presentations, which I'm sure will be of a high level. I am delighted to see so many representatives from the world's financial and insurance community here today. And I welcome the opportunity to speak to you about the important challenges we face in the regulation of the financial services industry in general and – the insurance industry in particular. In my opinion, we all play a key role in achieving our shared goals of keeping our world financial system strong, stable, and efficient.

Ladies and gentlemen, I have structured my views along the following lines: First, I will elaborate on some of the weaknesses of our Caribbean economies and the impact of globalization on our region. Next, I will elaborate on the challenges and opportunities that we as insurance regulators face in this globalized world. I will conclude my address with some remarks on the role that we all can play in preparing ourselves to meet the challenges we face with global competition.

Ladies and gentlemen, against the background of an ever globalizing world, it is fitting to portray the road ahead of us as a journey into the future. We have to realize that because of their size, Caribbean countries are very vulnerable to international developments and external shocks. The erosion of preferential market access to the European Union, the establishment of NAFTA, the terrorist attacks on the United States, the international efforts to combat money laundering and terrorism financing, and natural disasters all have had a great impact on our economies.

As I just noted, the high vulnerability of our economies is primarily because of our smallness, which results in significant diseconomies of scale. Both the private and public sectors are affected by these diseconomies of scale.

The small size of our national markets limits the international competitiveness of our goods and services for both export and the domestic market. Small firms are at a disadvantage in the global market place because they cannot realize economies of scale, they are not attractive business partners, and they cannot spend significant funds on marketing, research and development.

Small economies have severe constraints on their material and labor inputs both in amount and variety. These constraints are related to their limited land area and small populations, leading to high unit costs of production. For instance, the small size of the labor market limits the range of available skills, pushing up the price of scarce skills. On the supply side, employment alternatives are limited, which promotes a brain drain of highly skilled workers and causes high social costs for low-skilled workers when industries have to restructure.

Moreover, the small market size and limited range of resources result in a narrower range of domestic and export production and tend to cause high costs because of a lack of competition.

The provision of public goods and infrastructure is usually characterized by indivisibility. This indivisibility has two implications for small economies. First, the costs of public services per capita are higher than in larger economies. Second, the government may be forced to provide some goods and services –often at subsidized rates. In larger economies, these goods and services typically would be offered by the private sector thereby lessening budgetary pressures.

Besides diseconomies of scale, our countries are characterized by high vulnerability to external shocks. Various factors that are largely beyond our control contribute to this vulnerability. These factors include our geographical location and high level of openness. Our countries are located in an area prone to natural disasters, particularly hurricanes. These natural phenomena are recurrent and affect a large proportion of our population and economies. In some cases, economic damages have exceeded annual GDP. The result is a long recovery time. Our high degree of openness, illustrated by levels of imports and exports of goods and services near and even over 100% of GDP, also makes us extremely vulnerable to external shocks. This openness is aggravated by the concentration of exports in a narrow range of products and markets. For example, the erosion of preferential access of agricultural products to the European market is having a significant impact on some Caribbean economies.

To mitigate the effects of diseconomies of scale and the high degree of vulnerability to external shocks, broader and deeper cooperation among the countries in the Caribbean region is an inevitable strategy. The need for this strategy is even more evident in light of the structural changes taking place in the world and the way they affect the countries in the region.

These structural changes can be described under the phenomenon of globalization. Globalization is a multi-dimensional process that transforms all aspects of national and global activities and interactions in a rapid and profound way. Inherent in the globalization process is that existing barriers to international flows of goods, services, capital, money, and information are increasingly being reduced and/or eliminated. The fact that world trade grows about three times faster than world output illustrates this development. The small Caribbean countries, which are vulnerable to external events and have limited adjustment capacity are particularly exposed to the effects of globalization, which brings along potential risks for these nations. Risk permeates all our lives. Whether as individuals, businesses, or governments, we confront a vast range of risks. Insurance is the most basic financial mechanism for dealing with risk. Therefore, insurance plays a vital role in our economies. While the importance of the insurance industry far outweighs its size in terms of its relative share of total assets in the financial sector, its size is nonetheless impressive.

In this whole process of globalization, the importance of global regulatory cooperation in ensuring open, competitive, and stable financial and insurance markets becomes preeminent. Such cooperation is needed to strike the right balance between protecting investors and policyholders and entrenching financial stability on the one hand and encouraging innovation, foreign investment, and market efficiency, on the other.

As the global economy goes through a period of fundamental transformation and integration, negotiations and regulatory decisions at the global level increasingly have a major bearing on the competitiveness and efficiency of our insurance markets.

In this global environment, it is vital that a cooperative approach be adopted to achieve our shared goals.

International convergence of global standards is a central theme in the prudential regulation of the insurance market. The European Union is creating a new regulatory framework – Solvency II – which aims to achieve convergence with emerging global standards in key areas, including international accounting standards and frameworks for insurance supervision.

A global perspective is necessary because the globalization of financial services makes efficient supervision of insurance groups and financial conglomerates operating internationally a key challenge for all regulators. Global convergence of international accounting standards can also reduce the cost of capital due to enhanced transparency and leveling of the playing field. This will also make comparison of cross-border investment decision easier. I believe that we all gain in the long-term from greater global cooperation and mutual recognition.

Ladies and gentlemen, let me now turn to some of the numerous challenges and opportunities that impact insurance regulation in a globalized world. The structural changes that are reshaping the global insurance market have had a major impact on the insurance industry. The most significant of these changes is the breakdown of traditional barriers that once segmented the market for financial services. Driven by powerful technological innovations and changing regulatory structures worldwide, the financial sector is witnessing a process of convergence in the delivery of products.

The rise of conglomerates poses a special challenge both for insurers and regulators. Financial institutions such as banks, with more capital and greater opportunities to cross-sell insurance with traditional bank products, are a threat to non-diversified insurers. Indeed, in Europe, *banc assurance* is already a fact of life, and conglomerates will increasingly become the norm, rather than the exception.

Newer threats are emerging from nontraditional competitors like retailers, finance companies, and Internet providers, who are using new IT platforms to circumvent traditional marketing and distribution channels, such as insurance agents. Together, these forces are leading to an unprecedented wave of consolidation in the insurance industry, both in our country and overseas.

Recognizing that growth is the key to survival in a flat market, merger and acquisition activity among companies is at record levels. Insurers have to adapt to this fluid business environment. Failing to do so is to be left behind. These developments have also consequences for the regulatory framework governing the financial sector. We will have to transform our regimes to provide this sector with a world-class regulatory framework that will allow it to prosper in the face of current and future challenges.

Ladies and gentlemen, as globalization is drawing our national economies together, the importance of establishing a transparent, flexible, and growth-oriented regulatory framework cannot be overestimated. The growing complexity of the financial sector, including the insurance sector, raises special challenges, not just to regulators but also to senior management.

Technological innovations, convergence, and rationalization are undermining the old assumptions about how to do business. Whatever the developments, one basic tenet remains unchanged – that is, the importance of good corporate governance practices to the success of companies. Directors might need new skills in the “new” economy, but the old fundamentals of disclosure and accountability remain unchanged.

Ensuring that directors are aware of their fiduciary duties means they need to be informed of the standards required of them both by law and by best practice. Continuing education is the only way to achieve that. And while education is vital, it must be remembered that corporate governance is a dynamic and interactive process. As the supervisory authority, we strongly encourage institutional investors to act in the best interests of those they represent, while continuing to keep a close watch on their activity.

Ladies and gentlemen, globalization brings also with it constraints for insurance regulation. The question is, how should we work within these constraints arising from our international obligations while still respecting the rights of each nation to regulate its own insurance industry against the background of its own traditions and cultures?

The recent turmoil and volatility in the financial markets demonstrates that economic systems can benefit from improved financial services regulation. It is in everyone's interest to have an optimal framework for financial services regulation. The globalization of the capital markets also prompts the need to revisit the current regulatory structure in our countries. Companies now can raise capital across the world, seeking environments that provide adequate capital and liquidity at the optimal cost. Market participants today have many jurisdictions from which to raise or invest their capital. Because of this dynamic, market participants have choices today that were unavailable as recently as 10 years ago. This borderless world pressures regulatory regimes to compete with each other because capital flows to where investors expect to achieve the greatest risk-adjusted return. Note that a welcoming regulatory regime does not mean that it is ineffective or lenient. In fact, market participants value well-regulated markets because they foster market integrity and investor confidence.

In this new globalized marketplace, we are engaged in a race-to-the-top to achieve the optimal regulatory structure for the financial services and insurance industry. The optimal regulatory structure needs to attract capital based on its effectiveness in promoting innovation, managing system-wide risks, and fostering consumer and investor confidence. Insurance is an industry that is heavily influenced by external factors as is the regulatory structure. The global nature of insurance is vastly different from what it was some decades ago. Therefore, regulatory authorities should reevaluate and adapt their insurance regulatory regime to reflect the changes taking place in the insurance markets.

A lot has changed in the past 25 years in the insurance industry. Some decades ago, insurance didn't really take place across national lines. Now we are concerned about regulation across oceans. With the occurrence of more mergers and international ownership of insurance companies, CEOs are finding themselves having to negotiate with insurance supervisors in various jurisdictions.

These changes could not have occurred in recent years without the use of technology, which makes it easy for insurance companies to do business all over the world. The information revolution is changing the way that insurance is sold – by delivering products closer to the consumer than ever before, directly in their homes. This is giving the consumer a considerable advantage over middlemen and agents. Consumers can use the Internet to find the best product at the best price, and they are using that power more than ever before to their benefit. But there is another side to all of this change. While the information age empowers the consumer, it also provides greater opportunities for the unscrupulous operator. It increases the chances of insurance fraud. As supervisors, we need to be alert for these threats which come along with globalization and technology.

Fraud not only inflicts losses on the insurers, but it also erodes the very foundation on which the industry operates and flourishes. The insurance regulation community has to match the threat that fraudulent agents and companies pose by staying ahead of the information technology curve. To do so, runs the gamut from enhancing financial solvency activities to educating consumers via the Internet.

As agents, providers, and consumers begin to complete more of their insurance-related transactions online, new regulatory issues will have to be resolved. Because insurers are collecting more information on customers, privacy is a greater concern. In fact, privacy will become one of the more important issues that we as insurance regulators deal with, especially as it relates to the transfer of medical information.

The globalization of the insurance business and the change in the way that insurance products are delivered via the Internet puts a lot of pressure on insurance regulation. Information on the insurance industry is of utmost importance for us insurance regulators if we want our insurance market to operate efficiently and properly. We must, therefore, not simply focus on the collection of more information and data, but also on intelligent ways to use that information.

The trend is towards global regulation; however, the move towards uniformity in regulation is very contentious throughout the insurance industry and nations. The European Commission's proposed new Solvency II legislation, coupled with the Reinsurance Directive, represents a major effort to reorient and modernize insurance regulation, treating insurance firms as cross-border actors.

It is clear that the increasing globalization of the insurance business requires global regulation. Regulation of insurance will be threatened unless we become more uniform and efficient in what we do.

Those of us involved in insurance regulation have our work cut out for us. We have to keep up with a transformation that is taking place all over the world. The question we must ask ourselves then is, how do we effectively oversee, global seamless markets when we have only national or local regulators? Indeed, the ideal solution to contending with global markets would be to have a global regulator. However, even the members of the European Union – who now share a common overarching legal structure and, in many cases, a common legal and financial history – have not yet been able to conclude that a single EU-wide financial regulator is feasible or desirable. Instead, the issue has been reformulated to ask, how, given national regulation, can regulators coordinate their enforcement and regulatory activities in ways that reflect the global nature of our markets?

Fortunately, organizations such as the International Organization of Securities Commissions, the Basel Committee on Banking Supervision, the International Association of Insurance Supervisors, the Financial Action Task Force, and the Organization for Economic Cooperation and Development have done much to help answer this question. Through these organizations, as well as through bilateral networks, financial regulators have created channels of collaboration, cooperation, and information exchange that allow national regulators to do their jobs effectively and efficiently in a world of global financial markets.

It goes without saying that prevention is better than cure. Proper legislation and good regulation provide the basic safeguards. Cooperation among insurance supervisors is and remains a key element. We in the Netherlands Antilles recognize the need for closer cooperation and have in this respect strengthen our relationship with different foreign supervisors by concluding MOU's with these jurisdictions. Also new legislation was drafted in the Netherlands Antilles to modernize our regulatory framework, whereby consideration was given to what will best serve our interests and the global economy in maintaining an insurance marketplace that attracts capital and does not set up artificial and costly barriers. This draft Harmonization legislation was submitted to our Government in 2007 and is pending enactment. I am confident that this legislation will ensure that we can maintain our approach to insurance market regulation without imposing a disproportionate burden on the institutions themselves. On the other hand, external regulatory competitive pressures require a constant reevaluation of financial services regulatory structure.

Ladies and gentlemen, globalization is an irreversible process. It is a reality we must learn to deal with. It provides opportunities as well as threats to our economies. The most effective way to deal with globalization is to pursue policies that reduce our vulnerabilities. By acting as an effective and competitive jurisdiction, we can reduce the threats and risks of globalization and benefit from its challenges and opportunities.

Coming back to the Caribbean, I have to say that on our own, we as Caribbean countries and our companies will fall rapidly behind and will marginalize ourselves given the current trends in globalization. Through regional alliances, cooperation, and integration, we can overcome our inherent weaknesses and be able to compete successfully in the global market. This process of strategic global repositioning is far from finished and requires unrelenting efforts by our governments, business companies, and other interest groups to implement the adjustments and structural transformation necessary for sustainable economic development in the decades ahead.

I would like to conclude by stressing that global regulatory cooperation will continue to be key as we work to address the challenges facing the insurance industry today. I believe that with sound macroeconomic policies, a world-class regulatory structure, deep and stable capital markets, and a highly-educated workforce, all of us should be well primed for the challenges we are facing in this globalized world. I hope this will be the beginning of a lasting and fruitful cooperation among us Caribbean nations and the rest of the world – a cooperation that will lead to strong partnerships, creative investment opportunities, and sustainable economic growth for all of us.

I wish you a productive and interesting conference, and I hope that you will find time to enjoy the hospitality and beauty of our island.

Thank you.