FDI in Emerging Markets by Canadian Insurance Companies: An Overview

The purpose of this short note is to provide a brief overview of foreign direct investments by Canadian insurance companies in emerging market countries. At the moment, only one Canadian insurance company, Manulife Financial, has significant investments in emerging market countries and these investments are concentrated entirely in Asia, mainly in East Asia.[1]

The information in this note was collected from an interview and correspondence with senior Manulife Financial officials, from their annual reports and from newspapers articles.

The note will be organized based "building blocks" and "issues for discussion" outline circulated to the working group 11 November 2002.

1. Understanding the Character of Financial Sector FDI in Emerging Markets

For Manulife Financial, a key objective upon entering a foreign market is to establish a significant presence in order to take advantage of economies of scale. In particular, a well-organized and well-trained sales force is necessary to provide the high level of personal service required to sell their products (e.g., in Shanghai, Manulife has a sales force of over 5000).

Manulife's primary motivation for FDI in emerging market countries is to earn high rates of return, typically much higher than can be earned in the industrialized countries (e.g., in Hong Kong with a population of 7.3 million, Manulife earned a profit of CDN $188 million in 2001, which represented approximately 15% of total profits). Geographic diversification of income streams does not seem to be a critical consideration. Manulife officials recognise that there are higher risks associated with investments in emerging market countries, but are willing to proceed if they feel "comfortable" with the overall business environment and the associated level of risk, and if the expected returns are sufficiently high.

The potential for high rates of return from these investments is due to two key factors: there is typically little domestic competition and the products that Manulife offers are superior to those available locally. Manulife also strives to be one of the first foreign entrants into an particular emerging market country (e.g. in China, they were second after AIG).

Manulife's preference is to own its foreign operations entirely, because joint ventures are sometimes problematic (e.g. in Indonesia, which is discussed further below), but will consider joint ventures if required by law (e.g. China) or if they lack local expertise and there is a suitable local partner (e.g., Vietnam).

Manulife also considers macroeconomic issues in their FDI decisions, but at a fairly high level. The firm looks for countries with a healthy, growing economy, and with an expanding middle

1. Manulife Financial is primarily a life insurance provider, but also offers other financial protection products such as health insurance and pension products. Other Canadian insurance companies (e.g., Sun Life in India) have small operations in emerging market countries.

class that can afford their financial protection products. Political stability is also important as is access to a reasonably well-educated work force that can sell their products

Manulife has a long history of providing insurance services in Asia. They began operations in Hong Kong and China in 1897 and then expanded into the Philippines, Indonesia, and into other countries in the region with ethnic Chinese populations (e.g. Singapore and Taiwan). Given their long experience in Hong Kong they feel that they have the expertise to service customers of Chinese extraction. They closed their Asian operations during World War Two and then re-opened them once hostilities ended.

Currently, Manulife has operations in Hong Kong, The Philippines, Taiwan, Singapore (50% joint venture), Indonesia (originally a joint venture) and more recently has expanded into Vietnam (50% joint venture), China (Shanghai - 50% joint venture) and Japan.

Manulife also had a foreign subsidiary in India after the war, but it was subsequently nationalised. It has not returned to India because they feel the business environment is not yet sufficiently attractive. Manulife also had operations in South Korea, which were wound down because of losses. The firm has not invested in other emerging market areas, such as Latin America and Eastern Europe, because these areas are outside of its normal sphere of operations and geographic expertise, and because the initial and ongoing costs of entering and operating in these countries are relatively high.

The Indonesian and Chinese cases are interesting. In Indonesia, in 1985 they entered into a joint venture with a local firm. The International Finance Corporation (the private sector arm of the World Bank) was also involved in the formation of the joint venture. Their Indonesian partner subsequently brought forth a fraudulent law suit to drive them into bankruptcy that was initially upheld at the lower court level, but was eventually (in 2002) overturned by the Indonesian Supreme court. Their case was strongly supported by the The World Bank and the IMF (both of which viewed this as an important test case for protecting the property rights of foreign investors in LDCs) as well as by the Canadian government.

In China, Manulife Financial opened an office in Beijing in 1992 and then entered into a joint venture in Shanghai in 1996 (the first joint venture involving a foreign life insurance provider). Although it took several years to obtain the license to sell insurance, Manulife played a useful role in shaping the domestic laws governing life insurance companies.

2. FDI in the Context of the Business Policies of Financial Firms

The risk management problem faced by insurance companies and other financial sector firms in emerging market countries is difficult because, as noted above, the domestic legal and regulatory framework governing their operations (e.g., joint ventures) are often opaque, discriminatory and not well established, and thus are a source of risk to the expected returns from FDI that cannot be easily hedged. As noted in the case of Manulife Financial in Indonesia, guarantees (explicit or implicit) by the large multilateral institutions are often necessary to initiate the FDI because their intervention may be required to ensure fair treatment and protect property rights.

Manulife does not normally hedge against macroeconomic country risk by diversifying their investment holdings from their premium income streams. Life and other insurance premiums are

typically invested in the host country from which they originate. Although such an investment strategy shelters net income streams of the local operation from exchange rate fluctuations (e.g. Manulife's overseas operations were not greatly affected by the Asian Crisis of 1997-98), it is not clear that such a strategy is globally optimal from the firm's perspective. Political concerns and local regulation may, however, explain this behaviour; having claims on local assets may garner more political influence for foreign firms with local subsidiaries, but it also leaves them vulnerable to possible expropriation (e.g., foreign banks in Argentina). The other possible explanation for the host country bias in the investment of insurance premiums is that the local operators may have good information about domestic investment opportunities, which may reduce the perceived risk of the investment. Finally, it is important to note the host country benefits when subsidiaries of foreign insurance companies re-invest their premiums locally. The subsidiary is providing intermediation services (channelling local savings into investment) as well as helping to develop local financial markets.

This rule-of-thumb hedging strategy of matching the currencies of assets and liabilities by host country may not be an optimal risk management strategy. It will depend on whether any excess risk is offset by diversification of the firm's other assets.

3. The implications of financial sector FDI for market functioning and the stability of financial institutions

As noted above, Manulife has contributed to the functioning of financial markets in the emerging market countries in which it has invested by influencing the laws and regulations governing insurance companies and foreign investment in the financial sector. In addition, by investing premium revenue locally it provides efficient intermediation of savings into investment and it encourages the development of financial markets. Also, by supplying financial protection products to consumers it allows them to insure themselves against risks and increase savings for their retirement. Finally, it provides effective competition to domestic firms which forces them to offer products of comparable quality and pricing, and to improve their own financial reputation to that of Manulife Financial.[2] Hence, Manulife's investment and operations serve to enhance market functioning and stability and thus generate many benefits (including positive externalities) for the host country.

4. Concluding remarks: Policy lessons from Manulife's experience

The main issues concerning financial sector FDI in emerging market countries are:

1. Because of positive externalities, the benefits to the host country of subsidiaries (or branches) of foreign firms in the financial sector providing efficient intermediation and effective competition are greater than the expected returns the firm can hope to attain, especially given the risks (e.g., political/country) that cannot be adequately hedged;

2. Host countries have difficulty credibly committing to institutions and policies that will reduce these risks and other impediments to investing in these markets (because of vested political interests that may oppose such investments).

---

2. The advantages of developing a life insurance industry is discussed in more detail in Chapter 3 of K. Black and D. Skipper, *Life Insurance,* 12th Edition (Englewood Cliffs, New Jersey: Prentice Hall, 1994).

The combined effect of these two factors may be a sub-optimal equilibrium for the investing firm, the host country and the world at large.

To facilitate these welfare-improving investments the following policy measures could be considered:

1. Multilateral organizations and the home country governments should encourage host country governments to reduce regulatory impediments to FDI in the financial sector (especially require national treatment) and to alter their institutional arrangements to protect property rights, improve corporate governance and reporting, facilitate the formation of financial markets, and strengthen bankruptcy laws.[3]

2. Multilateral organizations and the home country governments should provide financial aid and technical assistance to implement legal and institutional reforms and improve supervision.

3. Multilateral organizations should be given an oversight role (e.g. the IMF's FSAP) on FDI in the financial sector especially for host countries that are members of the organization or that are receiving financial assistance (e.g. on an IMF program).

3. The home country might also consider removing their own impediments to inward FDI in the financial sector.