CHAPTER – I:

INTRODUCTION
1.1 Introduction

Insurance industry is an important and integral component of the macro economy. It has emerged as a dominant institutional player in the financial market impacting the health of economy. It has multi-dimensional role in savings and capital market, while the primary role of an insurance company is to provide insurance coverage for managing financial risks, it plays a very crucial role in promoting savings by selling a wide range of products and also actively contributes in promoting and sustaining the capital market of a country. Insurance sector has micro and macro effects on the economy. The micro effects are on individual safety, investments, savings perspective, and contribution to growth of economy. The macro effects are financing infrastructure, promoting investments, contribution to capital formation, financial leveraging and accessing resources.

In the emerging economy, characterized by the reduced role of state and declining state supported social security, the importance and the role of the insurance industry has increased significantly not only as a risk manager but also as retirement security and annuity provider. Moreover, growing institutionalization of the financial market has also provided a momentum to boost the insurance companies. There is phenomenal growth resulting from both micro and macro effects of insurance. If the insurance sector is not regulated, then it will go to affect adversely the insurance growth, like in the micro sense people will lose their savings and in the macro sense the financial market will destabilize and collapses. Therefore, there is a need to regulate insurance in the context of the changing market and economic environment is required for managing insurance companies effectively.

This study is an attempt to work in this direction. Most of the research available on insurance in India is basically a kind of historical account which focus on life insurance as an insurance entity rather than an important component of financial services industry. Therefore, a need was felt to study insurance industry as well as the regulation of insurance in India in the context of changing dynamics of macro economy and financial markets in the backdrop of ongoing globalization and economic reforms. Moreover, several emerging and crucial issues which are critical to growth such as risk
management, regulation, business ethics, corporate governance, etc., have not been given the required attention by industry managers. These are not merely the required conditions to enhance customer value but are necessary for strategic market expansion.

The insurance business has become highly important to society's prosperity, for people and for economic development. Its solidity, as a financial market, is vital for the economy. Some say that the macro-economic effect of Insurance Business/Firms collapse would be tremendous and that insurers are just "too big" to be allowed to fail. However, due to certain characteristics, insurance markets' soundness is fragile, especially when judged by the general concept of assuring competition in the market. The importance of the insurers' solvency to the economy and the un-balanced relationship between the insurers and the insured population, led legislators to heavily regulate this sector. This regulation includes licensing rules, ongoing supervision and intervention in the insurers-insured relations. Among other measures, the regulatory efforts rely upon the restriction of intra-industry competition. Regulating the industry with prudential principles will help the growth of the industry.

Any sector, which touches the life of the common man needs regulation, particularly so when inequalities and disparities of different types obtain or are likely to occur on account of the action or inaction on the part of the economic agents involved. For example, there can arise inequalities of opportunity; inequalities of income; wealth; regional imbalances; inter-sectoral imbalances; inequalities in social infrastructure, etc. This becomes particularly relevant in developing countries when they launch on a liberalization programme. As the markets in such countries are not well-developed, they cannot be relied upon for ensuring that in the process of deregulation, public monopolies are not replaced by private monopolies.

Economists in the developed world would like the correction of imbalances to be left to the market forces and would not like the government to intervene. The assumption of the trickledown effect implicit in this arrangement may have been viable in those countries at a point of time in history. Later, the experience in developing countries was
different in that the vested interests blocked any efforts at distribution of social benefits. For preventing such a phenomenon from occurring, and for ensuring social justice, an element of compulsion and regulation becomes necessary.

Regulation is the result of pressures from business, consumers, and environmental groups and results in regulation, which supports business and protects consumers, works, and the environment. Regulation is undertaken to ensure that the economic system operates in a manner consistent with the public interest and to overcome market failures.

Regulation is an activity carried out on regular basis by the government by which it tries to direct, control and modify the behavior of its citizens, organization and business entities operating within its boundaries in a desired way so as to achieve an equalitarian growth and development of the country. It is a process enacted by the law that supervises or controls some specific activities made by the affected firms and it is planned in such a way that it protects the public from exploitation by industries with monopoly power. So government agencies will regulate the specified task of administering and enforcing the law. While enforcing the regulatory law, these agencies are actively supported by the courts.

**Regulation: Definitions**

According to Philip Selznick (1985), “Regulation is sustained and focused control exercised by a public agency over activities which are valued by a community”. This definition very much states centered view of regulation with total emphasis being given to intervention of public agencies. In the view of Posner (1971) “Regulation is supplied in response to the demand of public for the Correction of inefficient or inequitable market practices”. Stigler (1971) states that “Regulation instituted primarily for the protection and benefit of the Public at large or some large subclass of the public”.

Robert Baldwin (1999) has defined regulation in three different senses,

- As a specific set of commands
- As a deliberate state influence
- As all forms of social control or influence
Julia Black (2002) states that (i) Regulation is the promulgation of rules by government accompanied by the mechanisms for monitoring and enforcement, usually assumed to be performed through a specialist public agency. (ii) It is any form of direct state intervention in the economy, whatever form that intervention might take. (iii) Regulation is all mechanisms of social control or influence affecting all aspects of behavior from whatever source, whether they are international or not.

Regulation is the sustained and focused attempt to alter the behavior of others according to defined standards or purposes with the intention of producing a broadly identified outcome or outcomes, which may involve mechanisms of standard-setting, information-gathering and behavior-modification.

However, as the definition suggests, regulation is also often used to achieve wider social goals like equity, diversity, or social solidarity and to hold powerful corporate, professional, or social interests to account.

1.2 Evolution of Regulation

The evolution and rationale behind regulation can be traced back to 1676 in the works of Lord Matthew Hale. He has justified the governmental intervention in specific areas of public interest. Hale considered the law of business “to be affected with a public interest” in cases where facilities and business derive some common public interest and thus cannot be treated as private. The court of Illinois gave a verdict based on Hales work to justify government’s regulatory intervention in the case of Munn v/s. Illinois. This principle later known as ‘Public Utility Principle’ is applicable greatly in the areas of finance, education, telecommunication, insurance etc., which serves larger public interest.
Baldwin and Cave (1999) has compounded many reasons:

- Checking abuse of market power by monopolies and natural monopolies eg. utilities
- Distribution of benefits arising from windfall profits.
- To protect consumers from information asymmetry/inequacies and promote healthy competitive market
- Continuity and availability of services in public interest, where the supplier may find continuance of services uneconomical. Regulation can ensure continuity of services in social interest; by finding alternative means say cross subsidization. eg. Telephone in rural areas.
- Check anti-competitive behavior and predatory pricing by market participants.
- To protect interest of weaker groups in case of unequal bargaining powers.
- Regulation may be needed to co-ordinate altruistic intention for benefit of future generations or society at large.

1.2.1 Rationale for Regulation

(i). Economies of scale

In some industries and activities due to technical and natural advantages, one firm may find it cheaper to expand production and the relatively large firm will take advantage and may gain market power. One cause is economies of large scale production.

In insurance, as in banking, there are significant economies of scale. The financial economies of scale in property – liability insurance and reinsurance derive mainly from the pooling of risks – the larger and the better diversified a pool, the better it works. In terms of diversification, the more extensive the markets from which risks are drawn the better, since property risks are often correlated geographically.

For life insurance, the financial economies come on the asset side rather than on the liability side as in property – liability. The larger the portfolio of assets, the better diversified a life can be and the larger the individual investments.
Because of these financial economies of scale, a large insurance company doing business over a wide geographic area will be inherently safer than a small, local company. That means that the larger firm will require a lower equity ratio and therefore, that its return on equity will be higher.

In insurance, as in banking, many of the fixed costs are indivisible. This is true both of the specialized personal, such as actuaries, underwriters and investment managers and information technology. A large insurance company will need to spend proportionally less on these budget items than a small company, giving the larger company a competitive advantage.

Reputational economies of the scale are particularly important in insurance. An insurance policy represents a promise. The value of the policy to the insured, therefore depends on his or her confidence that the promise will be kept. A large, long-established, and well known insurer is more likely to inspire such confidence than a new, small company that no one has ever heard of.

(ii) Economies of Scope

A single, large firm may also have a cost advantage over a group of small firms when it is cheaper to produce a number of different commodities together rather than making each separately in a different firm. Savings made possible by simultaneous production of many different products by one firm are called economies of scope.

Economies of scope draw insurance companies into related activities and draw other financial institutions into insurance.

- Life insurance and property – liability: one obvious advantage of scope is between the two types of insurance – life and property – liability. Although the two businesses are different in important respects, there are similarities.
- Insurance and other financial services – as we have seen, life insurance companies are already deeply involved in financial intermediation and in the financial markets.
Insurance and banking – the economies of scope between banking and insurance seem to lie principally in marketing. As we have seen, marketing costs are a significant part of the cost of insurance.

(iii) Theory of Limit Pricing

Even if society reconciles itself to monopoly in such cases, it generally does not want to let the monopoly firm wield its market power without limits. Therefore it will consider regulating the company’s decisions on matters such as pricing. The first and most universal problem facing the regulator is how to prevent and regulate the firm from pricing and taking other actions that exploit the public and undermine the efficiency of the market, but to do so in ways that do not destroy the regulated firm or prevent it from serving the public effectively.

(iv) Barriers to Entry

Lack of Information is one the barriers for a new company entering into the market of insurance. As we have seen the key to making a profit is pricing premiums correctly. The lack of actuarial information and also setting up of marketing network to sell the insurance products easily will act as a barrier to entry for a new firm.

1.2.2 Aims of Regulations

Generally regulations has the following goals

- To enforce applicable laws
- To prosecute cases of market misconduct, such as insider trading.
- To license the providers of financial services.
- To protect clients and investigate complaints.
- To maintain confidence in the financial system.
- To face the challenges of market imperfections such as (i) Information asymmetry (ii) Market power (iii) Negative externalities.
1.2.3 Objectives of Regulation

- To enhance the confidence of economic agents in the financial system.
- To foster the development of competitive and efficient financial markets.
- To promote public understanding of the financial system.
- To improve the framework for regulatory performance and accountability.
- To contribute to enhancement of financial stability.
- To strengthen the protection of financial service consumers.
- To promote financial inclusion and universal access to financial services.

To assure that the industry operates with a sense of fairness, equity and reasonableness in the market. To promote prudential regulation, this assures safety and soundness of financial systems and institution to increase the confidence of the stake holders. To guide financial firms on how to conduct the insurance business.

1.2.4 Methods of Regulation

- Maintains of Capital Adequacy
- Maintains of Liquidity
- Exposure to Risk
- Maintains of Solvency Ratio

1.2.5 Classification of Regulation

Regulation can be broadly classified in to three categories (Skipper, D. Harold and Know, J. 2007).

- Economic regulations- the analysis of government intervention relating to risk management by emphasizing the financing and legal dimension of societal risk management, by intervention directly in market decisions such as pricing and competition.
- Social regulation-protect public interest, for example, the environment, health and safety.
- Administrative regulations-‘red tape’ or administrative mechanisms through which government collect information and monitor industries.
1.3 Financial Regulation

Financial regulations are a form regulation or supervision which subjects financial institution to certain requirements, restrictions and guidelines aiming to maintain the integrity of the financial system. This may be handled by either a government or NGO. Since the three powerful forces viz globalization, information technology and convergence will pose significant challenges to financial stability, the market requires regulation in order to protect the investors all stack holders and to protect financial stability in the economy

1.3.1 Financial Regulations versus Liberalization

Substantial empirical evidence on the working of financial regulation vs. liberalization for more than 30 years in a large number of countries across five continents is now available to enable us to form a more informed and balanced judgment regarding the choice of regulated vs. liberalized financial system. Much of this evidence suggests that over-enthusiasm and over-optimism need to be avoided in respect of both regulation and deregulation. The IMF-WB guided/imposed liberalization, deregulation policies have significantly increased volatility, instability, contagion and vulnerability in the financial system. They have in many cases been accompanied by the collapse of banks, other financial institutions, national currencies, etc. As a result, the approach of economists, financial experts, authorities, IMF, WB has now become far more cautious. It is now widely admitted that while private ownership results into financial crises, and public ownership and policy often helps to rescue the financial markets out of crises. and collapses. The massive misallocation of capital by the Savings and Loan Associations, and by banks in the aftermath of partial deregulation of the early 1980s in USA suggest that “free” or “competitive” markets do not necessarily allocate resources more efficiently.

The lessons from the liberalization in Eastern Europe, Central Asia, Soviet Union, and South East Asia have not been encouraging. As per one assessment, the liberalization experiment has not proceeded the way many economists had predicted. The post-
liberalization period has been a difficult period for most of the countries. There have been many bitter and disappointing deregulation failures.

It has been observed that the liberalization–globalization process has exposed nations to enormous shocks. Growth requires financial institutions that lend to domestic firms. The policy of selling banks to foreign owners has impeded growth and stability. The contractionary policies under liberalization have forced many countries into deep recession. Faced with substantial adverse evidence, the partisans of financial liberalization have argued that it has failed because of

(a) The existence of implicit or explicit deposit insurance.
(b) Inadequate banking supervision.
(c) Macroeconomic instability.
(d) Excessive risk-taking by banks.

They have suggested the following prerequisites or preconditions for the success of liberalization:
(i) Adequate banking supervision and prudential regulation should be introduced so that banks have a well-diversified loan portfolio, and which provide at least minimum accounting and legal infrastructure.
(ii) Macro-economic and price stability should be achieved.
(iii) Fiscal discipline and restraint should become a reality.
(iv) The government should not impose discriminatory taxes on financial intermediation.
(v) The banks should pursue competitive and profit-maximizing policy. The newly emerging cautious approach to liberalization is well-reflected in the following viewpoint of the World Bank.

Good regulation of financial firms is essential. The policy makers should align private incentives with public interest in such a way that the scrutiny of financial institutions by official supervisors is buttressed by supervision by market participants. Although there is much for the government to do, there are other areas where the public sector has little comparative advantage.
The shift towards accepting the mix of regulation-deregulation is reflected in the newly coined and used concepts such as “market-aware regulation”, “prudential regulation”, ”enabling regulation”, “incentive-compatible regulation”, and ”right-type regulation”.

While Stiglitz (1999) has suggested decentralization as the alternative to regulation or liberalization, the World Bank has suggested the following policy as the appropriate policy for the future.

We need to have a right type of regulation which has the following features:

(a) It is “incentive compatible”, i.e. it is designed in such a way that it ensures the creation of incentives for market participants which help it to achieve its goals.

(b) It works with the market but does not leave things to the market, it is a “market-aware” regulation.

(c) It keeps authorities at arm’s length from transactions, lessening the opportunities for conflicts of interests and corruption.

(d) It removes distortions that lead to too little direct investment, too little long-term finance, too little equity finance, and too little lending to small firms and the poor
Table. 1.1 Types of Financial Regulations

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<th>Type of Financial Regulation</th>
<th>Measures taken by the Regulator</th>
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| Competitive Regulation (Prevention of anticompetitive behavior) | • Rules designed to deal with the structure of industries  
• Rules designed to prevent anticompetitive behavior  
• Rules designed to ensure that markets remain contestable |
| Price Regulation | • Administering interest rates, fees and commissions  
• Permitting price cartels  
• Direct lending controls and compulsory investment schemes  
• Restrictions on cross border capital flows |
| Market Integrity (Prevention of Market Misconduct) | • Disclosure of Information  
• Conduct of business rules  
• Entry restrictions through licensing  
• Governance and fiduciary responsibilities  
• Conditions of minimal financial strength |
| Prudential Regulation (Prevention of Asymmetric Information) | • Entry and Capital requirements  
• Balance Sheet restrictions  
• Liquidity and Accountability requirements  
• Customer support schemes  
• Restrictions on associations among financial Institutions |
| Government Policy (Prevention of Systemic Instability) | • Maintenance of sustainable 'macroeconomic' environment  
• Monetary, Fiscal and Credit Policy |
| Insurance regulation | • Rules designed to deal with the structure of insurance industries  
• Rules designed to prevent anticompetitive behavior in insurance market  
• Rules designed to ensure that markets remain contestable |

Source: Carmichael et al. (2002)
1.4 Insurance Regulation

Regulation acquires significance in sensitive areas like financial transactions, where chances of mismanagement, deception, fraud etc., are more possible. If such mal-practices do occur, the loser is the common man, who does not understand the intricacies of the transactions and can be misled. Hence, social supervision, that is, government supervision, becomes essential. This is true for all the sectors in the financial services viz. banking, stock markets and insurance (Palande, et al. 2003).

In common with other financial services, insurers are repositories of public trust, and accept money from the insured in return for a promise of payment at some future date or on the occurrence of some particular event. An insurance company can fulfill this commitment only if it has adequate professional capability, is financially soundly managed, holds adequate reserves to meet the requirement of funds with reference to the nature of term of liabilities, and invests its huge funds carefully, so this needs to explain the paradox that even while on the one hand, countries with a very stiff restrictive regime are trying to dismantle some of the redundant controls, and on the other hand, countries with a less interventionist policy are attempting an increased level of regulation.

Regulations in insurance are a general set of principles covering minimal requirements for best practices in the areas of licensing, prudential regulations and requirements; supervisory powers, managing asset quality and loss provisioning and most importantly, enhancing corporate governance in insurance organizations all unexceptionable in principle. However, there is no universally accepted model of regulation and different countries have different arrangements. There can be shades of control by the regulator, regulation can be strict or it may be liberal; supervision can be reactive or proactive; intervention may be more intrusive or less; a large area of activities may be brought under the purview of the regulatory authority or it would be limited. The exact set-up will depend on the economic and political philosophy of the country concerned. The countries with open economy will encourage the domestic firms to collaborate with foreign companies, which are having global experience in capital and asset management, and are large in size in terms business volume and with using high technology. But there is no guarantee that all such companies
will behave well. Reckless rate wars, undercutting, unhealthy links with industrial houses and a disregard for prudential norms are not totally unknown in other markets. Hence, the need to regulate them strictly and accordingly, they are subjected to close regulation by the state in all countries, with the objective of ensuring that their business is run fairly, is conducted by competent persons, and protects the legitimate interests of the insuring public.

### 1.4.1 Purpose of Insurance Regulation

The ultimate purpose of insurance regulation is to protect the policy holder or consumer by ensuring that the insurance firm will be able to pay in the event that the policy holder files a claim. In other words it is about the slovenly that is maintaining sufficient capital to meet the obligations. This is particularly important for life insurance or liability policies where there is typically a long time span between the purchase of the protection policy and the payment of the claim. The need for regulatory control arises because, insurance services or only produced and delivered after they are purchased and paid for by policy holders. Since policy holders, typically lack the skills and information to monitor the financial soundness of their insurers, government laws are needed.

The purpose of insurance regulation is not to prevent insurance in solvencies all together as this would be highly distortive and inefficient, i.e the cost of achieving such a result would outweigh regulation benefits. One of the goal of insurance regulation should be to reduce insolvencies to an acceptable minimum to minimize their negative impact.

The secondary of insurance regulation is to treat insurance customers fairly and promote efficiency and competition in the industry. Insurance regulation is micro-prudential focusing on the solvency of the individual insurance companies.

### 1.4.2 Reasons for Insurance Regulation

Insurers are regulated by the states for several reasons including the following

1. Maintain insurer solvency
2. Compensate for inadequate consumer knowledge
3. Ensure reasonable rates
4. Make insurance available

Maintain Insurer Solvency: Insurance regulation is necessary to maintain the solvency of the insurers. Solvency is important for several reasons. First reason, premiums are paid in advance, but the period of protection extends into the future. If an insurer goes bankrupt and a future claim is not paid, the insurance protection paid for in advance is worthless. Therefore, to ensure that claims will be paid, the financial strength of insurers must be carefully monitored. Second reason for stressing solvency is that individuals can be exposed to great financial insecurity if insurers fail and claims are not paid. E.g. If the insured’s home is totally destroyed by a cyclone or an earthquake and the loss is not paid, he or she may be financially ruined. Thus because of possible financial hardship to insured’s, beneficiaries, and third party claimants, regulation must stress insurer solvency finally, when insurers insolvent, certain social and economic costs are incurred. Examples include the loss of jobs by insurance company employees, a reduction in premium taxes paid to be states and a “freeze” on the withdrawals of cash values by life insurance policy owners. These costs can be minimized if insolvencies are prevented.

Compensate for Inadequate Consumer Knowledge: Regulation is also necessary because of inadequate consumer knowledge. Insurance contracts are technical, legal documents that contain complex clauses and provisions without regulation, an unscrupulous insurer could draft a contract so restrictive and legalistic that it would be worthless.

Majority consumers do not have sufficient information for comparing and determining the monetary value of different insurance contracts. It is difficult to compare dissimilar policies with different premiums because the necessary price and policy information is not readily available. For example, individual health insurance policies vary widely by cost converges and benefits. The average consumer would find it difficult to evaluate a particular policy based on the premium alone.
Without good information, consumers cannot select the best insurance product. This failure can reduce the impact that consumers have on insurance markets as well as the competitive incentive of insurers to improve product quality and lower price. Thus, regulation is needed to produce the same market effect that results from knowledge consumers who are purchasing products in highly competitive markets.

Finally, some agents are unethical and state licensing requirements are minimal. Thus, regulation is needed to protect consumers against unscrupulous agents.

**Ensure Reasonable Rates:** Regulation is also necessary to ensure reasonable rates. Rates should not be so high that consumers are being charged excessive prices. Nor should they be so low that the solvency of insurers is threatened. In most insurance markets, competition among insurers results in rates that are not excessive. Unfortunately, this result is not always the case. In some insurance markets with relatively few insurers, such as credit and title insurance, rate regulation is needed to protect consumers against excessive rates. Regulation also protects consumers against some insurers who may attempt to increase rates to exorbitant levels after a natural disaster occurs so as to recoup their underwriting losses.

**Make Insurance Available:** Another regulatory goal is to make insurance available to all persons who need it. Insurers are often unwilling to insure all applicants for a given type of insurance because of underwriting losses. Inadequate rates, adverse selection, and a host of additional factors. However, the public interest may require regulators to take actions that expand private insurance markets so as to make insurance more readily available. If private insurers are unable or unwilling to supply the needed converges, then government insurance programmers may be necessary.

It is not as if regulation becomes necessary only when there are private players in the field. There are operations which require professional regulation even in the nationalized sector, particularly in areas relating to expenses, customer service, claim settlements, resolution of disputes, reasonableness of tariffs, and prevention of restrictive trade
practices. The Malhotra Committee also felt that the insurance regulatory apparatus should be activated even in the present set-up of the insurance sector and recommended the establishment of a strong and effective Insurance Regulatory Authority in the form of a statutory autonomous Board on the lines of the SEBI.

The experience of the banking sector and the capital markets, where regulatory mechanisms have been set up and regulation has been enforced with some firmness, has been good. Thus, the banking sector has a Board for Financial Supervision since November 1994, and the stock markets are overseen by the SEBI. Insurance has seen the emergence of the IRDA, which has become functional since the beginning of the year 2000.

With the private sector's entry into the insurance business, a regulatory system became even more necessary in the insurance industry where large monetary stakes are involved and for which there are parallels in other parts of the world. The Malhotra Committee also observed that while regulation over the other financial sectors has been strengthened, the regulation of the insurance industry was organized in a peculiar manner under which the industry itself was also its regulator. This rendered the concept of regulation itself ineffective. It, therefore, felt that the re-establishment of effective regulation over the insurance business would become all the more urgent if the sector were to be liberalized.

To put this in place, special dispensations given to the LIC and the GIC and its subsidiary companies by government notifications had to be withdrawn so that they do not enjoy a favored treatment vis-à-vis other insurers. In the light of this, the government set up a regulatory mechanism in the form of the IRDA to ensure that the same regulation is applicable equally and seriously to all the players, public and private. In this sense, the IRDA is not an active player, but really a referee. This will ensure equity and social justice and at the same time prevent a recurrence of the old malaise and emergence of new monopolies. The IRDA has taken active steps towards closely monitoring the industry and bringing in some discipline therein.
In some countries, there are attempts at creating some self-regulatory organizations (SROs). There are others where responsibilities are sought to be put on professionals such as auditors, and actuaries. It is not known whether and how far such arrangements have been effective. However, it is difficult to visualize that in a country like India, long used to regulations and controls of various types, self-regulation in sensitive sectors like financial services can prove effective in the short run. It is naïve to believe that enlightened self-interest will force the companies to be more transparent.

Regulation is often opposed on the ground that regulations render the market less competitive, less efficient and inhibit entrepreneurship. Regulations are also perceived to be inflexible, expensive and administered as in a ‘command and control’ fashion. However, these anxieties are misplaced, because in essence, regulation is to be used as an efficient mechanism for permitting the financial market place to work. Although in certain quarters there are misunderstandings and reservations about regulation in general, and a regulatory authority in particular, it is really in the general interest of the economy as well as the insurers themselves to have a sound regulatory mechanism. That is the only way to ensure that all the players in the market are brought under the same discipline and the interests of the insured are adequately protected.

It is argued that the resolution of these issues by an open market will obviate the need for any legislation. On the other side, there is a forceful school that insists that such regulations are needed because the private sector incentives will never be adequate. It is too costly and virtually impossible for individuals to monitor large institutions, and the government can do so more efficiently with various instruments at its command. Without regulation, the individual would be unable to differentiate between honest, unscrupulous or shaky insurers.

There are alternatives, but the most effective is the rule of law. The government has the authority to impose penalties for breach of contract and mechanisms for determining when that has occurred. Regulation is a preventive approach that attempts to set boundaries for behavior beyond which there would be an implicit or explicit breach of
contract. Such a breach would have to be handled by the courts or by arbitration, or by a similar law-dispensing agency.

1.4.3 Insurance Regulation in India

Regulation of insurance in India was introduced with the promulgation of the Indian Life Assurance Companies Act, in 1912. The Insurance Act, 1938 sought to create a strong and powerful supervisory and regulatory authority in the Controller of Insurance, who was a statutory functionary. It set out his role and responsibilities more clearly and emphatically and empowered him to direct, advice, caution, prohibit, investigate, inspect, prosecute, search, seize, fine, amalgamate, authorize, register, and liquidate insurance companies. In fact, the government perhaps exercised more control on insurance than on any other economic activity.

Prior to nationalization, the insurance industry in India had suffered from certain weaknesses such as malpractice in claims settlement, unhealthy rate cutting and misuse of insurance funds for speculative and other purposes. Several financial scandals that arose even during a control regime did, in fact, further underline the need for strict and prudent regulation.

In 1999, the IRDA Bill was introduced which became Act and brought into effect from April 2000. The main objectives of the Act where to protect the interest of the holders of insurance policies, and to regulate, promote and ensure orderly growth of the insurance industry.

Regulatory Measures

“A sound regulatory mechanism is an essential prerequisite for the success of any market – related reforms, particularly when the sector under consideration is the financial sector” by C.S. Rao, Chairman, IRDA (2002).

Development of stable & strong insurance system is essential for economic development of the country. Regulatory measures are required for instilling public
confidence in insurance companies, deliver reliable and quality services. It has to secure the long-term stability of financial services through monitoring their financial soundness and fair treatment of their customer. With the experience of failure of non-banking. Financial institutes and loss of depositor’s money, regulatory measures have a very effective, role to control with facilitating investment and trade. Insurance Act 1938 is being modified as per the suggestions of IRDA. Globalization of financial activity, innovations in financial instruments and practices have to be strictly controlled.

There is often a conflict between strict regulation and development. Regulation is based on past experience where as development is future oriented. Developing new products, processing and servicing is not an easy matter. It is expected that regulations will work as driver for change and force the players to do things in a better way. Regulations by IRDA in India are praiseworthy as they are pro-development. It has emerged as prudential supervisor and developer of capacity in terms of risk pooling, reinsurance and skills. It has to guide towards insurance penetration and insurance density. It makes insurance available to poor in rural areas. Insurance companies have to provide risk cover as well as contribute to long-term investment.

Regulation consists of rule making and enforcement: Economic theory offers complimentary rationale for regulating financial institutions. In financial services markets for regulatory service create outside discipline that controls and co-ordinates industry behavior. Institutions benefit from regulation that enhances customer confidence, increases the convenience of customer transactions, or creates cartel profits.

1.4.4 Justification for Regulation

The standard explanation or justification for governmental regulation of a market is that the market, left to itself, will not produce the goods or services in an efficient manner and at the lowest possible cost. Of course, efficiency and low-cost production are hallmarks of a perfectly competitive market. Thus, a market unable to produce efficiently must be one that is not competitive at the time, and that will not gain that status by itself in the foreseeable future. Of course, it is also possible that governments may regulate
markets that are viewed as competitive currently but unable to sustain competition, and thus low-cost production, over the long run. A version of this justification for regulation is that the government controls a feature of the economy that the market mechanisms of competition and pricing could not manage without help. A shorthand expression economists use to describe the reasons for regulation is market failure. A market is said to fail if it cannot, by itself, maintain all the requirements for a competitive situation.

The economist explanations for the need of regulation is limited to check market failure but the requirement cannot be negated in the areas where there exist no markets especially in the case of monopolies and natural monopolies to check the abuse of market powers. So, economists see regulation largely as a remedy for market failure.

Governments in most developed economies have created elaborate systems of regulation for financial markets, in part because the markets themselves are complex and in part because financial markets are so important to the general economies in which they operate. The numerous rules and regulations are designed to serve several purposes.

They fall into the following categories:

1. To prevent issuers of securities from defrauding investors by concealing relevant information.
2. To promote competition and fairness in the trading of financial securities.
3. To promote the stability of financial institutions.
4. To restrict the activities of foreign concerns in domestic markets and institutions.
5. To control the level of economic activity.

In the present climate of deregulation, suggesting any regulatory mechanism may sound odd. Regulation and attendant laws are sometimes seen as anomalies in a democracy or as antithetical to liberalization. It may be pointed out that any regulation or discipline is not incongruent with the concept of democracy. Rather, liberalization and regulation go hand in hand, because after the deregulation of the public sector, the market-driven economy can produce certain distortions which need to be avoided. Liberal
policies do not demand total withdrawal of the government from economic activity. However, it is expected to disengage itself from areas where it does not have strength and concentrate on improving its performance in respect of activities which are its direct responsibility.

Even in societies where most decisions are left to the market place, the government still has a role in shaping and monitoring the market. In fact, without supportive regulatory measures, mere enthusiasm for a market economy and a belief in its inherent efficiency will not be enough and may actually create some problems in the short run. In these matters, we should be guided not by ideology, but by experience, which suggests that the introduction of appropriate intervention in important sectors is absolutely necessary.

Under liberalization, the role of the government is expected to shift from that of a producer and provider to that of a protector. The model of the state as the owner of the means of production, the producer and provider of the goods and services as well as the regulator, has turned out, in most parts the world, to be too inefficient to meet the rising expectations of the consumers. The government can fulfill its varied responsibilities effectively and efficiently only if there is well-equipped machinery in place. They cannot be handled through a department of the government, but are best left to a body of experts which takes collective decisions and not at the discretion of a government official who reports directly to the government and can, therefore, be influenced in his decisions. The Asian financial crisis has demonstrated the dangers of weak regulatory and supervisory systems, unable to match the added risks taken on by market participants in a more competitive environment.

The transition from a command economy dominated by the public sector to a market economy where the private sector is more active needs to be organized carefully. This has been corroborated by the experience even in developed countries which are proponents of the free-market economies, but which, after the deregulation process was carried out, had to set up regulatory authorities for different sectors. For instance, after
privatization, the UK had to adopt a system of 'supervisory authorities', especially in respect of utilities like telephones, which earlier were in the domain of the public sector. The Japanese statutes provide for the industry's supervision, and set out policies for a company's license, the capital or foundation fund, restriction on dividends, dissolution or liquidation, and day-to-day supervision. Singapore, South Korea and Taiwan also have fairly elaborate systems for regulation.

This need explains the paradox that even while on the one hand, countries with a very stiff restrictive regime are trying to dismantle some of the redundant controls, and on the other hand, countries with a less interventionist policy are attempting an increased level of regulation.

Collaborations with foreign companies which are globally experienced and are large in size are no guarantee that all such companies will behave well. Reckless rate wars, undercutting, unhealthy links with industrial houses and a disregard for prudential norms are not totally unknown in other markets. Hence, the need to regulate them strictly needed. Accordingly, they are subjected to close regulation by the state in all countries, with the objective of ensuring that their business is run fairly, is conducted by competent persons, and protects the legitimate interests of the insuring public.

1.4.5 Forms of Regulation

Disclosure regulation is the form of regulation that requires issuers of securities to make public a large amount of financial information to actual and potential investors. The standard justification for disclosure rules is that the managers of the issuing firm have more information about the financial health and future of the firm than investors who own or are considering the purchase of the firm’s securities. The cause of market failure here, if indeed it occurs, is commonly described as asymmetric information, which means investors and managers have uneven access to or uneven possession of information. This is referred to as the agency problem, in the sense that the firm’s managers, who act as agents for investors, may act in their own interests to the disadvantage of the investors. The advocates of disclosure rules say that, in the absence of the rules, the investors’
comparatively limited knowledge about the firm would allow the agents to engage in such practices.

It is interesting to note that several prominent economists deny the need and justification for disclosure rules. Led by George Benston, they argue that the securities market would, without governmental assistance, get all the information necessary for a fair pricing of new as well as existing securities. In this view, the rules supposedly extracting key data from agent-managers are redundant. One way to look at this argument is to ask what investors would do if a firm trying to sell new shares did not provide all the data investors would want. In that case, investors either would refuse to buy that firm’s securities, giving them a zero value, or would discount or under price the securities. Thus, a firm concealing important information would pay a penalty in the form of reduced proceeds from sale of the new securities. The prospect of this penalty is potentially as much incentive to disclose as the rules of a governmental agency.

Financial activity regulation consists of rules about traders of securities and trading on financial markets. A prime example of this form of regulation is the set of rules against trading by insiders who are corporate officers and others in positions to know more about a firm’s prospects than the general investing public.

Regulation of financial institutions is that form of governmental monitoring that restricts these institutions’ activities in the vital areas of lending, borrowing, and funding. The justification for this form of government regulation is that these financial firms have a special role to ply in a modern economy. Financial institutions help households and firms to save; they also facilitate the complex payments among many elements of the economy; and in the case of commercial banks they serve as conduits for the government’s monetary policy. Thus, it is often argued that the failure of these financial institutions would disturb the economy in a severe way.
Regulation of foreign participants is that form of governmental activity that limits the roles foreign firms can have in domestic markets and their ownership or control of financial institutions.

Authorities use banking and monetary regulation to try to control changes in a country’s money supply, which is thought to control the level of economic activity. We mention it here briefly in order to provide a comprehensive picture of the government’s role in modern financial systems.

1.4.6 Regulatory Reform

Regulatory reform is the result of several forces and developments. First, as we noted earlier, financial crisis often prompts significant shifts in the focus and extent of regulation. Several recent examples from the United States illustrate the point.

At one time, the maximum interest rate that depository institutions were permitted to pay on certain deposit accounts was set by government regulation. When interest rates in the open market rose above the ceiling imposed by the government, funds inevitably flowed out of depository institutions and were used to purchase securities, that is, to make direct investments. When this process of “disintermediation” threatened the economic well-being of many U.S. banks, the Federal Reserve and other regulatory bodies were forced to remove the interest rate ceilings. The U.S. savings and loan crisis is another example where federal legislation was passed in 1989 which changed the regulatory structure of deposit-accepting institutions. Finally, the stock market crash of October 1987 produced some shifts in the rules governing the U.S. markets for stock and derivative stock market instruments such as stock index futures and stock index options.

A second motivation for regulatory reform in the recent past has been financial innovation, or the development of new financial products. A wide array of new classes of financial assets appeared in the last two decades and forced the introduction of new regulations on trading these products. Specific products that spurred new regulation in the 1980s include the derivative instruments (options and futures) based on stock market
indexes. The German government extensively revised its laws on futures and options and even authorized the establishment of a German exchange for them. The U.S. government has also found it necessary to devise new rules for the use of these innovative products by regulated financial institutions.

Globalization of the world’s financial markets is the third reason for recent, notable reforms in the regulatory structure of many counties. Naturally, any government’s regulations are enforceable only within its borders. If a regulation is too costly, has little economic merit, or simply impedes an otherwise worthwhile financial transaction, market participants can evade it by transacting outside the country. As financial activities move to other nations, many interested parties lose money, and see reason to call for reexamination and reform of the questionable regulation. The German response to the widespread use of futures and options is an example of this phenomenon. Another example is Britain’s deregulation of its stock market (or the “Big Bang”), which was, in part, a response to competition from foreign exchanges and trading opportunities (Schwartz, Robert. A. 1991).

Another impact of globalization is that it reveals the costs of unwise regulations that prevent financial institutions from competing effectively for business in the world marketplace. Here a good example is regulation of the Japanese financial market. While at one time Japanese banks had sufficient funds to provide funding for non-Japanese multinational companies domiciled in Japan, regulations kept the banks from lending to foreign firms and from capitalizing on clear financial opportunities. The banks protested to the government, which eventually lifted the regulations and permitted them to compete with non-Japanese banks.

An important result of reform has been structural change in the financial institutions being regulated. As noted above, the U.S. regulatory system has separated the activities performed by different financial institutions. (Similar separation was characteristic of the United Kingdom and Japan.) Today, however, in a change that has a global sweep regulatory reform gradually has permitted financial institutions to offer a
wider range of financial services and to become “financial supermarkets.” A major focus of current and prospective regulatory reform, in several major industrial countries, is the outdated and regulation needs to be re-oriented according to the changed structure of global financial architecture.

1.5 Statement of the Research Problem

Insurance of life and properties have gained more importance in all the civilized societies in the world. Insurance in India was a protected area till 2000 has market was control by public sector insurance companies. After 2000, the new reforms brought in Indian insurance sector to fasten the growth of insurance market, to increase insurance penetration and insurance density in the country.

Consequently much reform measure brought in, which resulted into inflow of several players into the insurance sector. The reforms/regulatory measures brought in the name of IRDA with a intention to regulate and develop the insurance sector which influenced positive investment behavior on insurance among insurance investors.

Hence in this context a study is designed to examine what is the impact of insurance regulation on the growth of insurance sector in India and also to examine the impact of regulation on insurance density, insurance penetration and concentration of insurance industry before and after the setting up of IRDA. The study considers the following variables for analysis and interpretation of the objectives.

Researchable Issues

a) What is the impact of regulation on insurance sector? Macro level analysis
b) What is the impact of regulation on insurance market? Meso level analysis
c) What is the impact of regulation on insurance market? Micro level analysis
1.6 Objectives
1. To examine the nature and direction of regulation of insurance sector in India.
2. To examine the impact of regulation on insurance market penetration and insurance market density in post reform period.
3. To examine the impact of regulation on insurance market concentration in India.
4. To examine the impact of regulation on the confidence of investors in the insurance sector.

1.7 Hypotheses
1. Growth of insurance sector in India is positively correlated with Insurance regulation.
2. Insurance regulation has positive impact on market penetration and market density of insurance sector in India.
3. Post regulatory period has shown a positive change in the market structure of insurance sector.
4. There is a positive change in the confidence of insurance investors after insurance regulation.

1.8 Scope of the Study
This study focuses on the impact of insurance regulation on insurance sector in the post liberalization period from 2000-01 to 2012-13. The study attempts to analyze the impact of regulation on nature and direction of insurance sector, insurance penetration, insurance density and insurance market concentration. The study also attempts to unravel the dynamics involved in the confidence of insurance investors in the post regulation period. The study is also importance the fact that it has attempted to understand the psyche of Indian insurance investor towards public and private sector insurance companies after opening up of the insurance business in India. Variable such as age, gender, occupation, qualification, geographic location etc., have been analyzed thoroughly in this study. Since insurance subject falls in the center’s list, this study is a national study, where all India values aggregated. The present study compares India’s
position with world averages in terms of insurance density and penetration and national values are computed for analyzing insurance market concentration. The primary data collected to analyze the impact of insurance regulation on insurance investor’s confidence covers the four major areas in Karnataka viz., Bangaluru, Mysore, Mangalore and Dharwad with adjoining rural areas.

1.9 Methodology

This study has used different methods for conducting research. In order to analyze the macro level variables like insurance density, insurance penetration and comparing India with world averages, the study has used the descriptive methods. To evaluate market structure the study used analytical methods in the meso level. At micro level for analyzing the confidence of insurance investors after insurance regulation the study has used a participatory method and Focused Group Discussion (FGD) approach. It includes both primary and secondary data. Primary data on confidence of the insurance investors was collected through a structured questionnaire. The secondary data used in the research are extracted from different published sources such as IRDA Annual Reports, RBI reports, Swiss-Re Sigma reports World Bank-reports.

The composition of the respondents include insurance investors from both public and private insurance companies drawn from four major areas in Karnataka viz., Bangaluru, Mysore, Mangalore and Dharwad with adjoining rural areas. The responses from 126 respondents were collected. For the purpose of processing and analyzing the collected primary data, the following statistical tools were used in this study. Mean and standard deviation, correlations are used for descriptive statistics. Cronbach’s alpha is used for determining the predictive validity and reliability of the variables used in the study. The hypotheses are tested using One Sample T-test, ANOVA, Levene’s Test for equality of variances and Tukey’s HSD post-hoc test. The data collected from respondents is analyzed with the help of SPSS.
1.10 Organization of Thesis

The present study is organized in six chapters.

The first chapter explains the background of the study (theories of regulation, financial and insurance regulation, etc.,) provides justification and statement of the problem. The major researchable issues, objectives, hypotheses, methodology, relevance and scope of the study are also presented.

The second chapter briefly presents the thematic review of literature and methodology used in the study. Thematic reviews are covered under three groups (i) studies related to market regulation, (ii) studies related financial regulation, (iii) studies related to insurance regulation. Reviews of studies were undertaken at the national and international levels.

The third chapter discuss about the nature and directions of regulation and the regulations framed by IRDA. The impacts of regulation on Indian insurance market were analyzed in the Indian context.

The fourth chapter contains an analysis of the impact of insurance regulation on insurance penetration, insurance density and market structure in the post reform period in India.

The fifth chapter provides a discussion on the impact of insurance regulation on the confidence of investors in the insurance sector in the post liberalized period.

The chapter six summarizes the major findings, conclusions and suggests a few policy measures.