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The EU Insurance Industry: Are we Heading for an Ideal Single Financial Services Market?

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The expert group "Insurance and Pensions" discussed the state-of-the-art of the (EU) insurance market with members of the European Commission and carried out a controlled review of the single market regulation that has been achieved or is being strived for in the future. The article now stresses the gaps between the intended and the actual situation in a critical but constructive way and points out what still needs to be done. The statements of the expert group ascertain that the process of developing a single financial services market in the EU has become entangled in the net of the many regulations issued by the European Commission. These regulations are impeding the productive implementation of the single market in all 25 EU Member States and making it quite difficult to achieve the aim of the most successful single financial services market in the world.
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The European Union insurance market on the path to excellence

On 1 May 2004, the European Union (EU) enlarged its sphere of action and influence by another 10 countries. This eastward enlargement has given it added momentum for growth and development. Over 100 million consumers represent a substantial added consumer base now able to enjoy the blessings of the global market economy. However, they must also be guarded against the excesses of liberal economic systems. These new markets have a lot of catching up to do, among other things opening up the prospect of growth in the financial services sector (credit services and insurance). The potential for growth becomes obvious when one looks at the discrepancy between the number of consumers and value added. The 10 new EU Member States currently account for 18 per cent of the population of the EU-25 but to date for only 5 per cent of aggregate EU GDP.

As for the insurance sector, insurance premiums total 9 per cent of GDP in the older EU Member States but only 3 per cent in the accession countries, clearly signalling that there is scope for substantial growth. Moreover, the new EU Member States account for a mere 3 per cent of aggregate non-life premiums in the EU and 1 per cent of aggregate life insurance premiums. Those figures also point to something of a

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"growth goldmine" for the insurance industry. These are clear signs that the EU insurance industry has a particularly large amount of lost ground to recover in the region, creating ample opportunities for insurance groups with an eastward orientation and a local presence (catering for the empirically proven reality that applies throughout the insurance industry, namely that all business is effectively local business).

A liberal and flexible economic environment is needed to boost the nascent potential of the insurance markets in the new EU Member States. Sustainable economic growth in the new EU Member States will therefore depend on the creation of a single services market if the market economy benefits of a single market are also to be enjoyed by those countries. In the context of financial services, this noble objective finds expression in the Financial Services Action Plan (FSAP). Its implementation during the period up to 2010 is intended to create the world's most efficient financial services market (the goal of the still incumbent Internal Market Commissioner Bolkestein). The FSAP – adopted in 1999 – lays down a general roadmap for the efficient development and exploitation of a synergetic single financial services market. After a five-year implementation phase, various groups of experts have been closely assessing the extent to which the FSAP has been put into effect so as to gauge the need for possible adjustments. Insurance, banking and investment experts have carried out a controlled review of the single market regulations that have been achieved to date or are being planned for the future in the course of discussions with members of the European Commission and have – in a critical but constructive way – put into words the gaps between the intended and actual situation and what still needs to be done.

The participants have ascertained, in a somewhat disillusioned tone, that the process of developing a single financial services market has become entangled in the net of the many regulations issued by the European Commission and that those regulations are impeding the productive implementation of the single market in all 25 EU Member States. A huge number of adopted decrees requiring incorporation into national law (e.g. Insurance Mediation Directive, Financial Conglomerates Directive, Pension Funds Directive, Environmental Liability Directive, EU Transparency Directive (Insurance), Investment Services Directive, Feed Hygiene Regulation (Liability Insurance)) as well as directives pending acceptance by the European Council of Ministers (Unisex Premiums Directive (decision by the European Council of Ministers in favour of the insurance industry through reversal of the burden of proof at the beginning of October, thus allowing the adequate reflection of risks), 5th Motor Insurance Directive, Reinsurance Directive), action plans (Insurance Contracts Directive, Consumer Protection Directive) and initiatives that are likely to be adopted in the near future (Solvency II (risk-aligned management of insurance companies' capital resources), International Accounting Standards, disclosure of cash management structures) give just a cross-section of the marked trend towards over-regulation.

The insurance industry is straining under the weight of those countless and far-reaching regulations, whereby the number of regulatory areas in the industry has increased by a factor of nearly 10 in the last decade. This drastic re-regulation by EU initiatives could thwart or even destroy forever the delicate bud of prosperous economic growth in both the new EU Member States and the older members. The potential to grow and catch up is being limited by re-regulation and blocked by supranational regulation. Given the potential for growth in the new EU Member States, the national economies in particular and the EU insurance industry in general could be deprived of a historical opportunity as a result. One cannot comment on re-regulation within the EU insurance industry more aptly than Gérard de la Martinière, recently elected President of the *Comité Européen des Assurances*: "It's time for a break in the flood of EU legislation."

To put it in a nutshell, the EU needs to give the EU insurance industry a breather so that this important sector of the economy can make the most of its potential for growth, not just in the new Member States but also in the older EU members. The general requirements for a functioning single EU insurance market were the subject of discussion by the Panel of Experts on "Insurance and Pensions" together with the EU Commission. The suggestions made by this advisory group, which is understood to be a regulatory and controlling body, should help the FSAP achieve its true goal, namely the creation of a financial services market of the highest quality. Below, we comment on the extracts and the résumés of these high-quality expert recommendations so as to point the way to an EU financial services market of excellence.

The FSAP as the route to market integration

The creation of a single integrated EU financial services market is still in the initial stages. Although the "single passport" system has made it simpler for companies to turn the freedom of establishment into reality, the corporate reality is that the EU insurance market remains fragmented. The principal task of the EU's single market directives is to mould the market fragments into a unit capable of benefiting from synergies and economies of scale.

EU legislation should support national legislation rather than be seen as an adjunct to it. An integrated financial services market should generate significant economic benefits by promoting growth and employment in conformity with the goals approved by the EU Heads of State in Lisbon in March 2000. One aim should be the creation of a cost-efficient and effective regulatory environment that allows financial service providers to develop their own maximum-performance pan-EU corporate models.

The resultant lower prices, greater choice and faster product innovation would benefit customers. On the supply side, an integrated EU market would improve risk diversification and boost competitiveness. Financial stability would be assured and the position of the EU insurance industry in global markets would be enhanced. At the same time, life insurers and pension funds could help Europe successfully meet future demographic challenges created by an aging population.

Assessment of the current level of integration

The FSAP Panel of Experts on "Insurance and Pensions" undertook an assessment of the current state of market integration. It looked at competition, market entry, product choice and prices. The small number of available samples did not allow an exact quantitative assessment, but tendencies were apparent.

The Panel concluded that cross-border competition is virtually non-existent because market entry barriers still exist. Consequently, growth in companies' cross-border insurance portfolios has been limited to date. So far, with the exception of asset management services, large risks cover and the activities of reinsurance companies, market integration has only taken place by way of acquisitions of local providers.

Results of the questionnaire on market integration

Every participant in the FSAP Panel of Experts answered a questionnaire about the present state of EU market integration. The questionnaire looked at the current state of integration from the point of view of the following aspects of integration: corporate functions, products, market entry channels.

The questionnaire produced the following results:

- In general, life business is less integrated than non-life business.
- Reinsurance and the associated underwriting of large risks are most integrated, whereas integration in the mass risks, motor insurance and company pension segments is minimal.
- The founding of subsidiaries generally involves low entry barriers that are surmountable. The opening of branches is practicable for some reinsurers and niche operators.
- The implementation of the Pension Funds Directive is expected to act as a catalyst for enhanced cross-border activities by lowering entry barriers. A large number of participants emphasized the importance of acquiring local sales capacities to facilitate market entry.
- To date, there has been little or no cross-border integration in the areas of international emission risks (environmental protection issues) and claims settlements.

Analysis of the questionnaire shows that cross-border acquisitions remain the insurers' key means of successful market integration. In all, 14 major insurers were identified as having significant sales in two or more Member States. Although that is only a relatively small number of insurance companies, they do hold a combined EU market share[1] of about 37 per cent. The fact is that there are still regulatory barriers to insurers that need to be removed. The Panel of Experts summarized its findings in a number of recommendations:

- The role of a leading EU supervisory body needs to be extended and reinforced (creation of the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS)).
- Greater supervisory convergence is required. Better coordination between supervisors is a basic prerequisite for more efficient supervision of individual companies, groups and financial conglomerates. Solvency II needs to deliver harmonized capital requirements (pillar I) and supervisory action (pillar II). Moreover, the capital requirements under Solvency II must not create any more financial barriers to insurance companies. Otherwise, the competitiveness of EU insurers will suffer.

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[1] This market share was calculated on the basis of life and non-life insurers' premium income in 2000.

- Furthermore, the implementation of the "Lamfalussy" model should improve cooperation between national supervisory authorities. In order to achieve uniform supervisory standards for EU insurers, one could set up a team made up of various national supervisors (as an impetus, as it were, for collaboration within CEIOPS).
- A more radical line of attack must be considered should this approach in conjunction with the "Lamfalussy" model fail. Some members of the Panel of Experts are already in favour of setting up a common EU-wide supervisory authority that would be binding on and responsible for every Member State. Such a supervisory authority could make rapid and consistent judgements in infringement cases. It could also supervise conglomerates at the present level and it could lay down rules for purely regional and multinational insurers.
- Parallel efforts should be made to simplify and standardize supervisory authority reporting. An important step in the direction of standardization has taken place with the introduction of the IAS/IFRS international accounting standards. This development should be continued by increasing uniformity with respect to the format, content and frequency of regulatory reporting in order to further supervisory convergence, promote financial stability and cut costs.
- In a converging EU market, the cross-border allocation of human resources is also of special importance. However, Article 3 of Directive 95/26/EC works against it. According to the Directive, an insurer's head office must be in the same Member State as its registered offices.
- Further administrative hurdles such as those that hinder business amalgamations should be abolished. One single report to the supervisory authority in a company's home country should suffice for it to operate throughout the single market. The amendment of data protection law to permit the shared use of data for customer relationship purposes would also help insurance groups.
- The environment for cross-border transactions has been improved by the decision to award a European Statute to insurance companies. Nonetheless, further action is still needed in some areas, such as taxation, financial reporting and social issues.
- Harmonization of capital resources requirements and supervisory regulations will be essential to the continued consistent implementation of the FSAP.
- The General Insurance Directive should be brought into line with the Financial Conglomerates Directive (FCD) by January 2006 at the latest.

Prevailing conditions and the external effects of a single EU insurance market

The FCD

Although the FCD has yet to be introduced, it has the clear advantage of serving as a coordinating role. However, the Panel of Experts feels that the achievement of its real objectives is likely to be held back by conflicting interpretations and conflicting implementation. The European Commission therefore needs to closely monitor the FCD's purposeful introduction.

Guidance should focus on significant risk concentration, intra-group transactions, reporting frequency and the required harmony between the different models used to calculate solvency.

The following two issues affecting groups in the EU should be borne in mind:

- the need to implement a macroeconomic crisis management mechanism at EU level;
- the need to eliminate overlaps in regulatory and supervisory functions and other significant areas of jurisdiction.

There is an urgent need for alternative modes of action with respect to the institutional arrangements for macroeconomic crisis management within the EU insurance industry. The EU-wide standardization of insurance supervision is only addressing crisis management at enterprise level. Consequently, better coordination of the EU's regulatory system is needed. Close attention should be paid to the effects on insurance companies of strategic mistakes made at a macroeconomic policy level.

Despite the relative independence of the EU financial services market, it still has strong interconnections with the global economy and, above all, the U.S. economy. It therefore makes sense to discuss legislative initiatives jointly with the U.S. regulators. Because of the growing volume of regulatory measures, there are more and more overlaps between controlling authorities that have a direct impact on European companies.

Despite EU legislation and a wide variety of Commission initiatives, the FSAP experts have reported that the volume of cross-border business in homogeneous EU-wide policies[2] is very small. With a few exceptions, it is limited to fractions of a per cent. The reasons include the naturally local orientation of this business segment. However, a distinction must be made between large risks insurance and mass risks cover.

- The large risks and industrial risks situation is generally felt to be satisfactory, even if the bulk of cover is not sold on a freedom of services (FOS) basis. On the one hand, that is because policies in these segments are less affected by contractual requirements and strict legal standards. On the other, it is because the strict consumer protection laws do not apply to industrial clients. Furthermore, these risks attract significantly higher premiums.
- Although it may appear at first sight as if insurance companies could sell homogeneous mass risk policies, this option is severely limited by local and national conditions. Indeed, in some lines, it appears to be impossible to design products that meet the needs of every consumer. Changes to supervisory regulations could only overcome some of those restraints. Regardless of the FSAP, no significant increase in turnover has been observed in the past. There is now concern about the costs that would be incurred in making EU-wide distribution simpler. It is also doubtful whether a significant increase in turnover would actually occur to justify those costs. Consequently, planned legislation should first be subjected to cost-benefit analysis.

[2] Business sold on a freedom of services basis.

Entry barriers for suppliers and customers

On the demand side
An insurance policy must provide security. For this reason, consumers are unlikely to take out policies with companies that they do not know and which are based in a foreign country. Faith is a particularly important factor in the life assurance sector, where the customer entrusts the insurer with large amounts of money over a lengthy period. In addition, it is of considerable importance how a prospective customer sees an insurer's future performance and claims management mechanisms. Furthermore, tax relief is an important issue in the life insurance segment, and it cannot be guaranteed if a policy is taken out abroad.

On the supply side
Local risks and individual business and distribution systems create enormous barriers to market entry on the supply side. Local circumstances also differ with respect to claims management, premium calculation and tax legislation. In the case of third-party motor insurance cover – the largest non-life market, accounting for 40–50 per cent of premium income – national regulations[3] clearly make it impossible to sell products on an FOS basis. It is not enough just to remedy these shortcomings if one wants to create an EU-wide insurance market. Additional measures are also needed. For instance, local service units are needed to handle claims management and claims policing (see the approach in the 5th Motor Insurance Directive), not least given the growing number of fraudulent claims. Since competition keeps premiums low, these factors make the market unattractive. In other words, selling homogeneous EU-wide policies would entail added risks.

Demand for products on an FOS basis

Despite the explicit and implicit barriers to market entry that we have described, there certainly is potential for FOS sales. The main target groups are populations living in border areas, expatriates and Internet customers. To be suitable for sale, products must be little influenced by local risks, and so term life, supplementary medical and household contents cover are possible examples. Should homogeneous regulation of consumer protection law and tax structures take place, it may also become possible to sell unit-linked life insurance, simple savings products and some pension insurance on an FOS basis.

The Panel of Experts has developed a number of measures whose cumulative effect could boost FOS sales in the target markets.

- *The development of a "26th regime"*: An additional EU regime (in the form of a supranational institution) should be set up to clarify contractual and legal issues for each segment so as to simplify EU-wide distribution.

[3] For instance, vehicle registration rules differ throughout the EU.

- *The development of homogeneous products*: In addition to the cross-border sale of national products, new products should be developed specially for the EU market. These new products could be sold throughout the EU and would offer their suppliers economies of scale. Even if these products only met the needs of a fraction of the EU's 450 million citizens, their sales potential would nonetheless be significant. For instance, it is assumed that an EU-wide annuity product sold against the background of an EU-wide controlling body (a suitable 26th regime) could have substantial sales potential in the pension products segment. However, the design of such products should not be governed by EU legislation. Free market mechanisms will suffice. It is important for the insurance industry to be motivated to develop these products and for an open discussion about the differing viewpoints to be encouraged.
- *The bolstering of consumer confidence in homogeneous EU-wide products*: Consumers should be better informed and should benefit from faster and more effective information and redress systems (e.g. FIN-NET, SOLVIT and their successors).
- *The broadening of the definition of "large risks"*: Because it is generally easier to sell large risks on an FOS basis, one should attempt to define a larger number of risks as large risks. This would also make it easier for SMEs to buy insurance cover in other EU countries.
- *The harmonization of tax legislation*: On the consumer side, it will be important to retain tax relief on life assurance and to avoid double taxation in the non-life segment. On the supply side, insurers face difficulties on several levels. In general, taxation needs to be simplified at a local level. In addition, one should strive for the harmonization of tax legislation. One special problem for companies operating throughout the EU is that of VAT. Although VAT is imposed on intra-group services, it is impossible for those groups to reclaim that input VAT. This is preventing an increase in the movement of services within groups. Furthermore, there is a need for greater uniformity in the taxation of decentralized units and subsidiaries. In-depth analysis of tax problems in the company pensions segment has exposed three main problem areas: the double taxations of profits, the lack of tax relief for insurance premiums and investment income, and the impossibility of transferring pension rights to a new employer when going to work abroad.

Specific single market issues affecting industrial customers, intermediaries, mutual insurers and niche operators, pensions providers and reinsurers

Industrial customers

The following issues have emerged in the industrial customers segment. The administration and integration of the insurance coverage required by international groups is hampered and thus made much more expensive by the increase in the number of mandatory national "pools" required to cover risks such as terrorist attacks and natural disasters. In addition, technical problems and variations in the definition of large risks from one region to the next make it very difficult to calculate cover.

Intermediaries

Insurance intermediaries play a central role in protecting the interests of insurance customers by providing them with advice and assistance and by analysing their individual needs. They could do a great deal to promote cross-border sales of insurance, and the recently adopted Insurance Mediation Directive (IMD) will also help. However, the degrees of freedom of implementation offered by the IMD are creating problems in that different countries are making different use of them.

Mutual insurers and niche operators

In practice, mutual insurers and niche operators have limited cross-border experience. In addition, the legal structure of mutual insurers means that they need special treatment.

The Panel of Experts recommends the implementation at EU level of a specifically designed legal instrument – similar to the *Société de groupe d'assurance mutualiste* introduced in France 2001 – to improve cross-border cooperation between mutuals. That could significantly improve their risk diversification and risk management as well as allow the cost-efficient shared use and development of day-to-day services. Furthermore, the capital resources requirements need to be reviewed so as to eliminate the disadvantages that mutuals suffer from when raising capital.

Pension providers

Given demographic realities, pension products will continue to grow in importance in the future. These products can hardly do without local distribution if national tax benefits are not to be lost. If pension products are to succeed in an EU-wide marketplace, the obstacle to sales needs to be identified. For instance, consultation with every interested party is needed to identify the tax barriers that are genuinely affecting consumers' purchasing decisions.

Reinsurers

The reinsurance sector is above all faced with problems when it comes to preparing supervisory reports and financial statements. The situation should improve considerably once the proposed draft Reinsurance Directive has been implemented.

Principles governing the preparation and application of EU law

The European Commission should take into account a number of principles that would allow EU legislation to be efficient, effective and convergent. They concern a variety of different product and market sectors.

Convergence (consistent implementation and enforcement of EU law in all 25 Member States)

Supervisory measures should be supported by determined enforcement by the Commission and the Member States. In particular, the Commission should prepare an action plan laying down a uniform response to infringements. Moreover, the increasingly public dissemination of information about EU and national legislation via the Internet would facilitate the implementation of legislation and make it more effective.

The Commission and supervisory authorities should help the new EU Member States come into line with EU law.

EU policy prioritization

Since resources are limited, efforts to create an integrated single financial services market should focus on measures that combine the maximum net benefit with the lowest costs. Cost–benefit analysis (CBA) needs to be the focus of consideration for every directive, including not just future legislation but also existing legislative measures. Systematic and continuous CBA of legislation is needed. It would make it possible to relax regulations that have already been adopted. Furthermore, EU legislation should function as a substitute for national legislation.

The following three examples demonstrate how suitable CBA would have led to better EU legislation:

- The inconsistent treatment of insurance companies under the General Insurance Directive and the FCD.
- The differing capital requirements laid down in different directives.
- The conflicting provisions regarding insurance contract closure laid down by the 3rd Life Insurance Directive, the 3rd Non-Life Insurance Directive, the Distance Selling Directive and the Insurance Mediation Directive.

Self-regulation

Whenever possible, over-legislation should be avoided. More trust should be placed in industry codes of practice. These are responsive and flexible and can be more easily adapted to specific circumstances. Pre-contractual and technical information disclosure also raises problems. The insurance industry could, for instance, develop a kind of "harmonized European information prospectus" similar to the documents introduced for mortgages and other banking products.

The EU insurance and pensions market – a vision

The single EU insurance and pensions market should be open, efficient, competitive and diverse both for financial service providers and for their customers. The cultural and socio-demographic factors that set the individual markets apart must be accepted as legitimate differentiating features.

Entry barriers laid down in legislation unnecessarily increase the market pressures on companies. The resultant enforced concentration on domestic insurance companies *de facto* and *de jure* creates direct and/or indirect disadvantages for the policyholder. Opened to new entrants, local markets should be permitted to converge with the single EU market at their own pace and according to their natural business dynamics. Local markets should not be shaped solely by regulations: a multiplicity of business models and a wide-ranging choice of products can maximize benefits for the customer – if the legislative and regulatory environments permit competition to be increased in that way.

Market-oriented solutions need to be found for the problems and risks that have been clearly identified. Wherever possible, unbureaucratic routes should be followed. The principle of subsidiarity should be strictly applied. Even where legislative solutions are felt to be justified, they should only enter into force if local market solutions have proven impracticable or have failed.

At the same time, we need to look at possible ways of simplifying the regulatory environment, inclusive of tax structures and common accounting standards. The EU should set itself the goal of reducing overall regulatory and supervisory costs by 30 per cent over the term of the next FSAP. The EU can only become an attractive capital market in the future if the existing framework is simplified.

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