INTERNATIONAL JOURNAL OF BUSINESS, 3(1), 1998 ISSN:1083-4346

Towards A Single European Insurance Market

Thomas Hess and Thomas Trauth

This paper describes the path to the single European insurance market and discusses the consequences of the EU framework for insurance regulation, which was established on July 1, 1994. Furthermore, it investigates the upcoming impact of the European Economic and Monetary Union on the insurance industry, focusing on insurers' financing and investment policy.

I. Introduction

Considerable efforts have been made to establish a single European insurance market with some 5,000 insurance companies and almost 400 million potential customers. Adding up the premium volume of the European Union's (EU) national insurance markets, the EU life ($300 billion USD) and non-life ($290 billion USD) insurance market becomes the second largest in the world, according to Swiss Re [9].[1] In 1995, the largest life insurance market was Japan ($510 billion USD), and the largest non-life insurance market was the US ($360 billion USD). The EU and US insurance markets exhibit high premium volumes per capita and per GDP (see Figure 1, Swiss Re [9]).

The objective of this paper is to discuss the implications of the European single market project on the European insurance industry. Since the insurer's business is twofold, comprising both insurance and investment, the effects on both sides of the business are investigated. There are at least two developments that have been changing and will continue to change the European insurance markets dramatically. First, during the last few decades, European Union (EU) insurance companies' access to all of the EU insurance markets has been liberalized and supervision of the EU insurance markets has been deregulated. The latest step was taken when the so-called Third Generation Directives came into force on July 1, 1994. Second, the European Economic and Monetary Union (EMU), comprising at least the European core countries, i.e. Austria, Belgium, Finland, France, Germany, Ireland, Luxembourg, and the Netherlands, is to be established by January 1, 1999.[2] The first development has been changing the insurance side of the business. The second will change financial markets and, thus, the investment side.

In the following sections, we discuss seven hypotheses about the likely consequences of the latest deregulation and liberalization efforts and those likely to take place after the EMU has been established on January 1, 1999. Up to now, it is too early to make a sound empirical analysis. Nevertheless, we take a look at the data of the four largest European insurance markets, i.e. Germany, France, Italy, and the UK, and try to identify emerging trends.

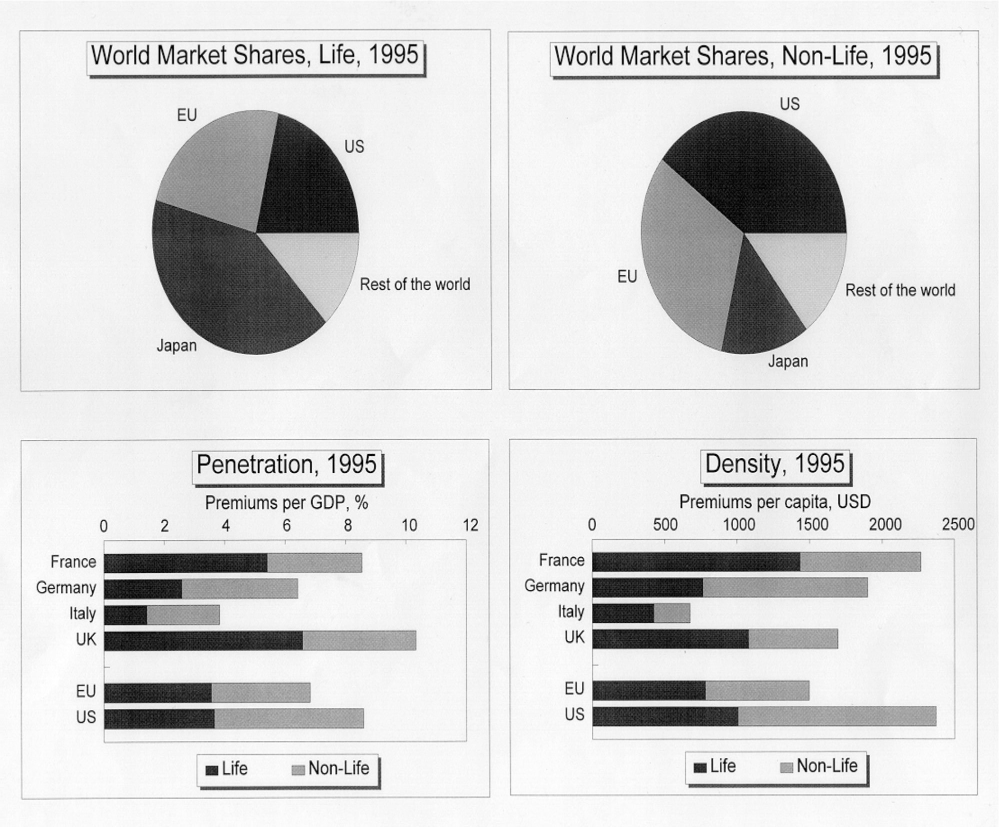
The paper is structured as follows. The second section describes the path to the single European insurance market. Since all aspects of the EMU are widely discussed in the daily press, we do not describe this process and the likely outcome of the EMU project in this paper. The third and fourth sections examine hypotheses about the expected changes in the

Thomas Hess and **Thomas Trauth,** Swiss Reinsurance Company, Economic Research, Mythenquai 50/60, P.O. Box, 8022 Zurich, Switzerland.

Copyright©1998 by SMC Premier Holdings, Inc. All rights of reproduction in any form reserved.

insurance markets that are due to the single insurance market project (Section III) and EMU (Section IV). The final section summarizes and concludes the paper.

Figure 1
Insurance markets overview, 1995



Source: Swiss Re [9].

II. The Path to the Single European Insurance Market

In 1957 the governments of Belgium, France, Italy, Luxembourg, the Netherlands and West Germany signed the Treaty of Rome and, thus, established the European Economic Community (EEC).[3] One of the objectives was to achieve a common market and to coordinate the economic policies of the member states. Governments tried to create a framework to ensure free movement of goods, persons, services, and capital. However, this objective could be achieved only gradually and at different speeds for different sectors. The insurance markets were particularly strictly regulated, with major differences existing between national regulatory frameworks. Furthermore, market entry for foreign insurance companies was heavily restricted. In the 1970s, however, a series of initiatives was launched to achieve a truly single European insurance market. The progress came about through three generations of directives[4] that are described by Boleat [1], Butler [2], Hogan [4], and Swiss Re [7]. The framework for a single European insurance market was completed in July 1994. Figure 2 lists these directives and their dates of occurrence.

Figure 2
Milestones on the way to a single EU insurance market

First Generation Directives: freedom of establishment with host country control

- Reinsurance (1964, including freedom of services)
- Non-life insurance (1973)
- Life insurance (1979)

Second Generation Directives: freedom of services

- Large risks (1988)
- Automobile insurance (1990)
- Passive life insurance (1990)

Third Generation Directives: single license, home country control, deregulation of supervision

- Home country control of cross-border business (1992)
- Deregulation of insurance prices and conditions (1992)

Source: Swiss Re [7]

First Generation: Freedom of Establishment

Freedom of establishment was the first step in the liberalization process. All insurance companies based in EU countries have the right to establish subsidiaries, branch offices, or agencies in every other member state. As early as 1964, reinsurance "started the ball rolling". The non-life and life sectors followed in 1973 and 1979. However, integration effects remained limited. For the most part, this was due to the rule of host country control. As authorities in the host countries carried on licensing and supervising foreign insurance companies, foreign companies were often not able to reap the benefits from the competitive advantages they had acquired at home.

Second Generation: Freedom of Services

Freedom of services is tantamount to being able to do business abroad without having established a branch there. Once again, reinsurance played a pioneering role in this: The main obstacles to engaging in cross-border business were eliminated as early as 1964. It took almost 25 years until, in 1988, the authorities established freedom of services for large commercial risks in the direct non-life insurance sector. Note, however, that the automobile insurance business followed only in 1990, together with the passive life-insurance business.[5]

One obstacle to meeting the criteria of a common market was the directive differentiated between company and private business. Most governments believed they should protect private insurance customers, in particular. In principle, therefore, all countries except the UK and the Netherlands opted for sticking to host country control; and home country control was mainly applied to large commercial risks and passive life insurance. As a result it remained hard for foreign insurers to take part in most national insurance business.

Third Generation: Single License, Home Country Control, Deregulation of Supervision

The Third Generation directives, which came into force on July 1, 1994, are the high point so far in the implementation of the single-market program for the insurance industry. The first two generation directives made rather modest progress in achieving an integrated insurance market. This was mainly due to the principle of host country control, which made many suppliers reluctant to establish branch offices abroad.[6] The Third Generation directives comprise three key elements:

- the single EU license,
- the principle of home country control, and
- the abolition of substantive insurance supervision.

The single license permits insurance companies registered in their home EU country to transact insurance business anywhere in the EU; i.e. the principle of home country control is generally valid. This holds true not only for all cross-border transactions, i.e. commercial and private risks, but also for the establishment of branches and agencies.[7]

Another extremely important decision was to abolish substantive insurance supervision so that prices and conditions can be freely set between insurer and insured. What remains is supervision in the form of solvency control. The EU member countries agreed on EU-wide minimum standards for financial supervision, which covers, for example, the calculation of technical provisions and the type and spread of assets.

Limitations of the Single European Insurance Market

Although the described initiatives have made considerable progress toward a single European insurance market, a few loopholes remain. First, every country has the right to deny market access to products that run contrary to the public interest. Since the term "public interest" leaves a lot of space for interpretation, this clause could easily be misused for protectionistic objectives.

Second, tax discrimination and differences in direct and indirect taxation are still having distortional effects. EU member states can still use their tax policy to discriminate against other EU members’ insurance products. For example, a Belgian tax law prevents Belgian taxpayers from deducting premiums paid for certain lines of life insurance from their income tax unless such premiums were paid to Belgian insurance companies. In 1992, the European

Court of Justice decided that the Belgian practice is legal, since, without tax harmonization in the EU, Belgium is allowed to protect the integrity of its fiscal system according to Hogan [4].

Third, contractual law differs considerably among the EU member countries, especially among those with Anglo-Saxon and Roman legal traditions. These differences in contractual law are further obstacles to insurance companies doing business in foreign countries.

Although not all hurdles have been taken so far, in principle the EU has opened national insurance markets to competitors from within the EU (liberalization effect) and given domestic suppliers considerably greater freedom of action (deregulation effect). Both effects have created more dynamic and competitive European insurance markets. Comparing the European insurance market to the US insurance market, one can conclude that, due to mutual recognition of supervisory provisions, market access within the EU has become more liberal than within the federal states of the US, in the opinion of Swiss Re [7] and [8].

III. The Impact of the Single Insurance Market Project

This section discusses the impact of the described deregulation and liberalization efforts on the insurance industry. The objective is not to give a complete list of consequences but rather to stress four hypotheses about the expected changes for the insurance industry.

Hypothesis 1:
Liberalization of market access within Europe allows the insurance companies to build up an insurance portfolio that is better diversified internationally. This, in turn, leads to lower insurance costs and, thus, to lower prices.

An insurance portfolio that is better diversified needs less equity capital to ensure a sufficient degree of solvency than does a less diversified portfolio. This is due to the fact that more risks that are statistically unrelated lead to a more even claims distribution over time. Furthermore, better international diversification leads to a lower relative exposure to catastrophic risks.

Hypothesis 2:
A larger European insurance market broadens the range of products. National suppliers make their distinct products available to all EU customers. Furthermore, in larger markets more specialized products can be supplied efficiently.

The increase in the range of products can already be observed today. For example, in some European countries the introduction of automobile insurance contracts with a savings element is being discussed. Furthermore, in many European countries more differentiated tariffs in the automobile business are available than were available in smaller markets.

Hypothesis 3:
Highly regulated markets have led to cartel-like price-setting behavior and a uniform range of products in many countries. After deregulation, profit margins tend to decline and become more volatile due to greater competition.

In many European countries, the market was highly regulated and characterized by government-guaranteed minimum prices. As a result, insurance companies' first priority was to increase their sales strength to maximize their turnover. In the now deregulated markets, insurers can compete via prices, products, underwriting criteria, innovative sales methods, and creditworthiness. The higher degree of competition will lead to decreasing prices and, thus, to declining profit margins. Note, however, that in some countries, e.g. in Italy, governments have introduced price ceilings in the service of their social and economic objectives.[8] In these cases, deregulation has not necessarily led to declining profit margins.

Furthermore, as competition becomes harder and market development becomes more dynamic, the volatility of profits will rise. Comparing the performance of the long-deregulated UK insurance industry[9] with the performance of the insurance industry in Germany, where the government heavily regulated the insurance market, the UK market results are lower and more volatile than they were in Germany. It is likely that in Germany, profit margins will decline and the volatility of results will increase. However, this will not be fully reflected by the data since German insurers will continue to be able to smooth out fluctuations by balance-sheet-related measures, in the opinion of Swiss Re [7].

Figure 3
Performance of non-life insurers

Hypothesis 4:
Deregulation is changing the structure of the insurance markets. More foreign companies are being encouraged to enter the markets. Since there will be pressure on profit margins, less

profitable companies are in danger of dropping out of the market or being merged with other companies.

Figure 4 shows that, in the 1990s, the total number of domestic insurance companies has stagnated or even declined. This is mainly due to mergers and acquisitions. Outstanding recent examples are the merger of the French companies Axa and UAP, creating the largest insurance group in the world with a combined turnover of $57 billion USD, the merger of the UK's Royal Insurance and Sun Alliance with a joint premium volume of $15 billion USD, and the creation of Germany's second-largest insurance group, named Ergo, combining the Victoria and Hamburg-Mannheimer with a premium volume of $12 billion USD. The objectives of these mergers are mainly to cut costs in the fields of administration, marketing, and distribution and to achieve a higher degree of diversification. Nevertheless, we want to stress that not only the biggest companies are able to survive, but in Europe there is also still space for smaller specialized niche players. Note, that although insurance companies' tendency to enter other EU markets will increase,[10] access to foreign insurance markets is often still not a simple task. This is due to the remaining obstacles to the single insurance market described above. Furthermore, the insurance business requires a high degree of consultancy, credibility, and client confidence. Therefore, opening foreign branches is often necessary to enter a market successfully. Especially in countries like Germany, where consumers are used to dealing with tied agents, opening a branch is very important, according to Swiss Re [7]. In countries where a net of independent brokers exists, however, the access of foreign insurance companies tends to be easier since brokers are usually better informed and able to spread information to local clients.

IV. The Impact of the European Monetary Union

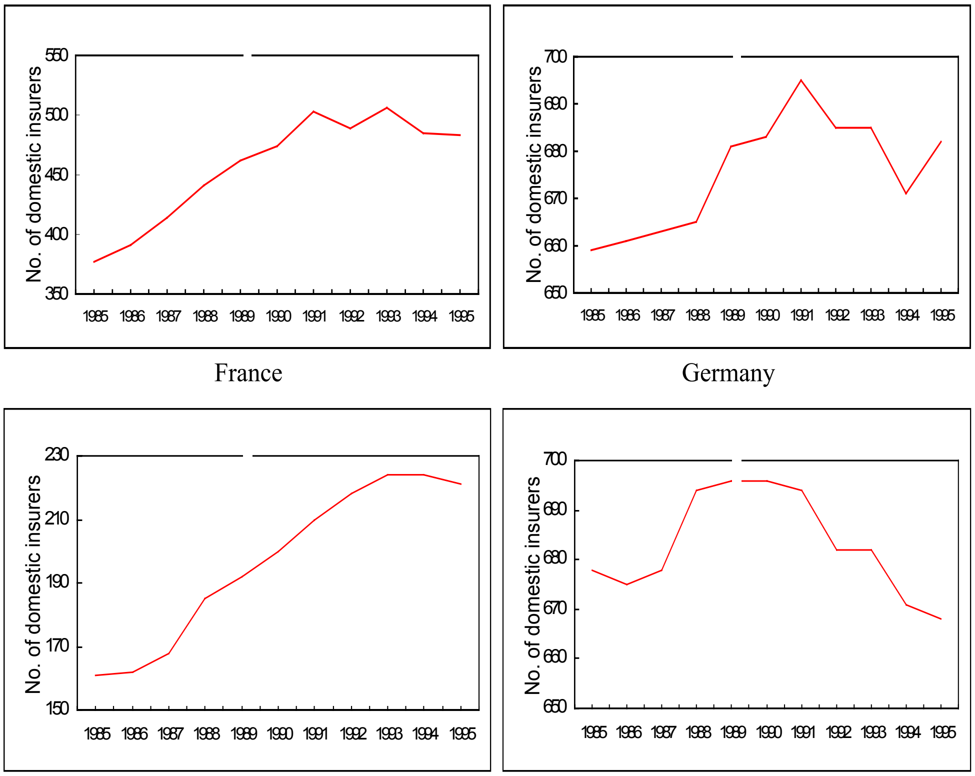
The impact the European Monetary Union will have on the economy is being widely discussed, but no common consensus has been found. Economists, who stress the positive impacts, argue that lower transaction costs and dwindling currency risks will lead to more trade, faster technical progress, and, thus, to higher real growth rates. The EURO-pessimists, however, emphasize that adjustable exchange rates as an important means to compensate for divergent economic developments will be lost; and, thus, factor and goods prices will have to do all the adjustment. However, since wages in particular are rather rigid, asymmetric productivity shocks will lead to unemployment in countries with rising unit labor costs. In principle, the insurance industry will gain from a booming economy and lose from a recession and high unemployment rates. It would go beyond the scope of this paper to delve deeper into the discussion on what outcome is more likely.

In the short term, the European insurers have to cope with a bundle of problems arising during the transitional phase to Monetary Union. First, existing insurance contracts and information technology have to be adapted. Datamonitor, a UK-based management consultancy, estimates that the EU insurers have to raise $8.3 billion USD for EMU-induced conversion costs, of which $5.3 billion USD are information technology costs. Other areas where costs will be incurred include staff training, reprinting material, and notifying policyholders.

Second, long-term contracts, e.g. life insurance contracts, sometimes include guaranteed returns. Since nominal interest rates will decline in countries with formerly high inflation rates, insurers might have trouble achieving their guaranteed rate of return.

Setting aside the problems during the transitional phase, the EMU will be another step towards a common insurance market since customers will not be exposed to currency risks when buying an insurance contract abroad. Nevertheless, we believe that the EMU will have only limited long-term effects on the insurance side of the insurers' business. We rather want to focus on the effects of the EMU on financial markets and the financing and investment side of the insurance business and discuss three hypotheses.

Figure 4
Number of domestic insurers



France

Germany

Italy

United Kindom

Source: *OCED*.

The EMU will create one of the biggest financial markets in the world. At the end of 1995 the value of bonds, equities, and bank assets in all EU countries amounted to $27 trillion USD. By comparison, the market volume of assets in the US is around $23 trillion USD and in Japan $16 trillion USD, according to Prati and Schinasi [6]. Note, however, that not all 15 EU countries will join the EMU in the first round and, thus, the common capital market will be smaller.

Insurance companies hold a considerable portfolio of assets. The sum of all portfolios in the insurance sector amounts to $500 billion USD in France, $660 billion USD in Germany, $125 billion USD in Italy, $820 billion USD in the UK, and $2,400 billion USD in the US. The insurers build up their asset portfolios because

- claims are often very cyclical, i.e. insurance companies have to be able to cover extraordinarily high claims in certain years,
- claims payments often take place long after first premium payments, eg the need to cover health expenditure usually increases considerably during a short period before death,
- certain insurance contracts include a savings component, e.g. endowment life insurance contracts.

Hypothesis 5:

The introduction of a single currency will lead to keener competition for equity capital between European insurance companies.

Since currency risks are an important obstacle to investment in foreign countries, there was, until now, hardly any competition between European insurance companies when procuring equity capital. The EMU will lead to a uniform capital market in which French Axa-UAP and German Allianz will have to compete for investors willing to buy their equities. Thus, overall competition within Europe will increase since financial markets reward successful insurers with cheaper equity capital. In order to achieve a competitive advantage, insurers may pursue a shareholder value policy and try to increase their return on equity. At the same time, they will be forced to provide more transparent balance sheets as well as profit and loss accounts. Insurers who will not meet the return on investment targets will come under pressure of financial markets and will become potential targets for takeovers.

Hypothesis 6:

The common financial market will lead to a higher degree of diversification of investors' asset portfolios. This is due to a broader and deeper European capital market without currency risks. Insurance companies will, thus, be able to diversify their portfolios with a broader range of EURO instruments as well as with assets outside the EURO area, as stated by Prati and Schinasi [6].

All assets in EMU member countries will become available to portfolio managers of insurance companies without any currency risk. As a result, markets will price the assets according to the implied credit and liquidity risks; and lower-ranked governments, companies, and other institutions will have to pay higher interest rates. Since a higher number of different assets will be available in the common capital market, portfolio managers will be able to increase the share of risky or more volatile assets and, thus, increase investment returns.

Furthermore, the EU's Third Generation Directives include the so-called "prudent man rule", according to which at least 80% of insurers' assets must be held in currencies that match their liabilities. Since, after the European Monetary Union is established, all currencies of member countries are regarded as one currency, there will be more freedom for insurers to invest in third countries' assets. This will lead to a higher degree of non-EU diversification.

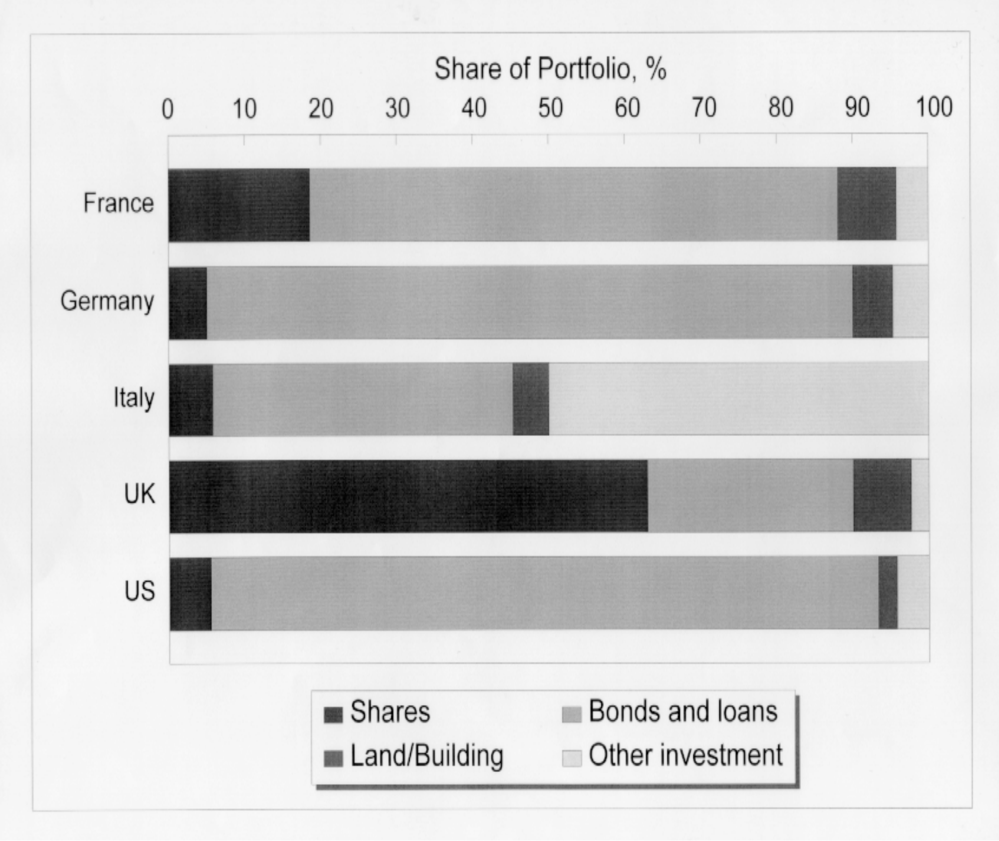
Hypothesis 7:

In countries where insurers hold only a small portion of equities, the share of equities is likely to rise. This is due to higher competition, which forces insurance companies to yield higher investment returns, and to better opportunities to diversify and reduce the risks of the equity portfolio.

Up to now, insurers' asset portfolios differ considerably from country to country (Figure 5). The portfolios of German life insurers consist of only 5% of equities, whereas UK life insurers hold 63% of their assets in equities. It is expected that competitive pressure will lead to more efficient investment portfolios.

Figure 5

Portfolio structure of life insurers



V. Summary and Conclusions

Considerable efforts have been made to deregulate insurance markets and to liberalize market access within Europe. This has been enhancing and will continue to enhance competition and is forcing insurance companies to undergo fundamental changes. The introduction of the EMU will intensify this process further. As a result, insurance clients will benefit from a broader range of insurance products, more efficient suppliers, and, thus, lower insurance prices. The insurance companies will be able to exploit new markets and build up more diversified insurance portfolios. Nevertheless, insurance markets will remain more segmented than the single European capital market, which will come into being together with the EMU. This is due to the remaining language barriers, customers' reservations about dealing with foreign companies, and differences in tax and contractual laws.

The single European capital market will be broader and deeper, and will, thus, provide improved opportunities for insurance companies to reach better-diversified and more efficient investment portfolios. Another effect of the single European capital market is that it will lead to keener rivalry for equity capital between insurance companies, which will enhance competition further.

To sum up, the insurance companies are seriously challenged by the necessity to adapt to the more competitive environment in Europe. In addition, during the next few years, they will have to manage the transition phase to the EMU. In the new European corporate landscape, efficiency and customer orientation will be critical factors of success. In the past, large insurance companies dominated national markets. We expect that in a similar way, European insurance markets will be dominated by a few large European players. However, in the larger European insurance markets, there will be plenty of opportunities for efficient and specialized niche players. Only the future will show which companies and what range of products will be victorious.

ACKNOWLEDGEMENT

We would like to thank Roman Lechner, Beatrix Meyer, and Dr. Kai-Uwe Schanz for helpful comments and discussions.

NOTES

1. The figures refer to 1995.
2. Note that, up to now, there is considerable uncertainty about the group of countries that will make up the Monetary Union in the first round. It is particularly uncertain whether Italy, Spain, and Portugal will be able to come sufficiently close to the convergence criteria. Greece is not expected to meet any of the convergence criteria and will, therefore, stay out; and the UK, Denmark, and Sweden will not join EMU from the beginning for political reasons. Furthermore, the scheduled timetable might change since almost all countries have failed to meet the defined convergence criteria so far.
3. Note that, in 1973, the UK, Denmark, and Ireland; in 1981, Greece; in 1986, Spain

and Portugal; and in 1995, Austria, Finland, and Sweden joined the European community.

4. Note that directives are binding orders proposed and administered by the European Commission and issued by the EU Council of Ministers, which is composed of representatives from each member state. The European Parliament reviews and comments on proposed directives. Unlike the model laws and regulations promulgated by the National Association of Insurance Commissioners (NAIC) in the US, directives have the force of law (Hogan [4], LOMA [5]).
5. Passive life insurance business is made of life policies that are concluded on the initiative of the insurance customer without any deliberate sales efforts on the part of the supplier.
6. Note that, apart from this, problems in gaining access to distribution channels and customers' reservations about dealing with foreign insurance companies add to the poor integration progress.
7. Subsidiaries, however, still have to apply for a separate license in the host country.
8. In the case of Italy, one important objective was the fight against inflation.
9. Note that deregulation of insurance markets in the UK took place in 1982.
10. Note that there are no consistent data available for the number of foreign insurance companies in EU member countries. This is due to the fact that, since 1994, in contrast to the period before, branches from EU nations have been statistically recorded only by the supervising countries of origin and no longer by the country in which they are active.

REFERENCES

[1] Boleat, Mark J. (1995). “The European Single Insurance Market,” *The Geneva Papers on Risk and Insurance*, 20. 45-56.

[2] Butler, Laura. (1996). “Third Life and Non-Life Insurance Directives: Has a Single European Market Been Achieved?” *International Insurance Law Review*, 180-188.

[3] Finsinger, J. and F. A. Schmid. (1994). “Prices, Distribution Channels and Regulatory Intervention in European Insurance Markets,” *The Geneva Papers on Risk and Insurance*, 19. 22-36.

[4] Hogan, Arthur M. B. (1995). "Regulation of the Single European Insurance Market," *Journal of Insurance Regulation*, 13. 329-358.

[5] LOMA (Life Office Management Association, Inc.). (1996). “Global Survey of the Life Insurance Industry,” Atlanta, GA.

[6] Prati, Alessandro and Garry J. Schinasi. (1997). “European Monetary Union and International Capital Markets: Structural Implications and Risks,” *IMF Working Paper*, WP/97/62.

[7] Swiss Re. (1996). “Deregulation and Liberalization of Market Access: The European Insurance Industry on the Threshold of a New Era in Competition,” *Sigma*, 7/1996.

[8] Swiss Re. (1997). “US: Consolidation Accompanied by Weak Growth - A Business Challenge in Property and Casualty Insurance,” *Sigma*, 1/1997.

[9] Swiss Re. (1997). “World Insurance in 1995: Premium Volume Exceeds USD 2000 Billion for the First Time,” *Sigma*, 4/1997.