Benefits and barriers: global insurers’ role in foreign direct investment

Working paper

Foreign direct investment (FDI) promotes long-term economic growth and prosperity in developed and developing counties. Global insurers have an important role to play in helping global companies manage the risks posed by these investments. The design of regulation plays a key role in determining the extent to which insurers are able to realize this role.

This working paper aims to promote discussion on the oft-neglected role of global insurance in FDI and the influence insurance regulation has on the attractiveness of these investments.

The experience of the recent financial crisis and the still fragile economic recovery created a dilemma for many policymakers. They aim to protect their economies from international financial distortions, but at the same time they have to attract funding to fuel growth and create employment.

FDI, due to the stabilizing effect it has, is the preferred form of capital inflow. Many countries introduce incentives to attract these types of investments. But these direct incentives are only one element. To profit from FDI, open markets for foreign real investments should be complemented by open credit and insurance markets.

It is the role of global insurers like Zurich to support multinational companies in managing the increasingly interconnected risks posed by their FDI. However, fragmented insurance regulation that is often designed with retail customers in mind can pose significant challenges for global customers. Ultimately, this fragmented regulation makes it more costly to insure FDI and can limit the scale of these beneficial investments.

At Zurich, we believe that it is in the interest of global companies, as well as national economies that could profit from FDI inflows, to harmonize and liberalize the regulatory treatment of international insurance programs.

1. FDI and sustainable economic growth
Foreign direct investment (FDI) plays an important role in promoting long-term economic growth and prosperity in developed and developing countries. In the
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“As a relatively stable source of funding, FDI can contribute to economic well-being.”

FDI can help to quickly build up capital stock in these countries, spurring job creation. In 2013, the foreign affiliates of multinational companies employed 71 million people. FDI also has the potential to reduce an economy’s dependency on imports and stimulate exports.

Developed economies can benefit from FDI, too. Matthew Slaughter (2013) at the Organization for International Investment, for example, highlights this:

“While making up a relatively small share of the U.S. business community, the American operations of foreign companies account for a disproportionately large share of critical economic activities whose benefits accrue throughout the country.”

In addition, as highly-indebted governments of some developed countries find it increasingly difficult to fund the necessary investments, FDI can help to close the funding gap for infrastructure.

FDI contributes to financial and macro-economic stability

International portfolio investments can be withdrawn extremely quickly and investments redirected, which can often trigger large exchange rate fluctuations, especially in emerging countries. By contrast, FDI provides a relatively stable source of funding. As a result, FDI contributes to financial and macro-economic stability.

As Philippe Aghion and colleagues (2004, p. 26) have stated, “The reason why FDI acts as a stabilizing force is again that, unlike foreign lending, it does not depend on the creditworthiness of the domestic firms, and furthermore it is precisely during slumps that foreign direct investors may prefer to come in so as to benefit from the low price of the country-specific factor.”

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aftermath of the financial and economic crisis, promoting FDI has become a central element of the policy agenda of the G20 to support the global economic recovery and address long-term investment needs. In fact, the B20 – an organization of business leaders supporting the G20 dialogue – suggests that “private sector investment is a prerequisite for sustained and inclusive economic growth.”

Estimates for investment needs in developing countries alone range from USD 3.3 trillion to USD 4.5 trillion per year, mainly for basic infrastructure (roads, railroads, ports, power stations, water and sanitation), food security (agriculture and rural development), climate change mitigation and adaptation, health, and education.

FDI is an investment in real productive assets of a foreign economy with the intention to hold and use these over a longer period of time. FDI is therefore neither short-term portfolio investments nor loans, both of which leave the ownership of the productive asset in the hands of domestic entities. The long-term nature of FDI is also reflected in the OECD definition:

“Direct investment is a category of cross-border investment made by a resident in one economy (the direct investor) with the objective of establishing a lasting interest in an enterprise (the direct investment enterprise) that is resident in an economy other than that of the direct investor. The motivation of the direct investor is a strategic long-term relationship with the direct investment enterprise to ensure a significant degree of influence by the direct investor in the management of the direct investment enterprise.”

FDI helps to increase the productive capital stock and spur employment

FDI enhances the productive capacity of the receiving countries. Particularly in emerging economies, domestic savings are often insufficient to fund high investment needs associated with a rapidly-growing population.

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FDI promotes technology and knowledge transfer

FDI is often undertaken by large multinational companies with advanced products, production technologies, know-how and managerial skills. FDI helps receiving countries to adopt these technologies and acquire knowledge that would be difficult to build up from scratch. The diffusion of new technologies promotes productivity gains and helps receiving countries to move up the value chain. Research has shown that especially countries with a well-developed financial sector and with a high level of education can profit from this positive effect of FDI.

The impact of the global financial crisis on FDI

The financial crisis resulted in a global decline of FDI, which is still well below its 2007 peak (see Chart 1). While the decline particularly affected FDI inflows to developed countries, the growth rate of FDI flows into developing countries is considerably lower than before the crisis. With outflows of USD 860 billion, developed economies were the main source of FDI in 2013 (compared to USD 460 billion from developing economies). However, FDI outflows from developed countries are still 55 percent off their 2007 peak.

FDI is a long-term commitment that has the potential to foster sustainable economic growth, prosperity and knowledge and technology advances in receiving economies. In a world of increasingly complex and global supply chains, trade and FDI are often not alternatives, but go hand in hand. A favorable investment environment is therefore a key driver for global trade. After all, 80 percent of global exports come from multinational companies, the main foreign direct investors. There are, however, still barriers that prevent

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According to the 2014 Insourcing Survey by the Organization for International Investment (OFII) and PricewaterhouseCoopers, “More than half of CFOs identified educational priorities as the most important service a state can provide to encourage greater investment and growth.”


World Economic Forum (2013): ‘Foreign Direct Investment as a Key Driver for Trade, Growth and Prosperity: the Case for a Multilateral Agreement on Investment.’ WEF Global Agenda Council on Global Trade and FDI.
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“Promoting cross-border investments is a high priority for the G20.”

FDI from realizing its full potential. This is why promoting cross-border investments is very high on the agenda of the G20’s efforts to encourage economic recovery.12 The next section looks at these challenges in further detail.

2. The challenges facing foreign direct investors
Multinational companies may invest in a foreign country to facilitate access to an interesting market or to reduce production costs. Over the past 20 to 30 years, many countries have opened their markets to FDI to profit from its beneficial effects and attract foreign multinational companies’ investments by actively supporting these investments. This support may come in many forms, for example, preferential tax rates, subsidized loans and individual access to infrastructure. However, international direct investors face a number of challenges.

Regulatory challenges
In their recommendations to the G20 on driving growth and jobs, the B20 (2014) describes FDI as “an important driver of productivity and economic growth, but [one that] is often constrained by national regulatory environments that restrict market access, are corrupt and non-transparent, or which fail to protect investors against discriminatory, arbitrary and unfair treatment.”

UNCTAD (2014) highlights that among all investment policy measures “the share of regulatory or restrictive investment policies increased, reaching 27 per cent in 2013.”13 These measures to ‘renationalize’ include prohibitions on investment in certain strategic industries, constraints on capital flows, or requirements to transfer internal know-how to the domestic economy.14 As shown in Chart 2, countries with rules and regulations

Chart 2: Relation between rules on FDI and FDI (100 largest countries in terms of GDP, 2012)

Sources: World Bank (World Development Indicators) and Zurich Risk Room

14 See World Economic Forum (2013), ‘Foreign Direct Investment as a Key Driver for Trade, Growth and Prosperity: The Case for a Multilateral Agreement on Investment.’
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that strongly discourage FDI (high value) indeed have significantly lower FDI inflows. 15

**Risks facing investors**

In addition to legal restrictions, investors face many other challenges that make it more difficult to invest in a productive asset abroad. Like domestic investors, they face legal and political risks, economic, and property risks. These factors have gained in importance due to the still-fragile economic recovery in many countries, increasing geopolitical risks and the risks posed by climate change. Investors committing on a long-term basis require a stable and reliable legal and economic environment. FDI, like any other long-term investment, can be hampered by the risk that tax regimes or public subsidies will change. The same applies to long-term economic growth prospects, and risks tied to frequently-recurring natural catastrophes.

While the aforementioned types of risk also pose challenges to domestic investors, they are of particular relevance to foreign investors. Some political risks, like expropriation, might be greater for foreign than for domestic investors. Some types of risk have additional dimensions. For example, exchange rate risk increases an investment’s financial and economic risk. Embargoes or sanctions add to political risk. The foreign investor might also be less familiar with political developments, the legal system or the extent of natural hazard risks in a particular region.

Due to the increasing globalization of supply chains, multinational companies, the main originators of FDI, often operate today in as many as 100 or more locations worldwide. Managing the risks associated with such investments in order to protect local assets and employees is challenging. It requires detailed knowledge of local risk exposures across the different types of risks and a thorough understanding of local insurance conditions and related regulatory environments. To establish a ‘holistic’ view of the risks, corporate risk managers often take into account the way in which different risks and jurisdictions are interconnected.

The process of managing international direct investment risks is growing in complexity. Corporate risk managers therefore increasingly want insurance programs that cover all their worldwide exposures related to assets and their people centrally from just one insurer, or perhaps a panel of insurers. These international insurance programs offer a number of advantages for foreign investors.

3. **The role of international insurance in FDI**

**The benefits of international insurance**

Foreign direct investors can benefit from the expertise of global insurers in assessing a complex risk landscape across many different jurisdictions. Global insurers are able to understand the nature and risk of their customers’ multinational business and offer a broad range of products and services to match these needs. They have risk engineering experts able to provide key insights to better understand, benchmark and mitigate the risk exposures of their customers.

International property and casualty (P&C) insurance programs also offer the benefit of so-called ‘sleep easy covers.’ This means that coverage applies identical limits and conditions anywhere in the world. To achieve this, it has become common to agree that, in the case of a claim, where limits or conditions under a local insurance policy are exhausted, the underwriter will provide coverage for the difference up to the limit agreed under the master policy (difference in limits, or ‘DIL’) and/or on the conditions specified (difference in conditions, or ‘DIC’). 16

The result is effectively a uniform cover for all risks to be insured, regardless of the location. 17 For foreign investors, such cover makes it much easier to manage risk exposures across jurisdictions (see Box 1 on page 6).

An international P&C insurance program may allow a foreign investor to purchase cover for more complex risks (such as supply chain risks or political risks, for example) that may not be available on the local market. It may


16 See box on page 6.

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Box 1: Compensating differences in conditions and differences in limits with a master policy

A multinational company with headquarters in one country (the ‘producing country’) wants to buy protection for its investments in countries A, B, C and D. As shown in this hypothetical example, the conditions and limits of insurance protection are different in each country. In country D, no insurance protection is even possible. The global insurer addresses this problem by writing a master policy that covers all the DIC and DIL in these countries. The insurance customer can thus benefit from a ‘homogenous’ insurance protection in all of these countries.

also allow them to cover for catastrophic risk, for which the capacity of the local market may be insufficient. This may be particularly relevant for developing or emerging economies, where insurance markets tend to be less developed.

The role of captive insurance and reinsurance in FDI

Besides purchasing an international P&C insurance program, a geographically diversified corporation may consider establishing its own captive insurance. Captives offer the benefit of enhanced risk pooling not only across geographies, but also across different types of insurance such as non-life (P&C) and life insurance, especially employee benefits. Captive reinsurance programs further optimize the breadth and depth of international P&C insurance coverage and international corporate life.

Typically, captives are wholly-owned insurance subsidiaries of companies that set up a captive to manage and insure the owner’s corporate risks. They may retain an increasing share of risk and associated underwriting profits, address difficult insurance issues, pool and often reinsurance corporate risk, and ultimately reap significant financial and non-financial benefits.
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insurance by supporting investors’ global enterprise risk management (ERM) strategy. This combines risk portfolios in their captive. It makes full use of risk diversification to achieve maximum efficiency in terms of required risk capital and cost of risk (see Chart 3).

International insurance has an important role to play in mitigating and managing the complex risks faced by international companies, allowing them to make diverse and meaningful investments across jurisdictions. Captive insurance and reinsurance offer potential solutions. However, as will be discussed in the next section, the fragmented regulatory framework, and legal and regulatory uncertainties, greatly complicate efforts to establish and manage international insurance programs and captive solutions. The result is that corporate investors’ risk management will be less efficient. The changing regulatory environment presents a constant challenge for those seeking to keep up with developments in regulations around the globe. The introduction of Solvency II, for example, will have significant consequences for the management of captive solutions in Europe. Only a few insurance carriers are positioned to provide adequate solutions that are ‘globally compliant’ and services to support corporate investors with establishing and managing their worldwide risk in the most efficient way. Some of these issues are outlined in an article published in 2013 by Captive Review Magazine.19

4. Regulatory challenges for global insurers of FDIs

Regulatory insurance frameworks remain in large part domestically or regionally focused and have failed to keep up with the increasingly globalized nature of risk management.

The fragmented insurance regulatory landscape leads to significant inconsistencies and regulatory uncertainties. For example, the right (or the obligation) of regulators to supervise insurance transactions is usually tied to the country of the insured exposure. This means that if the insured investment (for example, a manufacturing plant) is located in one country, the regulatory requirements on the insurance for that investment are

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governed by the regulator in the same country as the plant – even if this insurance is provided from a different country.

This so-called ‘risk location rule’ seems simple enough. But it creates ambiguities where professional liability insurance, directors’ and officers’ exposures, or goods and vehicles in transit are involved, rather than just simple property insurance. The difficulty here is that almost every jurisdiction will have a different view, depending on the line of business, as to when and where their particular supervisory competence ‘attaches’ or pertains to the risk.20 While some regulatory laws maintain that the location of the insured risk or exposure is the relevant indicator, other laws may take into consideration the location of particular business dealings or contract negotiations, while still others take as a reference the location where the claim arises and is paid. Similar inconsistencies exist when it comes to different treatment of fiscal and tax requirements between countries.21 Such inconsistencies significantly complicate the design of international insurance programs.

A further complication arises due to the fact that most jurisdictions do not allow ‘non-admitted’ (in other words, ‘non-licensed’) insurance from abroad. Non-admitted insurance is not permitted in approximately 140 jurisdictions globally, according to Zurich’s Multinational Insurance Application (MIA) database, which tracks insurance laws and regulations globally.

Such restrictions on cross-border insurance are typically aimed at protecting individual, rather than corporate policyholders. As individual policyholders are generally not in a position to assess and monitor an insurer’s solvency, supervisors – amongst other things – require insurers to hold capital commensurate with the risks they take on to ensure they can meet future claims payments. To maintain control over insurers in their jurisdiction, supervisors require insurers to hold a license and establish a local presence.

To provide international insurance programs, an insurer must establish an adequate presence in a large number of jurisdictions by forming wholly-owned subsidiaries, branches or other kinds of licensed operations. This considerably increases the cost of such programs.

Ensuring sound policyholder protection is certainly relevant for retail customers. But professional insurance buyers acting on behalf of a multinational company are much better able to assess the soundness and solidity of their insurance provider. This may justify differentiating between policyholder protection standards for retail customers and corporate customers.

This could include allowing a greater degree of openness for providing certain types of cross-border insurance propositions. Even in the case of non-admitted cross-border insurance, the insurance provider is subject to solvency and other requirements in the home country.

Even if non-admitted cross-border insurance is permitted, difficult challenges may still need to be addressed. For example, regulations in some countries allow exposures located within the jurisdiction’s remit to be insured from abroad, but prohibit related services such as risk assessment, claims adjustment and claims payments on a cross-border basis.

This is illustrated by an ‘openness indicator’ for individual countries based on the Zurich MIA database (see Chart 4). The horizontal axis represents the percentage of business scenarios for which non-admitted insurance is permitted in a country. The farther to the right a country is located on the scale, the more open it is to out-of-territory risk coverage providers. The vertical axis indicates a country’s openness to related insurance activities such as risk engineering services, premium invoicing, claims payments, etc. that non-admitted insurers can conduct. Some countries, such as India, appear to be very open, judging by the permission provided to non-admitted insurance. But in practice,
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some of these countries are quite restrictive in terms of the activities that a non-admitted insurer is able to conduct (low value on the vertical axis). For other countries, such as Australia or Vietnam, the opposite is true.

Restrictions placed on related activities can also lead to considerable inefficiencies. One example is tied to severe flooding that occurred in Thailand in 2011. Restrictions on cross-border provision of claims handling and payment resulted in delays in settling claims of 12 to 18 months. Delays may not only trigger additional business interruption losses for the affected companies, but may also hinder recovery and reconstruction, with broader economic implications.

Such restrictions and inconsistencies make designing international insurance programs very complex. They require insurance carriers, insured parties and brokers to carefully assess each jurisdiction’s requirements and pre-agree contractually on how such inconsistencies will be dealt with. This task is further complicated by constant changes in regulations.

Complications not only affect the design of international insurance programs, but also the establishment and management of captive solutions. For example, a number of countries have recently introduced barriers to international re-insurance of these risks, making protection potentially more costly, or ultimately even completely unavailable to domestic policyholders.\(^\text{22}\)

Regulatory trends and requirements that prohibit certain activities increase the costs of insurance coverage and thus pose a major obstacle to FDI and its potential economic benefits. Besides hindering the assessment of a complex regulatory landscape and developing sophisticated insurance solutions, these requirements may also serve as a barrier to competition in domestic insurance markets. This could limit the scope of holistic risk management and increase the cost of insurance coverage.

\(^{22}\) Examples are Argentina and Brazil, but the U.S. has also proposed new restrictions on affiliate reinsurance that would hamper the ability to structure and service international programs.

\(^1\) Permission of non-admitted insurance (horizontal axis) relative to permission for related activities (vertical axis), such as payments of premiums or claims, that non-admitted insurers can conduct.

Source: Zurich Insurance Company Ltd

Chart 4: Openness indicator\(^1\)
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Domestic requirements are often designed with the individual or retail customer’s protection in mind. However, whilst this is undoubtedly an important area of focus, the same regulations are cumbersome to apply in a global corporate insurance environment. Ultimately, they make it more difficult to provide the global insurance coverage demanded by today’s international investors as a prerequisite to significant foreign direct investment.

5. Policy recommendations
This paper highlights the positive influence of FDI in sustainable economic growth and prosperity. It underscores the role of international insurance and captives in enabling FDI. It also identifies the hindering effects of fragmented regulation, not only on corporate investors, but also their insurers.

It follows, therefore, that reducing the regulatory hurdles that insurers face in serving the needs of international investors is likely to produce significant economic benefits. To achieve these benefits, policymakers should consider the following measures:

• Recognize the insurance needs of corporate direct investors. Differentiate more clearly between the needs of retail customers and those of corporate insurance buyers in terms of how national and international regulatory policies are designed and implemented.
• Consider making regulatory frameworks for non-admitted provision of DIL and DIC more open.
• As an international standard setter, the International Association of Insurance Supervisors (IAIS) should consider supporting cross-border investments through:
  − Engaging in a dialogue around regulatory reforms that would help streamline delivery of international insurance and captive reinsurance programs.
  − Having a voice in existing multilateral discussions like the Trade in Services Agreement (TISA) and the Transatlantic Trade and Investment Partnership (TTIP) to support mutual recognition of writers of international programs.
  − Adding language in the Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame) or other international platforms to encourage consistent regulation of international programs and removal of unnecessary barriers.

By taking these measures, regulators and policymakers can make FDI more attractive to corporate investors, increasing the potential for FDI supported by international insurers and captives. Given the positive effects of FDI, this will ultimately be of benefit not only to investors and insurers, but ultimately to governments and the societies they serve.

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