# The Mexican Insurance Sector under the Shadow of the North American Free Trade Agreement (NAFTA)†

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## Summary

Mexico, like the other countries in this international insurance symposium, is undergoing tumultuous growth and change. Centrally administered supply of insurance is giving way to privatization and globalization of insurance suppliers. As shown here, NAFTA presents special demands on Mexican insurance to become better integrated with the two well-developed private sector insurance systems in the United States and Canada. Privatization and modern regulatory systems are reviewed. The paper shows that the number of insurers and the sophistication of their products are responding to the needs of integrated North American trade and commerce.

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# Introduction

In the past decade, Mexico has seen remarkable changes in its regulatory environment both with respect to domestic deregulation and foreign participation in the financial sector. After the so-called "lost decade" of the 1980s, where Mexicans witnessed a substantial reduction in personal income, the government undertook a series of policy changes. The changes took the form of domestic deregulation, decentralization of power, trade agreements with other nations and attempts to enforce the law. These changes took place (and are still taking place) under three successive presidents: Carlos Salinas during 1988–94, Ernesto Zedillo during 1994–2000, and currently under Vicente Fox.

During 1991–92, Mexico privatized and deregulated the banking sector. This action turned out to be a mixed blessing. First, bank lending increased dramatically. But, the 1995 crisis saw a collapse of the banking sector leaving a bad loan problem of the banking sector of approximately $100 billion. This represents some 25 percent of the Gross Domestic Product in Mexico. In comparison, the savings and loans crisis in the United States in the 1980s represented less than 5 percent of the United States' Gross Domestic Product.

The weakness of domestic banks and the prospect of future growth have created an opportunity for foreign financial institutions. The three largest banks in Mexico are controlled by foreign financial institutions. Citigroup has bought the largest bank, Banamex. Spanish bank Banco Bilbao Vizcaya has bought the second largest bank, Bancomer. The third largest, Serfin, is in the hands of Spanish bank Banco Santander Central Hispano. Mexico has become the *only* country in the world, where more than 70 percent of bank capital is under the control of foreign financial institutions.

The importance of banks may not be immediately clear to the reader from the United States. In Mexico, like many countries in continental Europe, banks are the big conduits of sales of insurance policies. More than 50 percent of automobile policies are sold through banks. Life insurance policies are routinely sold when customers come for home loans. Banamex and Bancomer, the two largest banks, also manage the two largest newly privatized pension funds in Mexico. Bancassurance is a reality in Mexico. This success is due to legislative changes that allowed financial groups (grupos financieros) to own companies in banking, insurance and securities in the early 1990s. Depending on how the Gramm-Leach-Blily Act of 1999 is played out in the United States, a similar scenario might emerge there in the next decade (see, Condon, Sinha, and Sadka, 2001).

In this paper, we present on overview of the structure of the Mexican insurance market and the infrastructure available to support market growth within a market-drive framework. The main thrust of the paper is to discuss trade agreements and their impact on the insurance sector in Mexico.

## NAFTA and Financial Services

On January 1, 1994, the first phase of the North American Free Trade Agreement (NAFTA) came into effect. NAFTA has ensured (almost) free flow of goods between the three countries. It also began to open the financial services sector for all three countries (United State, Canada and Mexico). NAFTA provisions for goods were very different from the provisions for services. Thus, there is an ample scope for regulatory problems under NAFTA. Insurance provisions under NAFTA will severely test regulators in all the three countries. To understand the role NAFTA plays, we have to take a closer look at the provisions of NAFTA that affect the financial sector.

### *NAFTA—Scope and Operation of Chapter 14*

NAFTA Chapter 14 restricts the kinds of measures that governments in one NAFTA country can employ to regulate investments and activities of insurance companies from another NAFTA country, in addition to cross-border trade in insurance services. Financial services are broadly defined to include any "service of a financial matter, including insurance, and a service incidental or auxiliary to a service of a financial nature." NAFTA obligations apply primarily to the federal governments of Canada, Mexico and the United States. However, the federal governments are required to take all measures necessary to ensure the NAFTA provisions are observed by state and provincial governments.

Chapter 14 sets out the general principles that apply to national regulations, general exceptions regarding government social programs and prudential exceptions required for the protection of consumers or the financial system. In addition, each country has set out a series of specific exceptions—regarding specific laws or sectors—to the application of the general principles. This latter type of exception—referred to as reservations—are set out in annexes to Chapter 14 of NAFTA. All insurance regulations must either comply with the general principles, qualify as prudential exceptions, or be listed as reservations in the annexes.

The use of a "negative list" of reservations—listing specific measures that will not comply with the general rules—serves two key functions. First, it prevents the governments from creating future restrictions that violate the general rules, except where such restrictions qualify under the general exceptions or prudential exceptions. This limits the circumstances under which governments may create further restrictions on the sale of insurance. Second, the listing of non-conforming measures makes them easier to identify, simplifying future negotiations to eliminate them.

The NAFTA thus encourages innovation by providing insurance firms with an incentive to create new services that are not restricted by the negative list. The NAFTA clarifies that this is the case by specifically prohibiting governments from discriminating against firms from the other members in the provision of new types of financial services.

With respect to foreign investment in the insurance sector, NAFTA Chapter 14 incorporates a number of provisions from NAFTA Chapter 11. A broad array of investments, such as mergers, acquisitions or the establishment of foreign subsidiaries among Canadian, Mexican and United States insurance firms, are thus protected by the rules of Chapter 11.

## *Country Specific Issues: Reservations*

The NAFTA countries are permitted to maintain existing laws that do not conform to their obligations under the agreement, provided such laws are listed as reservations in annexes attached to the agreement. In the case of Canada and the United States, this includes reservations for measures maintained by provincial and state governments.

Reservations for federal measures are very limited for Canada and the United States. Mexico has more extensive reservations for federal measures, but none for state measures. The Mexican reservations focus on foreign investment limits and restrict the cross-border supply of insurance services. The reservations of each country with respect to insurance are discussed below.

**Canada: Federal measures.** Canada's reservations are very limited. There is only one reservation on cross-border trade and one narrow reservation related to foreign investment requirements. With respect to cross-border trade, the purchase of reinsurance services by a Canadian insurer from a non-resident reinsurer is limited to no more than 25 percent of the risks undertaken, unless the purchaser is a life insurer or a reinsurer. There is no expiry date for this reservation.

Canada has restrictions that limit foreign ownership of Canadian-controlled financial institutions, and restrictions on total domestic assets of foreign bank subsidiaries in Canada. In order to prevent non-NAFTA companies from avoiding these restrictions by incorporating in Canada, Canada reserved the right to require that a company from NAFTA member be controlled by one or more residents of that country in order to be entitled to the benefits of Chapter 14. Mexican companies have the same rights as United States companies in this regard.

**United States: Federal measures.** The United States reservations are even shorter than Canada's. There is only one. Branches of foreign insurance companies are not permitted to provide surety bonds for United States Government contracts.

**Canada's Provincial and United States' State Measures.** The reason why Canada and the United States have so few reservations for federal measures is that most of the restrictions exist at the state and provincial level. Under NAFTA Annex 1409.1, Canada and the United States submitted lengthy lists of existing provincial and state measures that do not conform to the obligations contained in NAFTA. NAFTA members have a general obligation to ensure that all necessary measures are taken to secure the "observance" of NAFTA provisions by state and provincial governments, except where specific NAFTA provisions state otherwise. However, constitutional law in Canada and the United States limits the ability of the federal governments to enforce compliance by provincial and state governments.

It may not be necessary for many state and provincial restrictions to be listed as reservations. NAFTA Chapter 14 contains many "loopholes" into which they may fit. With respect to market access through cross-border trade (i.e., by any means other than foreign investment), NAFTA members are not required to permit insurance companies from the other NAFTA countries to "do business or solicit in its territory". Moreover, each NAFTA member is free to adopt its own definition of what "doing business" or "solicitation" means, as long as they do not restrict activities that were permitted on January 1, 1994. In addition, they are entitled to require the registration of cross-border suppliers of insurance services as well as financial instruments. Those restrictions that do not fit into these narrow loopholes may still qualify as prudential exceptions.

Chapter 14 also contains detailed rules on how national treatment applies to state and provincial measures. Under these rules, if a state discriminates against out-of-state insurance companies from the same country, they must treat insurance companies from the NAFTA countries no less favorably.

**Mexico.** Foreign investment in Mexican insurance companies was subject to a transition period that ended January 1, 2000, during which time there were limits placed on authorized capital and common voting stock. As of January 1, 2000, these limits were removed, permitting insurance companies from Canada and the United States to own 100 percent of Mexican insurance companies, whether by acquisition or by establishment of wholly-owned subsidiaries. NAFTA insurance companies that owned 10 percent or more of a Mexican insurer as of July 1, 1992 were allowed to own 100 percent as of January 1, 1996.

## The Insurance Sector in Mexico

Compared with the United States and Canada, Mexico (still) has a small insurance market (Table 1). The United States has a population base 3 times higher than Mexico. There are 98 million Mexicans residing in Mexico. But, the size of the insurance market in the United States is 100 times as large. The market in Mexico is roughly comparable to that of the insurance markets of Iowa or Kansas.

In terms of the density of insurance and that of market penetration, it is also very small (see Table 2). However, there are two important elements that point to explosive future growth. First, with rising incomes, the Mexican insurance market is set to expand rapidly over the next decades. Second, according to the 2000 Census of the United States, 12 percent of Americans are of Hispanic origin and at least 65 percent of them are of Mexican origin. By 2010, the United States will be the second largest Spanish speaking country in the world—with 43 million native Spanish speakers—second only to Mexico. Not surprisingly, this fact has not gone unnoticed by the Mexican financial industry. The second largest Mexican financial conglomerate, BBVA-Bancomer is planning to open 600 branches in the areas in the United States heavily populated by the persons of Hispanic origin (*Houston Chronicle*, June 17, 2000).

TABLE 1
Direct Premiums (in Millions of US$) 1999

| NAFTA | |
|---|---|
| United States | $795,188 |
| Canada | $41,882 |
| Mexico | $8,099 |
| Total | $845,169 |

Source: Sigma January 2001.

TABLE 2
Insurance Market Share, Density and Premiums

| Item | Mexico | US | Canada | NAFTA |
|---|---|---|---|---|
| Share of World | 0.35 | 34.22 | 1.80 | 36.37 |
| Insurance Density (US$) | 84.60 | 2921.10 | 1375.30 | 2121.10 |
| Insurance Penetration (%) | 1.52 | 8.65 | 12.09 | 8.11 |

Note: Insurance Density (premiums per capita) is the premiums written divided by total population. Insurance penetration (premiums as a share of GDP) measures the significance of the insurance industry relative to the country's entire economic production. Life Insurance penetration typically increases in line with personal income.

Source: Sigma, January 1999.

## A Taste of the Future

The dramatic change in the Mexican insurance business can be illustrated by facts set out in Table 3. There are three clear trends:

1. The involvement of the government in the insurance sector is declining. Even though in 1990 there were three government-owned insurers, the amount of business they conducted was very high. Today, there are two. One of them, Seguros Hidalgo, will be privatized soon (in 2002).

2. The involvement of financial groups in the insurance sector has grown dramatically. Through this channel, banks have made inroads into the insurance business in Mexico.

3. The number of companies operating in the Mexican insurance market has grown tremendously. Before 1994, there was no foreign affiliation of any insurance company operating in Mexico. Now, nearly half of them are affiliates of foreign companies.

The largest insurance company in Mexico (Seguros Comercial America) is now a subsidiary of the international giant, ING. The fourth largest company (Monterrey) is owned by New York Life.

TABLE 3
Number and Types of Insurance Companies in Mexico (1990–1999)

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 |
|---|---|---|---|---|---|---|---|---|---|---|
| National | 3 | 3 | 3 | 2 | 2 | 2 | 2 | 2 | 2 | 2 |
| Private | 36 | 36 | 36 | 38 | 41 | 49 | 54 | 62 | 60 | 60 |
| Mutual | 2 | 2 | 2 | 2 | 3 | 3 | 3 | 3 | 3 | 3 |
| Reinsurers | 2 | 2 | 2 | 2 | 2 | 2 | 2 | 3 | 3 | 3 |
| Total | 43 | 43 | 44 | 44 | 48 | 56 | 61 | 70 | 68 | 68 |
| Affiliates (with foreign companies) | 0 | 0 | 0 | 0 | 1 | 13 | 18 | 23 | 26 | 28 |
| Financial Groups | 0 | 7 | 10 | 10 | 13 | 14 | 13 | 17 | 18 | 18 |

Source: Comisión Nacional de Seguros y Fianzas, Annual Reports, various years.

Many smaller insurance companies operated in Mexico are also foreign-owned or controlled.

Another way of seeing the change is to see how the composition of the insurance business in Mexico has changed. Table 4 shows that non-life insurance was the most important component of the insurance business in Mexico in 1990. The main non-life insurance business in Mexico was (and still is) auto insurance. The picture did not change much by 1995. However, between 1995 and 2000, there has been a tremendous growth in the life/pension business in Mexico. The main area of growth has been in the pensions market. The reason behind this phenomenal change is the privatization of pensions in Mexico.

## The Role of the Government

Among the 18 Spanish speaking Latin American countries, 8 have federal supervisory bodies specifically set up for regulating insurance markets. Mexico is one of them. The supervisory body is called Comisión Nacional de Seguros y Fianzas or the CNSF. The CNSF grants license to an insurance company.

The structure allowed takes the form of an "anonymous society" (sociedad anónima—similar to a corporation). Curiously, Mexico does not require a "fit and proper" clause for persons setting up an insurance company. Mexico requires the use of Generally Accepted Accounting Standards (GAAP) as the insurance accounting principle. The CNSF has the reporting requirements of "annual return, complemented by quarterly return." Only the annual return is generally audited. The solvency margin is determined by the Assets Counted

TABLE 4
Composition of Insurance Business in Mexico

| Year | 1990 | 1995 | 2000 |
|---|---|---|---|
| Life/Pension | 36% | 34% | 55% |
| Accident/Health | 7% | 9% | 9% |
| Non-life | 57% | 57% | 36% |

Source: Association of Mexican Insurers Yearbook (various years).

Towards Minimum Guarantee Capital (ACTMGC) minus the Minimum Guarantee Capital (MGC) required. The ACTMGC correspond to the assets capable of covering the MGC required. The MGC is equal to the Gross Solvency Requirement (GSR) minus deductions. Deductions are determined (mainly) by the balances of the equalization reserve and the catastrophic risk reserve. The GSR is equal to the capital required for probable deviations in the retained losses and/or adverse fluctuations in the price of those assets in which the technical reserves are invested. Investment regime restrictions also exist: at least 40 percent of total assets have to be invested in government securities. In fact, in 1999, more than 50 percent was invested in (short-term) government bonds. Investment in foreign currency is allowed only to the extent the policies are written in foreign currencies (almost exclusively in US dollars).

A federal government decree in 1998 stated that all government assets have to have 100 percent insurance coverage regardless of the size of the risk. Therefore, at least in theory, there is coverage for everything. Most of these policies were (until 2001) the exclusive domain of the government-owned insurance companies. Now only the insurance of police and armed forces assets are still insured by the government owned insurance companies. The rest are contracted out.

Until the 1996 law of insurance provision came into existence, the government played a big role in insuring social risk, such as social security including mandatory national health insurance. But, the government has stayed away from non-life insurance business. It even stayed away from introducing compulsory insurance for such things as third party compulsory auto insurance.

Self-insurance is not common in Mexico with the exception of very large companies, such as government-owned monopoly petroleum company (Pemex) or large multinational manufacturers, such as Volkswagen.

In Mexico, there is no requirement by the CNSF to have an actuary in any capacity with the exception of certification of ratemaking. Moreover, a person can become an "actuary" simply by obtaining a bachelor's degree in actuarial science from a program recognized by the Education Department.

In contrast, it is obligatory to have an appointed auditor. The auditor is required to have a recognized university degree in accounting with five years experience. In addition, the auditor has to pass an examination conducted by the CNSF.

## Privatization of Insurance

Large sectors of the Mexican economy have moved from centrally administered and funded services to competitive private insurance.

### *Pensions*

On July 1, 1997, Mexico went from a pay-as-you-go government run social security system to a publicly mandated but privately run system. Within this system, private companies called Administradoras de Fondos de Retiro (AFORE) manage pension funds for workers who joined the labor force on or after July 1, 1997. Each worker chooses an AFORE to receive the 6.5 percent of wages paid by his/her employer. The government contributes another 5.5 percent of the indexed minimum salary on behalf of each worker. Funds are generated by accumulation of contributions by the individual and by the yield from investment by the AFORE. Thus, the contribution and the performance of the fund determine each person's pension benefit.

This individual pension scheme contrasts sharply with the existing pay-as-you-go plan administered by Instituto Mexicano del Seguro Social (IMSS), a division of the Mexican government. Upon retirement, workers already participating in the IMSS before July 1, 1997, can choose to collect their benefits according to either the old system or the new accumulated funds system, whichever is larger (for more details, see Sinha, 2000).

### *Workers' Compensation*

In 1997, the Federal Government introduced a number of changes in the Social Security Law (Nueva Ley de Seguro Social). One such area was the calculation of premium for covering workers for accidents and injury at the workplace. Under the old system, each industry had a classification. Thus, the premium depended solely on the industry a company belonged to. It did not depend on the frequency of accidents. Thus, workplace safety was not high on the list of companies. The new system has an "experience rating" component.

Thus, previous history of accidents matters for future premium charged (Instituto Mexicano del Seguro Social, 1996). Despite the shift to price signals, this sector remains centrally administered and financed.

### *Auto Insurance*

In 1991, Mexico City passed a law making third party auto liability compulsory. However, the local government only began stricter enforcement in 2001. Several other large cities will join the ranks of Mexico City very soon. Consequently, the demand for auto insurance has grown 15 percent per year over the past five years.

Until recently, 15 percent of all cars in Mexico were imported from the United States. The government did not allow them to be registered. Thus, these cars were not covered by any kind of insurance policy. Only recently (July 2001), the Federal Government allowed these cars to be registered with Mexican license plates. Within this rising demand for insurance, the number of Mexican auto insurers is growing. Though United States insurers, under their domestic corporate forms, cannot directly insure in Mexico, affiliates of United States insurers, such as AIG and Allstate, are active there.

## There is a Fly in My Soup: Mexico's Free Trade Agreement with the European Union

Mexico entered into a free trade agreement with the European Union that took effect July 1, 2001. Mexico has also signed bilateral investment treaties with 13 of the 15 European Union countries. Taken together, these agreements impose obligations similar to the NAFTA. Many European companies are contemplating the possibility of using Mexico as a diving board to plunge into the other two NAFTA countries. This will increase competition for insurance companies in the United States and Canada. Mexico has opened its insurance market to the Europeans and they will be entitled to the same treatment as a North American company once established in Mexico.

# Conclusion

Domestic regulatory reform in Mexico, together with free trade agreements with North America, Europe and Latin America, will likely make Mexico a transatlantic hub for trade and investment. The Mexican insurance sector is relatively well positioned with modern regulatory and private sector resources. Economic activity and incomes are likely to increase rapidly in Mexico, making the country an increasingly attractive insurance market. However, it will probably lead to fierce competition between European and North American firms for a slice of the Mexican pie.

# References

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