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Effective Governmental Intervention into Insurance Market - Macro Economic Perspective

○ Tao YE, Muneta YOKOMATSU, Norio OKADA

The incompetence of insurance industry in coping with natural disaster risk has resulted in wide concern of public-private partnership in the financial management of disaster risk. It is suggested that government should use policy tools as well as fiscal instruments to intervene into the private disaster insurance market. In the past years, several national programs have been developed either in the form of public insurance or government-sponsored private insurance, e.g. NFIP (National Flood Insurance Program, USA), and TCIP (Turkish Catastrophic Insurance Pool). Although these national programs have been highlighted as exemplars, their flaws and unintended adverse consequences have recently been recognized (Gurenko, 2007). The over-subsidized rates could make the price distorted from the true cost of risk and increase the demand as well as the exposure considerably. Another consequence would be the reduced incentives of agents to invest in mitigation measures because of the heavily and indiscriminately subsidized premium rates.

In order to alleviate the huge stress of disasters on agriculture and farmers, the Chinese government initialized the China Agriculture Policy Insurance Program (CAPIP) in 2007. This program is a typical government sponsored private insurance program in which central and local governments are obligated to pay a certain percentage of the premium for farmers. This program is still under its experimental stage and specific rates of subsidy differ from province to province. Generally, governments would pay 50% of the premium for the famers if they purchase coverage from 6 domestic private insurers. Foreign insurers are excluded from this program.

As a newly launched government-sponsored insurance program, the CAPIP would inevitably have a series of positive or negative consequences in disaster insurance industry. 1) How is the impact of government intervention on the premium outflow? 2) Does domestic insurer have any incentive of over-pricing the insurance coverage? 3) Will foreign insurers be even forced to retreat from the market? In order to answer the questions above, a model is developed based on a small open economy. Agents face disaster risk and could probably lose some of their products. They have access to two insurance products, one from domestic insurer and the other from foreign insurer. We presume that the foreign insurer could diversify its risk internationally and therefore offers disaster insurance at a lower premium rate. The government operates disaster reserve fund from tax revenue and has access to international financial service. It uses the liquid fund in the reserve to subsidize agents in premium at a certain rate. By introducing the optimum government subsidizing strategy, one could check how the market is the intervened and how the behaviors of agents, domestic insurer and foreign insurer are affected.