

# Why Has the United States Had Big Insurance Trade Deficits?

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## ABSTRACT

The United States has had significant trade deficits in insurance for several years. This paper examines the reasons for such big annual deficits. A large home market, a low reinsurance capacity, and U.S. insurers' conservative attitude toward foreign markets are identified as the primary contributors to such deficits. The paper also addresses the issue of how U.S. insurers can improve their international competitive position. By expanding their operations abroad particularly in Mexico and Latin America and actively participating in the fast growing Asian markets, American insurers have their greatest chance to accomplish that objective. (JEL F10)

## 1. INTRODUCTION

Insurance is an important service industry in the US and around the world. In year 2005, the total insurance premiums written in the US were more than \$1,000 billions; the total assets of US insurance firms were more than \$5,000 billions. There were about 8,000 insurance firms in the US which employed millions of people.<sup>1</sup>

With the increasing internationalization of the world economies, the international trade in insurance has also been increasing. Foreign insurers have been important participants in the U.S. insurance markets. They provide about twenty five percent of the reinsurance coverage bought in the U.S. and are critically important in offering specific types of coverage. Many American insurance firms are also doing business overseas; some of them have been very active and successful in other countries' insurance markets.<sup>2</sup>

Over the years, however, the United States has experienced big trade deficits in insurance. In 1990, the U.S. total exports in insurance were \$0.57 billion and total imports were \$1.9 billion. In 1995, total exports were 1.4 billion, but total imports were \$4.5 billion.<sup>3</sup> During this 5 year span, the U.S. trade deficit in insurance was more than doubled from \$1.4 billion in 1990 to \$3.1 billion in 1995. This continues an over all trend of increasing negative trade balances evident for more than ten years. The insurance deficit in 1995 accounts for almost 3 percent of the U.S. total trade deficits for that year. In 1985 it measured less than 0.2 percent of the total deficit.<sup>4</sup> Thus, in a span of just ten years, the insurance deficit has increased by about 16 times in magnitude.

Not only does a country's trade deficit in insurance have direct effects on its total trade balance, but it also has indirect effects on its balance of payments. Insurance is a complementary service. Export in insurance will promote exports in other areas such as direct investments, and vice versa. Direct investment in another country by U.S. firms will increase the demand for U.S. insurance exports to the other country because many American investors in that country would like to purchase insurance policies from their own country's insurers doing business there. But the participation of American insurers in the foreign market will make American investors feel safer doing business there and that in turn will further boost their desire for more direct investment in that country which consequently will increase the total investment returns from that country. Such indirect effects of trade in insurance on a country's balance of payments may well overpass the direct effects.

Furthermore, by participating in foreign countries' insurance markets, and thereby diversifying its underwriting risk in the world, an insurance firm will be able to strengthen its competitive capability in its own domestic market. For example, a high percentage of the U.S. reinsurance premiums are ceded to foreign reinsurance firms because many U.S. primary insurers consider these foreign reinsurers as being more risk-diversified. Thus, when American reinsurance firms become more internationalized and more risk-diversified in the world markets, they will become more appealing in the domestic primary insurance market.

Given such importance of the trade in insurance, it is important to ask the following questions: Why does the U.S. have huge trade deficits in insurance? How can the U.S. improve its balance of trade in this respect? and particularly, what strategies should American insurers adopt to open foreign markets? This paper will attempt to address these questions.

## 2. REASONS FOR U.S. LARGE TRADE DEFICITS IN INSURANCE

A study of the trade in insurance since 1980 for the G-7 countries (including Canada, France, Germany, United Kingdom, Italy, Japan, and the United States) reveals that The U.S. has had the largest imports and the biggest deficits. On the other hand, during the same period, Japan has had the largest exports and the biggest trade surpluses. Great Britain is the only other country in the group that has maintained positive trade balances in insurance.<sup>5</sup> Reasons for this U.S. trade pattern in insurance are numerous, but only the most important ones will be discussed below.

### 2.1. LARGE HOME MARKET

One reason frequently mentioned to explain the U.S. insurers' reluctance to venture into foreign markets is their apparent need to be fully focused on their vast home market which is responsible for a significant portion of global insurance premiums. From 1980 to 1985 the U.S. insurance market accounted for 47 percent of the world total premiums.<sup>6</sup> Although the U.S. home market's share of worldwide premiums has decreased in the past ten years (because of the growth in the insurance business that occurred in other countries particularly Japan) it still represents, as Table 1 shows, a sizable percentage of the world's insurance premiums. In 1994, the global insurance premiums were estimated to total \$1.96 trillion, and the U.S. share of that total was about 30 percent. Also, in 1994 the U.S. ranked second behind Japan among the G-7 countries in terms of insurance density, i.e., insurance premiums spent per capita.<sup>7</sup>

**TABLE 1 Market Share of World's Total Insurance Premiums (Percentages)**

Country	1990	1991	1992	1993	1994
USA	35.56	34.42	35.64	31.31	30.20
Canada	2.35	2.39	2.35	1.98	1.74
France	5.48	5.70	5.75	5.27	5.61
Germany	6.82	7.38	7.33	6.44	6.53
U.K.	7.50	8.11	6.98	6.15	5.94
Italy	2.68	2.44	2.10	1.77	1.75
Japan	20.53	21.76	21.84	30.36	30.85

**Source:** Sigma, Swiss Reinsurance Co., various years.

The huge home market not only has occupied domestic firms full attention, but also has attracted the attention of many foreign insurers. The dollar exchange rate against many foreign currencies continues to motivate foreign insurance companies' investments in the U.S. market. Domestic competition has, therefore, been increasing in the U.S. with foreign insurers accounting for a growing percentage of premiums.<sup>8</sup> As a result, many U.S. insurers feel their domestic market provides ample opportunities and threats which require their full range of management skills and financial resources. This situation leads to the U.S. having low exports and high imports in insurance.

## 2.2 CAPACITY RESTRICTION

To varying degrees, several negative factors discourage U.S. insurers from entering new markets. Although the deterrent reasons differ from company to company because of internal strengths and weaknesses, a leading prohibitive factor is the large initial capital outlays required for expanding sales into foreign markets. Any new venture requires capital and adding the element of foreign globalization magnifies many of the initial costs. A great deal of marketing research will be necessary. As a result, advertising, product development, distribution and other marketing costs will increase. Employment costs will constitute a large part of the initial required capital outlays since U.S. insurers will have to hire employees who can speak the appropriate language and train them to operate effectively abroad. Many U.S. companies feel their financial reserves are currently strained and fear changing their capital structure to raise the required finances because of the uncertainty associated with global expansion. Also, there is the possibility that global expansion will lower profits in the short run and, thus, lengthen the payback period for initial investments. This situation may lead to the undesirable possibility of investors linking lower profits with poor management.

## 2.3 LAG OF REINSURANCE

Large domestic demand for reinsurance which can only be partially satisfied by domestic firms contributes significantly to U.S. trade deficit in insurance. Table 2 shows U.S. imports and exports in reinsurance between 1991 and 1994 inclusive and clearly indicates that the U.S. deficit in insurance mainly comes from that resulting from the reinsurance trade. In recent years, Americans have been paying about \$10.5 billions in premiums on average per year to buy reinsurance coverage from foreign companies. The corresponding figure for primary insurance is only about \$1.46 billions.<sup>9</sup>

**TABLE 2 U.S. Imports and Exports in Reinsurance (Million of Dollars)**

Year	Exports	Imports	Deficit
1991	-133	1,486	1,619
1992	278	289	11
1993	609	2,102	1,493
1994	639	1,877	1,238

Source: Survey of Current Business, Bureau of Economic Analysis, U.S., Department of Commerce, September 1995, pp. 94-97.

U.S. insurance companies' share of the reinsurance premium worldwide is quite small in comparison to other countries in Western Europe such as Germany, Switzerland, and the United Kingdom. Companies domiciled in these three countries have traditionally been the largest players in the reinsurance business, and since reinsurance is essential to business, U.S. payments to foreign reinsurers are substantial. The lag of the reinsurance industry in the U.S. and thereby its low share of world market premiums is attributable to the relative infancy of this industry.

Professional reinsurance firms were not formed in the U.S. until the 20th century while in most European countries they were set up more than one hundred years earlier.<sup>10</sup> Many foreign reinsurance firms are doing business in the U.S. because the demand for reinsurance in the U.S. is so large and because domestic U.S. reinsurers lack the capacity to absorb all of this demand. Foreign reinsurance firms are, therefore, major competitors in the American reinsurance market while the competition in the primary insurance market happens mainly among domestic insurers. Another explanation for the degree of foreign reinsurers presence in the U.S. market is that American primary insurers prefer doing business more with foreign reinsurers than with the domestic reinsurers. This biased preference toward foreign reinsurers is related to the idea of risk diversification. Ceding premiums to a foreign reinsurer, rather than to a domestic reinsurer, makes a primary insurer feel safer because the foreign reinsurer has presumably through its world-wide operations a better capability of diversifying its underwriting risk. Thus, although about one third of the largest thirty five reinsurers are domiciled in the U.S., the U.S. share of the global reinsurance premiums is below six percent.<sup>11</sup>

## 2.4 POOR PERFORMANCE OF REINSURERS

As the previous section indicated, because of the many foreign reinsurers' participation and competition in the U.S. reinsurance market, U.S. reinsurers earn a profit rate that is decidedly lower than that earned by U.S. primary insurers, and that in turn discourages growth in the U.S. reinsurance industry.

A study by Chen and Hamwi (2000) shows that on average, the combined ratio after dividends (CRAD) of the US reinsurers is about 132.1%, and it is 110.2 % for the US primary insurers; so it is 21.9% higher of the reinsurers than the primary insurers in terms of the average CRAD. Since the CRAD is the total cost per insurance premium, the US reinsurers are earning much lower profit rates than the primary insurers. Chen and Hamwi's study further tested the significance of such a difference of the CRAD between the reinsurers and primary insurers by controlling all other relevant factors and found that the difference is statistically significant.<sup>12</sup>

## 2.5 FOREIGN DIRECT INVESTMENT (FDI) IN THE US

As mentioned in Section 1, the Introduction, the demand for foreign insurance (i.e. insurance import) by a given country is usually correlated with the amount of the foreign direct investment in that country. For many years the US has attracted the largest FDI in the world; until 2003, China then surpassed the US to become the country that attracted the most FDI.

Table 3 gives the statistics of the FDI in the US over several years. In 1990, the US attracted FDI of \$48,422 millions, it was \$58,772 millions in 1995 and was \$283,376 millions in 1999. Such large FDI in the US will lead to big demand for insurance, particularly demand for foreign insurance imports.

**TABLE 3 Foreign Direct Investment (FDI) in the US (Millions of Dollars)**

Year	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Amount	48,422	22,799	19,222	50,663	45,095	58,772	84,455	103,398	174,434	283,376	314,007

Source: Survey of Current Business, Bureau of Economic Analysis, U.S. Department of Commerce, various years.

## 2.6 TRADE BARRIERS

A firm's attitude toward foreign markets significantly affects its behavior. Japan's export-oriented strategy in commercial goods has greatly contributed to its success in foreign markets competition. It is fair to say that most U.S. insurers and reinsurers are very conservative in their outlook toward foreign markets. Perhaps, only five U.S. companies could fairly be considered to be truly international with significant foreign-earned premium income.

Culture and geographical location are cited sometimes as factors affecting international trade in insurance, but these factors can not fully explain the U.S. deficit in that trade. For instance, the geographic advantages may explain why Americans firms prefer doing business in Canada and Mexico, but they can not explain why many European insurers are operating in the U.S. Cultural or political factors could explain why many European insurers prefer doing business in the U.S., but they can not explain why the U.S. insurers have not had the same preference toward Europe.

However, trade barriers can to some extent explain the negative U.S. insurance trade balance, particularly throughout the Asian landmass. Though they differ from one country to another, these barriers usually include things such as restricting access to reinsurance, refusing to grant licenses, restrictions on foreign investment, and inequitable tax treatment.<sup>13</sup> These protectionist measures have undoubtedly discouraged U.S. insurers from participation in these countries' insurance markets. Many Asian countries like India, China and Japan still limit foreign insurance penetration although they have been more open recently.

## 3. THE OUTLOOK

The primary factors leading to U.S. having a large trade deficit in insurance include a large home market, the lag in reinsurance, and U.S. insurers' conservative attitude toward foreign markets. Heretofore the U.S. market has been so large, familiar, and profitable, and trade barriers abroad thought to be onerous that U.S. companies simply stayed home. This is only now beginning to change. NAFTA will further open insurance markets, particularly in Mexico, which was previously closed except for joint ventures. Latin America and much of Eastern Europe have significantly relaxed restrictions on foreign insurers' entry to their countries. As these societies develop economically, increased industrialization and the resulting growth in private and commercial affluence will certainly lead to a growing need for insurance. Also, the EU with its recent insurance directives (specifically the 1992 Third Non-life Insurance Directive) is making it easier and more attractive for foreign insurers to service that area. The EU has a number of unsaturated markets growing at above-average rates, which provide U.S. insurers, especially in certain underwriting areas, more opportunities and more spread of risk than the saturated American market.<sup>14</sup> More importantly, many Asian countries have opened their insurance markets recently.

### 3.1 China's Insurance Markets

The slow opening of China's insurance industry will also offer exciting new opportunities. In terms of its population size and the recent annual growth rate in its GNP, China's insurance market has one of the largest potential for growth.<sup>15</sup> To illustrate this, one can point to the extremely fast growth of Chinese insurance companies. As an example, Ping An Insurance Ltd. Inc., the first stock-publicly-traded company in China, was established in 1988; within 13 years, its total assets have increased by 1,000 times, and its insurance revenues have increased by 5,000 times. It has now more than 15 million costumers.<sup>16</sup>

**TABLE 4 China Insurance Premiums (units=RMB thousands; 1\$ is about 8 units of RMB)**

Year	1999	2000	2001	2002	2003
Property & Casualty	5,211,215	5,983,900	6,853,912	7,782,974	7,875,271
Life	8,720,964	9,974,677	14,239,630	22,748,416	27,432,561
Total Premiums	13,932,179	15,958,577	21,093,543	30,531,391	35,307,833

Source: [www.circ.gov.cn](http://www.circ.gov.cn)

Table 4 gives the statistics of China's insurance premiums from 1999 through 2003. In 5 years, its total premiums were almost tripled.

The China Insurance Regulatory Commission (CIRC) has made great progress on its liberalization program. In 2004, it announced new rules for the opening of extra branches in China that will reduce paid-in capital and double the stake that local and foreign investors may purchase in Chinese insurers to 20 percent. The CIRC has also changed regulation that now allows the formation of insurance asset management companies and removed geographical and product restrictions on the existing foreign insurance companies and their joint venture partners. Under the new rules, foreigners will be able to sell group insurance and to apply to operate in any city in the country. As a result, many foreign insurance companies are entering and expanding their businesses in China, including the North America-based insurers AIG, Manulife, MetLife, New York Life, Principal Financial, and Sun Life.<sup>17</sup>

### 3.2. South Korean's Insurance Markets

South Korea has opened its insurance markets since 1996. In 1998, foreign life insurers held only one percent of the South Korean's market share. That share grew to eight percent in 2001, to 10.5 percent in 2002, and to 30 percent in 2003, according to the Financial Supervisory Committee (FSC) of South Korea. Among the North American life insurers active in South Korea are AIG, MetLife, New York Life, and Prudential Financial.

### 3.3. Japan's Insurance Markets

Japan has also been opening its insurance markets to foreigners. In 2004, foreign life insurers' market share in Japan reached 25%. There are 15 big foreign life insurance companies actively doing business in Japan, including AIG and Prudential Life Insurance Co. from the US.<sup>18</sup>

Also, the high economic growth experienced by other developing Asian countries such as India, Philippines, Singapore, and Malaysia will certainly increase insurance sale opportunities for both domestic and outside companies including U.S. insurers.<sup>19</sup>

**TABLE 5 Insurance Density\* and Penetration\*\* of Certain Economic Organizations and Selected Countries (1994)**

Organization	Density	Penetration
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or Country	(US Dollars)	(%)
OECD	1877	8.87
EU	1414	7.38
G7	2457	9.40
NAFTA	1657	8.07
Non-OECD	41	3.34
ASEAN 1	34	2.44
USA	2280	8.57
Canada	1168	6.22
Mexico	65	1.61
Brazil	74	2.13
Hungary	85	2.25
Poland	47	1.96
Malaysia	145	4.65
Philippines	14	1.49
PR China	4	6.97

<sup>1</sup>Thailand, Malaysia, Singapore, Indonesia, Philippines; \*Premiums per capita in 1994; \*\*Premiums as a % of GDP in 1994; Source: Sigma, Swiss Reinsurance Co., No. 4, 1996, pp. 34-36.

From the prospect of U.S. insurers, the trend of worldwide premium growth lies outside the U.S. borders. In most countries, per capita insurance premium is lower than it is in the U.S. and they have relatively low insurance penetration in comparison to their GDP growth. This, as Table 5 shows, is particularly true for countries in Latin America, Eastern Europe, and South-East Asia. As countries in these regions develop and mature economically they will represent the most promising immediate markets for U.S. insurers. Increase in insurance consumption has always been linked to increasing GDP.

As mentioned before, an increase in U.S. direct investment abroad will tend to increase the demand for insurance coverage sold by U.S. insurers. U.S. direct investment in other countries has been going up for many years and it tripled in size over the last ten years, when it rose from \$238 billion in 1985 to more than \$711 billion in 1995. The largest percentage increase occurred in Latin America and the Asia-Pacific countries. This percentage went from about 13% in 1982 to little over 17% in 1995.<sup>8</sup> U.S. insurers should take full advantage of the increase in sale opportunities that this situation presents. By being more active in foreign markets, U.S. insurers will benefit by diversifying their underwriting risk worldwide, by improving their competitiveness, by expanding their capacity, and thereby stabilizing their revenues.

**TABLE 6 U.S. Direct Investment Abroad in Manufacturing (Millions of Dollars)**

Year	1990	1991	1992	1993	1994	1995
<b>Amount</b>	170,164	179,230	186,285	194,336	220,328	257,589

Source: Survey of Current Business, Bureau of Economic Analysis, U.S.

Department of Commerce, August 1995, p. 115 and September 1996, p. 126.

One development that will negatively affect the US insurance trade balance is the mergers and acquisitions of foreign insurance companies in the US. As discussed before, the US has a huge domestic insurance market that is very attractive to foreigners. The US also has no substantial trade barriers for foreign insurers to enter its market. As a result, many foreign insurers come to the US using mergers and acquisitions.

The number of foreign-owned life insurers in 1988 in the US was 113 that was 7.8 percent of the total number of life insurers operating in the country. That number peaked in 2001 at 142 foreign-owned life insurers that was 11.6 percent of the total US life insurers. In 2003, Canada's Manulife Financial acquired U.S. insurer John Hancock. Through this merger, Manulife's market capitalization reaches US\$ 24 billion, making it comparable in size to MetLife and larger than Prudential Financial. The deal also makes Manulife to be the largest life insurer in Canada, the second-largest in North America, and the fifth-largest in the world.<sup>19</sup>

#### 4. CONCLUSION

Due to the magnitude and openness of the U.S. insurance market, U.S. insurance imports will remain to be large for the foreseeable future and, thus, improvement in the U.S. balance of trade in insurance must come from increasing insurance exports. Actually, there is no reason to limit U.S. imports in insurance because the country benefits from foreign insurers participation in its market. Such participation lowers insurance premiums and provides certain coverage that is critically needed in the U.S. market, but which is in short supply by domestic insurers.

As they search for growth and profit in overseas markets, American insurers clearly will face unfamiliar and unforeseen obstacles. They, however, must be firmly convinced of the wisdom of expansion overseas and the financial returns it will bring in the long run. It remains to be seen if in fact U.S. carriers will accept the challenge of becoming major players in the international insurance market by expanding their operations. If they do, one could look for declining deficit in the U.S. insurance trade.

#### ENDNOTES

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