Mexico

NAFTA has brought in substantial changes in the insurance business in Mexico

Radical change boosts Mexico

Developments in the Mexican insurance market has implications for American insurers, as Tapen Sinha explains

Two years ago, Mexico became the second largest trading partner of the United States (after Canada) with a total trade of $157 billion. The US exported $71 billion, and imported $86 billion. For Mexico, the US is becoming even more important, with 80% of its trade with its super power neighbour.

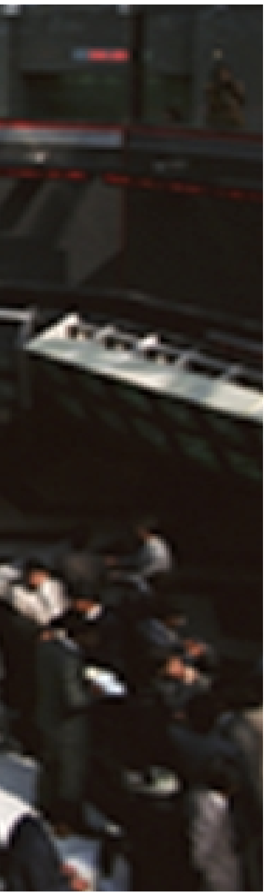
Why did such extraordinary growth in trade take place? Part of the answer lies in the formation of the North American Free Trade Area (NAFTA), and in part to a large devaluation of the Mexican currency in 1995.

For both exports and imports, much of the trade is not of final products but of intermediate goods. For example, car parts are made in Mexico and then sent to the US to be installed in cars. The main reason for such trade is low production cost of certain goods in Mexico. These facts have important implications for risk managers of American companies.

Consider a textile and apparel manufacturing company in the US with production facilities in Mexico. There are several important natural risks that a plant or a manufacturing facility in Mexico will face: earthquakes (central and southern parts of the country), tsunamis (Pacific coasts) and hurricanes (Gulf and Caribbean coasts).

Unfortunately, building codes that are commonplace in the US can be non-existent in Mexico. Storage of flammable material can produce another problem. In the US, most manufacturers rely on automatic sprinkler systems in such cases. But, in most parts of Mexico, water is fairly scarce. Even when it is available, the water pressure is typically insufficient to put out fires of industrial strength.

In 1997, the size of the insurance market in Mexico was



about $5 billion of direct premium written with a real growth rate of 15%-20% per year.

The single largest growth area in the last decade has been health insurance.

Mexico has a national health care system (IMSS). In theory, it covers every worker in the "formal" sector. Mexico also has a large "informal" sector, with 30%-40% of all the economically active population working in the informal sector.

However, the medical service from the IMSS has been very poor. This has led many businesses to set up their own private health insurance plan for their workers.

A recent survey by Brockman and Schuh showed that more than 90% of all large and medium-sized businesses have their own health insurance plans. Many of these plans have their own designated private hospitals. Almost all "maquiladoras" (foreign companies operating in Mexico solely for the purpose of exporting) have their own benefit plans.

In addition, in 1995, the IMSS law was modified in a significant way: private providers of health insurance are now allowed to operate alongside the state-run system.

Private hospitals in Mexico are now offering a package of medical services for a fixed annual fee, with routine care to be provided by the IMSS. Many health care service providers in Mexico expect that this process will create something like US-style Health Maintenance Organisations.

The hospital-run annual medical service package providers will soon transform into, or be replaced by, private health insurance companies.

There were at least three distinct impetuses for deregulation in the last decade. In 1988, the Mexican Federal Government initiated a set of (mostly internal) deregulation processes. As a result, in 1990, a new Law of Insurance was passed.

This law introduced both a new solvency requirement for the insurance companies and a new regime of investments by the insurance companies. In 1992, with NAFTA, a second wave of opening up of the insurance sector (mostly for the American and Canadian companies) took place.

With Mexico joining the Organisation for Economic Co-operation and Development, a third wave came in 1994. At the end of 1990, there were 44 insurance companies operating in Mexico. By the end of 1996, six had merged with others. More than half of them changed their names to reflect either acquisition or merger or joint ownership with foreign partners.

NAFTA has brought in substantial changes in the insurance business in Mexico. The Rules for Establishing Affiliates of Foreign Financial Institutions was adopted by Mexico's Secretariat of the Treasury and Public Credit in April 1994 (the "Rules").

The Rules establish the conditions for the incorporation and operation of an "affiliate" of a "foreign financial institution" in Mexico as a subsidiary of an American/Canadian insurer, and the acquisition of over 50% of the stock of an existing Mexican insurance company.

An "affiliate" is defined as the Mexican corporation "with majority participation in its capital by a Foreign Financial Institution or an Affiliate Holding Company" that is authorised to organise and operate under the General Law of Mutual Insurance Corporations and Institutions.

An "Affiliate Holding Corporation" is a Mexican corporation authorised to incorporate and operate as a holding company under the Law to Regulate Financial Groups, and which is majority-owned by a foreign financial institution.

Table 1: Market share by type of insurance

	1986	1991	1995	1996	1997
Life	28.99	35.57	33.80	34.50	35.20
Accident and Health	2.36	8.40	8.81	9.80	9.87
Property and Casualty	68.65	56.03	57.34	58.22	51.73

Source: Anurio Estadistico de Seguros, various years (Comision Nacional de Seguros y Fianzas) and EstadisticAmis, 1997

POTENTIAL GROWTH AREAS

The Rules are administered by the Secretariat of the Treasury and Public Credit (the "Secretariat") and the Financial Liberalisation Committee.

These rules have recently been extended to companies originating in Chile. There is some discussion about extending them for companies from Argentina as well.

Not surprisingly, many American companies have already firmly established in Mexico. This process is likely to accelerate at the turn of the century, with further stipulated relaxation of regulations of foreign holdings by NAFTA countries.

The National Trade and Development Board, an arm of the US Government, which advises US companies about potential growth areas in foreign countries, has identified four areas in which the insurance industry in Mexico is likely to grow over the next several decades: health insurance, annuities, workers compensation and business insurance of small and medium enterprises.

The expected growth in health insurance was discussed above. On annuities, with the new laws for compulsory retirement saving, the new (compulsory) individual retirement accounts will grow. This will inject large funds into the insurance industry. The old system of retirement is mainly a US-style pay-as-you-go scheme. But, from July 1997, new entrants into the workforce are not being allowed into the old scheme any more. They will be enrolling into the new compulsory, but privatised schemes. At present, there are 17 companies operating in this market. Many of these companies have foreign affiliates, mainly from the US, but one is from Chile.

Worker's compensation is another potentially big market that has not grown because laws were not in place to protect workers in the workplace. However, with the new NAFTA laws, at least in the organised sector, this will become a larger market over the next few years.

For business insurance, more than 90% of small and medium-sized enterprises do not have any insurance, but they are growing in Mexico. However, the owners of these enterprises have not yet understood the benefits of business insurance. With education, the situation will slowly change.

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Securitisation