



# Financial policy and insurance development: Do financial reforms matter and how?



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## ABSTRACT

This paper investigates the relationship between financial policies and life insurance development and how country-specific characteristics such as economic development level, financial structure, and governance environments influence the effect of financial reforms. We examine the association between life insurance development and the overall index as well as several sub-dimensions of financial reform, including interest rate liberalization, entry barriers, privatization, capital account restrictions, and securities market policy. We find that financial reforms alone are not significantly correlated with the development of the life insurance market. However, interest rate liberalization matters after accounting for the influence of country-specific characteristics.

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## 1. Introduction

A large body of literature has studied the determinants of life insurance development. Some studies look at the role of demographic, economic, and social-cultural factors (Beenstock, Dickinson, & Khajuria, 1986; Browne & Kim, 1993; Chen, Lee, & Lee, 2012; Lee & Chiu, 2012; Truett & Truett, 1990), while others document that financial development or banking sector development (Beck & Webb, 2003; Lee, 2013; Li, Moshirian, Nguyen, & Wee, 2007; Outreville, 1996) and the institutional environment (Chang & Lee, 2012; Ward & Zurbrugg, 2002) all play an important role on the development of the life insurance sector. As one of the major players in the financial system and a long-term institutional investor in capital markets, whether and how financial sector policies affect this sector should deserve an investigation. Surprisingly, this topic has not yet received any attention, particularly in the context of an international comparison.

This article attempts to fill the gap by examining the relationship between financial liberalization policies and life insurance development. We explore the link between liberalization policies and life insurance development from an alternative perspective. We examine whether financial sector policies not specific to the insurance sector, including policies related to the banking sector and the capital market, correlate with the development of the life insurance sector across countries. We also identify the influence of the degrees of economic development, financial structure, and governance environments on the reform–insurance relation.

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Using a new database of financial reforms introduced by [Abiad, Detragiache, and Tressel \(2010\)](#), we investigate whether and how financial liberalization policies, including an overall index of financial reform as well as specific policies such as interest rate controls, entry barriers, privatization, financial account restrictions, and securities market policy, are correlated with the development of life insurance sectors for 50 countries over 1996–2005.

The topic warrants an investigation because sectors within the financial system are so closely connected with financial policies in specific sectors, e.g., the banking sector or capital markets, and insurance sector. We present some points to corroborate this argument. First, for life insurance firms, banks have become an important distribution channel for insurance products, known as “bancassurance”. Banks have accounted for a significant proportion of insurance sales, particular in the life insurance business, in some countries such as France, Spain, Italy, and India ([Cummins & Venard, 2008](#)) and are becoming an important sales channel for insurance products in other countries. On the other hand, however, banks are, to some extent, also a competitor of life insurers as they need to compete for consumers’ fund. Under this circumstance, it is not unreasonable to expect that policies related to the banking sector, e.g., entry barriers or the importance of state-owned banks, should have some linkages with the development of the life insurance market. Second, looking for investment instruments with an adequate rate of return is necessary for life insurers given their potential obligations to the insured. Whether the government imposes restrictions on interest rates is relevant as interest rates are associated with the rate of return on investment instruments in the market. Moreover, the pricing of life insurance products is correlated with the level of interest rate across the financial market, which is related to the government’s interest rate policy. Third and finally, life insurers are important institutional investors in security markets and bonds as well as stocks constitute a substantial portion in life insurers’ portfolios. Well-developed bond and equity markets will be strongly associated with their investment performance, which are affected by securities market policies.

Utilizing a random-effect analysis of panel data, we find that financial reforms alone are not significantly correlated with the development of the life insurance sector either on a basis of the overall index or specific sub-dimensions. To explore if national characteristics such as economic development, financial structure, and the national governance influence the effect of reforms, we analyze the interaction effect of these environmental variables and financial reforms and find that these factors matter for some specific reform policy to be relevant. We observe that the overall index of financial reform is significantly related to the development of the life insurance market only in the economic development case, suggesting that financial reform could be relevant to life insurance development with the maturing of economic development. Among sub-indices of the reform, we find that interest rate liberalization plays a significant and dominant role after incorporating the environmental variables in the estimation model. The evidence suggests that the relevance of interest rate policies to life insurance development hinges on the level of economic development, the structure of the financial system, as well as of the soundness of national governance environments.

This article complements and contributes to the existing literature in two aspects. First, from an alternative perspective we investigate the connection of the life insurance development with liberalization policies related to other sectors that are closely correlated with the life insurance sector. The extant insurance literature concentrates on the effect of deregulation or liberalization policies specific to the insurance sector and mainly focuses on their impact on firm-level data in a single country, i.e., a micro-based analysis. We alternatively explore the association of broader financial sector policies with the overall development of the life insurance market across countries, i.e., a macro-based analysis. Under the trend that sectors within the financial system will be more closely interrelated in the future, our findings should be able to provide some guidelines for policy making. Second, our findings that financial liberalization alone are not significantly related to life insurance development, but rather depends on some environmental variables, suggest that financial reform policies along with a change in national circumstances like the improvement of the institutional environment may be necessary for the development of the life insurance market.

The remainder of the article is organized as follows. The next section presents related literature and develops our hypotheses. [Section 3](#) states model specification and variables definition and data. [Section 4](#) explains empirical results and [Section 5](#) concludes.

## 2. Literature review and hypothesis development

### 2.1. Related literature

The influential work of [McKinnon \(1973\)](#) and [Shaw \(1973\)](#) initiates an advocacy to reduce the role of the state in financial markets. Both pioneers argue that suppressed actions on financial markets imposed by the state, particularly in developing countries, such as state ownership in the banking sector, interest rate control, high bank reserve requirements, entry barriers, and mandatory credit allocation to specific sectors, result in high lending interest rates, monopoly power by banks, low financial intermediation, and concentration of credit in favored sectors and firms. The effects of specific financial sector reform episodes are, however, empirically mixed.

Some studies document a positive effect – e.g., faster economic growth promoted by the relaxation of interstate banking and branching restrictions in the U.S. in the 1980s ([Jayaratne & Strahan, 1996](#)); more rapid industrial restructuring after bank deregulation due to less bail-outs by banks for poorly performing firms in France ([Bertrand, Schoar, & Thesmar, 2007](#)); and a more efficient allocation of investment brought through financial liberalization ([Abiad, Oomes, & Ueda, 2008](#); [Chari & Henry, 2008](#); [Galindo, Schiantarelli, & Weiss, 2007](#)). Another strand of the literature finds a negative impact – e.g., a higher incidence of banking crises ([Demirgüç-Kunt & Detragiache, 1999](#)) or more output volatility ([Kaminsky & Schmukler, 2003](#)) caused by financial liberalization. Still another strand notes that financial reforms exert a differential effect on industries or financial development depending on some national characteristics such as the protection of property rights ([Tressel, 2008](#)) and political institutions ([Tressel & Detragiache, 2008](#)). [Berglof and Lehmann \(2009\)](#) indicate that real sector activity and financial sector growth reinforce each other in Russia.

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