The Geneva Papers on Risk and Insurance Vol. 24 No. 2 (April 1999) 145–162

The Development of European Private Sector Insurance over the Last 25 Years and the Conclusions that Can be Drawn for Business Management Theory of Insurance Companies*

by Dieter Farny**

1. Introductory remarks

The Geneva Association is 25 years old this year. This is a good opportunity to review the past period, both from the point of view of actual developments in the European insurance industries as well as the development of business management theory relating to insurance and insurance companies. All three of these areas have changed. The original French title of the Geneva Association, "Association Internationale pour l'Etude de l'Economie de l'Assurance", today tends to be better known in its English version as the "International Association for the Study of Insurance Economics". Its principal publications are *The Geneva Papers on Risk and Insurance*, divided into two series, *Theory* and *Issues and Practice*. The scope of the Geneva Association's activities, originally confined to economic questions concerning private sector insurance, has widened greatly to include risk management, legal aspects of insurance, social insurance, certain individual risk causality systems, economic aspects of health, as well as financial services in the broadest sense. English has for a long time been the principal scientific language of the Geneva Association.

This development mirrors the actual development of the insurance industries nationally, in Europe and worldwide. In 1973, the year the Geneva Association was founded, the EEC had just issued the First Non-Life Insurance Directive, which might be regarded as the conception of the European internal insurance market. It is well known that the birth did not take place for another 21 years, when the third generation of directives were adopted into the legal systems of the Member States. The current state of the internal market is still somewhat nebulous. It is only operational in a limited number of areas so far, and from some points of view its real development has only just started. It is also not always easy to differentiate the effects of the European internal insurance market from those of the deregulation of many national insurance markets.

Both the theory of insurance economics as well as the situation of research and studies concerning insurance economics have also undergone marked changes. Here two differing types of relationship between theory and reality must be distinguished. In the one instance it is economic reality that changes; insurance industry practice searches for, finds and assumes new forms. This often takes place in a very pragmatic and not particularly systematic manner.

---

* Paper presented at the 25th Seminar of the European Group of Risk and Insurance Economists, Vienna, 22 September 1998.

** Professor and Director, Insitut für Versicherungswissenschaft an der Universität zu Köln.

© 1999 The International Association for the Study of Insurance Economics.
Published by Blackwell Publishers, 108 Cowley Road, Oxford OX4 1JF, UK.

The theory then adopts these changes, models, interprets and develops them. In this example the initiative derives from actual practice and the theory "works it up". Good examples of this are the new types of risk transfer in reinsurance transactions; risk management has also largely developed through practice.

The opposite case is where theory is the initiator, developing models for new circumstances and decisions, which practice then adopts and applies to real insurance situations. Examples of theoretical innovation can above all be found in the areas of business risk theory, in company management techniques, including controlling, and in accountancy as a whole. Bancassurance and financial conglomerates are further examples of theory being significantly in advance of reality.

A retrospective review thus not only promises to provide several interesting insights and conclusions but also some predictions as well.

2. Some statistical information

Over the last 25 years the European insurance industry (i.e. the sum of the national industries) has, from a statistical point of view, developed in a variable manner in individual countries. However, comparing figures for 1973 and for 1996 (the most recent year available) is in some instances rather problematic as exchange rates have changed and rates of inflation have varied from country to country. The real growth of the European insurance industries cannot be calculated precisely over such a long period of time.

Converting all figures into a DM basis, the premium income of European insurers from direct domestic business amounted to DM 1,016 billion in 1996, which corresponds to a 32 per cent share of the world market. Of this amount the insurance industries of EEA countries and Switzerland accounted for DM 991 billion (a world market share of 31.3 per cent), whereas all remaining European countries, including those of Eastern Europe, only accounted for DM 25 billion (0.8 per cent world market share). The three European countries with the largest insurance industries are Germany, Great Britain and France, with approximately two-thirds of all European business. There are marked changes in comparison to the 1973 base year. Primary insurance premiums have increased roughly sevenfold, albeit with significant differences between the individual countries. On average life assurance has grown more strongly than non-life insurance. Today well over half the total premium volume is derived from life assurance; 25 years ago it was only about 40 per cent. The highest national growth rates are to be found in Ireland, Portugal and Spain, the lowest in Sweden, Germany and Norway. Here one can observe a clear proportional relationship between general economic development and the growth of insurance, as well as the influence of differing rates of inflation.

3. Points of departure: the 1970s

The situation of the European insurance industries in the 1970s was for the most part a relatively stable one. Post-war reconstruction and consolidation had been completed. The domestic insurance markets were clearly of primary importance. They were based on traditional "cultures" with defined structures and procedures, and all market participants followed characteristic patterns of behaviour. The legal, economic and social environment in which insurance was transacted varied from country to country, not least due to the different state social insurance systems. These to a greater or lesser extent limited the market opportunities for private sector insurance, above all in life assurance and health insurance.

© 1999 The International Association for the Study of Insurance Economics.

Furthermore there was no uniformity in the degree of regulation of insurance transactions within the European countries. There existed relatively liberally organized private sector insurance systems, such as those in Great Britain and the Netherlands, but also strictly regulated insurance industries, such as those in the German-speaking countries and Italy.

The national characteristics of the regulated insurance industries and a certain introspection in individual markets were also the cause of the difficulties in creating the European internal insurance market within the framework of the EEC of that time. Until 1973 the EEC consisted only of the six founder Member States (Belgium, France, Germany, Italy, Luxembourg, the Netherlands). In 1973 it expanded to nine states (with the accession of Denmark, Great Britain and Ireland). The obstacles to a uniform market that arose from the markets' structural differences subsequently led to the abandonment of the original plan, which was first to harmonize the legal and *de facto* preconditions for the transaction of insurance in Europe and thereafter to set up the internal market. As is well known, another approach was then adopted, to make the different market systems compete with each other. Up to now this has not functioned particularly successfully. At that time freedom of economic activity in Europe ended at the "Iron Curtain". The Eastern European states were subject to socialist planned economies with state monopolies in insurance; only in respect of international and reinsurance business did small insurance sectors exist that operated on a market economy basis.

The marked national orientation of the European insurance industries with their various regulatory systems never of course applied to reinsurance, which has always been an international, unregulated and competitive form of business. Here the main providers were the continental reinsurance companies, Lloyd's of London and the relatively recent development of professional reinsurers in America.

In the 1970s, European insurers still for the most part retained their pre-war business and ownership structures. National and international mergers and the restructuring of the major combines and groups had only just begun to take place. There are two important explanations for this. Although European insurers had survived World War II, they entered the post-war reconstruction period with limited financial resources and were initially obliged to put their core business in order again. The principal exceptions to this modest point of departure were above all to be found in Switzerland, which was not directly burdened by post-war economic and financial problems. This reconstruction process was largely carried out within old structures, as the resources needed for restructuring were not available. Secondly conditions were not yet favourable for the internationalization of insurance; in those days the buzz-words "internationalization" and "globalization" were of little significance in the insurance industry.

As a result, the reconstruction of national insurance industries followed old organizational parameters. Product innovation tended to be rare, rating systems were not fundamentally overhauled, existing distribution systems continued to be used. Only administrative systems were being constantly improved with the advent of the computer age. In France the major insurers were for the most part, nationalized, whilst in Great Britain the "Lloyd's market" operated alongside a completely differently structured "companies market". Fundamentally the same insurers were present in the German-speaking countries as before the war; a small number of companies founded after the war (some of whom used new business methods) enjoyed their first initial successes. In many countries clear distinctions existed between insurance based on the profit principle and provided by proprietary companies, co-operative insurance offered by mutuals, and finally public sector insurance provided by the state.

© 1999 The International Association for the Study of Insurance Economics.

Most European insurers transacted solely insurance in the 1970s. In most countries the insurance industry was in the widest sense still clearly separate from the banking and finance sectors. Although the terms "Allfinanz" and "bancassurance" had already come into being, the first attempts at actual implementation did not go beyond co-operation agreements in respect of distribution.

Insurers transacted insurance business and the investment business that arose from it. Investment business was for a long time essentially regarded as a corollary of the insurance fund. The current income from advance premium payments and from the savings element of life assurance and health insurance premiums was invested (subject to considerable supervisory restrictions) in the traditionally cautious manner, and above all in monetary securities, in order to obtain the actuarial interest for future insurance liabilities, as well as to fund the increasingly important participation in profits by policy-holders. It was not until the debate about cash flow underwriting which originated in the United States and the growth of unit-linked life assurance ("universal or variable life insurance") that investment activities became more important in their own right and gained a certain independence. In the final analysis, however, these activities played a rather subordinate role in the overall business strategy of insurance companies, that of a variable off-shoot "serving" the insurance business.

The 1970s situation could be summed up as follows: considerable importance of insurance cultures at the national level for primary insurers, continued existence of traditional structures and business practice, mostly strict regulation by supervisors and associations. In a manner of speaking, insurers in most (not all) European markets formed "convoys" that were led by the supervisory authorities and the associations. This limited product and price competition, entrepreneurial activities were above all focused on distribution and internal business procedures.

4. Individual changes and developments

Overview

At the end of the 1980s the relatively quiet and stable development of the European insurance industries was superseded by a period of change which is still on-going. A new stability has not yet been achieved and it is therefore not possible to draw a clear distinction between an analysis of the present and a prediction of the future.

The first impulses towards change were not initiated by the insurers themselves, but arose from actual and legal changes in the insurance environment. Here the following factors were of particular significance:

- The fall of the Iron Curtain and the opening up of Europe to the East led to the reunification of Germany and to economic, social and political changes in all the Eastern European states.
- The European internal insurance market was formally completed on 1 July 1994 when the Third Directives were incorporated into national law by the Member States, that is, 37 years after the Treaty of Rome was signed.
- The deregulation of national insurance markets consequent upon the internal insurance market had a fairly dramatic effect on some countries, particularly in those that had until then been subject to approval conditions and substantial powers of intervention by the supervisory authorities.
- Many sectors of the economy, above all industry, the financial markets, transport and telecommunications tended towards internationalization and globalization.

© 1999 The International Association for the Study of Insurance Economics.

- There was widespread privatization of organizations in the public sector, particularly in the area of the utilities, telecommunications, postal services, railways and airlines; in some countries the state insurance companies were also privatized and existing insurance monopolies came to an end.
- Most national social insurance systems are in a state of crisis, essentially as a result of demographic changes, high unemployment and falling tax revenues.

This combination of factors has not only had a direct effect on insurance business, insurers and policyholders, but has also shaken many insurers out of their somewhat passive participation in the national insurance industry "convoys" and led to new decisions about strategic concepts. Insurers are no longer "supervised businesses" with limited decision-making autonomy as was previously the case; they now have the freedom to participate fully in the market economy. Although state insurance supervision still exists in all European countries, it is restricted to legal supervision and financial supervision. Their principal functions are to ensure that insurers comply with legal regulations and to guarantee their solvency, primarily in the interests of consumer protection.

So far there has been a variable response by insurers to the challenges of their newly acquired business freedom. This applies as much to individual European insurance industries as to individual companies. In this context it must be remembered that changes in business strategy are much harder to effect in the insurance industry than in other branches of industry. Existing cultures within individual classes of business and companies are not automatically readjusted to a new situation by changes in external circumstances. Such transformation requires a creative and effective approach which experience has shown to be difficult to achieve within one generation of management. In many European insurance industries one can today observe the co-existence of insurance companies that continue to be managed in a traditional manner with those insurers who have already adapted to the new situation – a very interesting example of differential entrepreneurial behaviour. The speed at which an insurer can adjust to new situations is further reduced by the long-term nature of much insurance business and the persistence of insurance portfolios. In most insurance industries in continental Europe insurance cover (above all in respect of life assurance and health insurance) is either *de jure* or *de facto* effected for a long period of time and cannot easily be changed in line with a new business strategy incorporating, for example, new products and rating structures.

There are so far still no signs of the various national insurance cultures having given way to a uniform European one, nor does this seem at all desirable. A common Europe need not be a uniform Europe and competition between different systems of insurance, each with its own set of principles, may be more beneficial than competition within a homogenous system. However, one consequence of the cultural pluralism in the European insurance industries has so far been to limit the effects of the internal insurance market.

Eastern European markets

The reorganization of the insurance industries of the countries of Eastern Europe, and Western insurers' strategies to enter these markets have proved to be considerably more difficult than originally assumed. An exception to this is the special case of German reunification, as this involved the direct transplanting of West German economic, legal and social systems to East Germany. The transformation processes have had their greatest successes in those countries where old economic, social and cultural ties to Western Europe

© 1999 The International Association for the Study of Insurance Economics.

could be reactivated. For this reason the German, Austrian and Italian insurance industries have a special developmental role to play, due to their geographical proximity and their ability to take up former connections again.

It has for a long time been overlooked that the creation and organization of market economy based insurance industries in the former socialist states of Eastern Europe would remain difficult for as long as unstable legal, economic and political conditions prevailed and consumers had not yet "learnt" how to deal with market economy principles. The transformation of the old monopolistic state insurance providers has still not been achieved everywhere. Some of the old state insurance organizations were privatized, others sold to foreign insurers. Overall it is likely that business strategies for the Eastern European markets will fluctuate for a long time to come and present a highly variable risk/opportunity profile.

Effects of the internal market

Although an internal insurance market has formally existed in the EEA since 1994 (in which the Swiss insurance industry has a special status), in reality the situation continues to be characterized by a multitude of national markets, whilst entry to the markets and cross-border insurance transactions have been facilitated from a legal point of view. Significant internal market effects can only be observed in commercial insurance business where major international companies with geographically scattered risks may either require separate local cover in each respective country or, alternatively, seek uniform insurance cover from one insurer in its home country on the basis of the parent company's insurance programme. Both approaches have become technically easier in the internal market.

In personal lines business the national insurance markets with their individual characteristics remain largely unchanged. This is due to the realization that insurance business is primarily a local business. Insurance transactions cannot in practice be easily transported across borders on the basis of the import/export model. Only the essential core of the insurance transaction, namely the exchange of losses with an underlying probability distribution in return for fixed premiums, can (putting exchange rate problems to one side) be traded across borders, as indeed occurs successfully in international reinsurance. In the first place the types of the risks to be insured are strongly characterized by all manner of national factors, and this extends to the type of covers required, rating structures, the nature of advice given to customers, distribution and administration, including claims processing. All these processes should be carried out as close as possible to the location of the customer or the risks. A further complication arises from the fact that many areas of EU jurisprudence are not harmonized, for example insurance contract law and all taxation law; this also impedes cross-border insurance transactions.

A European internal insurance market for personal lines business is, and probably will remain, an illusion for a long time to come. Those insurers interested in expansion have long since recognized this fact. Entering new markets requires a local presence, either by the painstaking establishment of branches or subsidiaries, or by the expensive acquisition of existing insurance companies, the latter being also advantageous in achieving a minimum critical mass in the country concerned. In both instances the methods of operation are determined by the culture of the country of activity, not the country of origin. This is in fact the exact opposite of "globalization", as it involves the differentiation of business activities according to the conditions of each individual country concerned.

One effect of the internal market that can already be clearly observed is "virtual competition" between the systems. Insurers in the individual countries carry out detailed

© 1999 The International Association for the Study of Insurance Economics.

studies of the products, premiums, distribution systems and business procedures of the insurers in other countries. If in doing so certain features are perceived as particularly advantageous, they are adopted for the home market, *inter alia* to ward off potential entry to their market by foreign competitors. Good examples of this are the different forms of life assurance in Britain, German legal protection insurance and health insurance, French assistance products, the adoption of exotic London market insurance covers and sometimes also American insurance products, available from the European subsidiaries of American parent companies.

Broadly speaking one can conclude that the European internal insurance market is in place, but little use has been made of it so far. It has reduced the legal barriers to entry into foreign markets, but has not removed the actual difficulties associated therewith.

The effects of deregulation

An assessment of the effects of deregulation produces a significantly different conclusion, above all in respect of those countries that until 1994 were characterized by strict regulation by supervisors and associations and by the activity of state insurance companies, for example all the German-speaking countries, Italy and to a lesser extent France, Spain and Portugal. The most important effects of deregulation derive from the greater degree of freedom in designing insurance products and setting premiums. In a number of countries both used to depend on approval by the supervisory authority; now insurers have commercial autonomy in these spheres. Insurers now have the freedom to operate in competitive market places and can essentially determine for themselves those factors on which their success depends, namely portfolio composition, products, premiums, distribution systems and business procedures. This has led to increased levels of competition in many sectors of the market, particularly the major ones, which are in most cases life assurance and motor insurance.

The consequences of this are decreasing insurance business profit ratios, coupled with decreasing transparency for both sides of the market. Insurers are having increasing problems in maintaining meaningful claims statistics and competition is making it difficult for customers to determine which offer is really the best for them. Dogmatic proponents of competition like to put forward the theory that strong competition leads to the best consumer protection, but so far this has not proved to be the case in the European insurance industry. Competition is only beneficial to those consumers who know how to make use of it and are prepared not only to realize the opportunities it offers but also to accept the risks of wrong decisions that it entails. For those involved, the current situation in the deregulated insurance markets is still a highly nebulous one and far removed from a socially satisfactory state of affairs. For this reason thoughts are once again turning to regulation to provide additional consumer protection, perhaps in the form of insolvency protection funds for policy-holders. Such considerations as deregulation coupled with the introduction of insolvency protection funds surely belong to the realm of the absurd and indicate that an optimum mixture of competition and consumer protection has so far been achieved neither in the EU internal market nor in the individual national markets.

The crisis in the social insurance systems

In all the European countries the social insurance systems are facing serious crises, particularly in relation to retirement and dependants' provision. It is inevitable that the

© 1999 The International Association for the Study of Insurance Economics.

benefits under social insurance schemes will be reduced so that individuals must increasingly make their own provision in the private sector. Provision for retirement can only be made within the private sector through saving, that is by capital funding, and these arrangements must be linked with insurance against the risks of premature death, invalidity and longevity. For this reason, private sector arrangements for such provision are in general based on a combination of insurance and banking products. This again is the background to the new development of bancassurance strategies in financial conglomerates whereby products for capital funding and capital consumption are combined with risk insurance products. The traditional forms of life assurance, health and care insurance, the pension fund and pension investment business, asset management services and much more are all involved. This development has already resulted in some spectacular mergers amongst insurers, banks, investment and other financial institutions and there are no signs of an end to this development.

5. Strategies of the European insurers

Strategic concepts

The changes in the environment within which insurance is undertaken have led European insurers to seek new strategies to define the long-term development of the individual companies, albeit that the basic strategic concepts are not at present uniform.

The inherited strategic concepts of most insurers were strongly oriented towards production, and classes of business and the available resources, in terms of underwriting, administration and distribution systems, determined the business philosophy of the individual insurers. The offering of particular insurance contracts was the norm and, in essence, the customers had the option of accepting the insurance contracts offered or of declinature. This applied, above all, to personal lines business with private customers which has predominated in terms of both numbers and amounts. Conversely, in commercial business, under pressure from newer risk management concepts, and in reinsurance business, the insurers' strategic planning has always been based on the customers' requirements within the capacity dictated by resource limitations, such as available reinsurance cover and solvency capital as well as underwriting restrictions ("insurability" and premium calculation).

In the European internal market and resulting from deregulation, strategic concepts related to market and customer orientation have gained ground. "Customer orientation" is a frequently stated maxim of business planning, although its application is not without difficulties as it requires an overall optimization of the insurance cover offered, the price, distribution and business administration. To the extent that the distribution of insurance business depends on independent brokers, the basic philosophy of the company will increasingly have regard to the requirements of this category of insurance intermediaries. In line with this concept, insurers no longer address their products primarily to insurance customers but to the independent intermediaries who act as "retailers" of insurance products. This development again depends on the inherited mores of distribution. In certain European countries broker distribution predominates (for example, Great Britain, Netherlands) whilst in others it is the tied insurance agents (for example, Germany, Austria, Switzerland, Italy).

A relatively new strategic consideration of insurers is oriented towards the development of their "business worth", the overall strategic aim being the increase in the worth of the business. However, it is not only proprietors who participate in this wealth accretion (shareholder value) but in many cases also policy-holders (policy-holder value) and possibly

© 1999 The International Association for the Study of Insurance Economics.

also employees and other interest groups (stakeholder values). The definition of this philosophy of "business worth" is not yet finally settled. It should be emphasized, however, that in the insurance business the role of the customers, namely the policy-holder and other creditors, is much more pronounced than in most other business sectors.

"Big business" strategies

Big business strategies are directed towards growth, size, internationalization and perhaps globalization. They follow the hypothesis that there are advantages of size and network which result in the expectation of greater profits. As growth prospects in national markets are generally limited, such an overall strategy leads to concentration, in particular through the taking over of other companies. This concentration is clearly in evidence at the present time both nationally and internationally as well as in the insurance sector proper and in the wider field of financial institutions. It frequently extends beyond the European frontiers into America and Asia and there are well-known examples. One can even observe a degree of competition as to which is the largest worldwide insurance group or financial group or which is the largest worldwide insurer. In this context, the boundaries between insurance business and financial transactions are becoming ever more ill-defined.

Big business strategies should contribute increasingly to the company aims, that is, growth, market share, and not least profit. The major impression one has of the large take-overs and mergers of recent years is that the actual short- to medium-term synergy effects are far below expectations. The promise of success of expansionist strategies is evidently only realized in the very long term and frequently requires the foregoing of returns on capital in the short to medium term. Insurers speak enthusiastically of "globalization strategies" but such expressions should be interpreted with caution. Globalization implies the exploitation of the world market with standardized products, produced in locations with the minimum costs. This expression scarcely applies to the core business of insurers, at best to the associated investment and other financial transactions. Globalization should not be confused with internationalization of business operations where operational methods which accord with local practice are adopted in differing insurance markets, albeit that the associated investment and financial transactions are "globalized", that is, structured in the context of the world market.

The big business strategy leads almost inevitably to national and international concentrations in the insurance and financial sectors. Experience to date and the scenario for the years ahead demonstrate the predominance of concentrations among companies which themselves are already large. The fear that the large companies would take over small ones has not so far materialized. Nor is this likely in the near future, as the amalgamation of a large insurance or financial group with smaller companies does not usually give rise to advantages of scale or association.

"Small business" strategies

Strategies for small businesses are also observable, and again as a reaction to the changed environment. These strategies are based on specialization, regionalization, localization of the sphere of operations, they seek advantages in a more individual approach to the business and greater flexibility. The insurers have no wish to transact all and any business, but good business. In such cases the profitability arises above all from specialist resources, availability of "know how" for specialist business and stronger customer orientation. The concept

© 1999 The International Association for the Study of Insurance Economics.

matches business operations in niche markets that for the larger operators are likely to be uninteresting. Evidence to date suggests that this strategy promises to be successful. It involves lower capital intensity. The profitability arises less from large business volumes and more from the quality of the business.

New products

Increased competition in the national and international insurance markets has given rise to imaginative developments of insurance products and, at the same time, made the transitions between insurance and other financial transactions more diffuse. The initiative for new products stems, in part, from the acquisition policy of the insurers and as a result of particular marketing exercises; however they also result, in part, directly from specific demands from customers, in particular commercial customers.

There are a number of developments in the area of primary insurance. In personal lines business, insurance contracts are increasingly based on "modules", that is, specific risk coverages or insurance protections are put together, sold and processed in one insurance contract according to the customer's needs. In the light of customer orientation, a greater degree of personalization and flexibility of the product structure is thus achieved. Such module-based products do however involve greater calculation and administration difficulties than the traditional standardized products; in particular they demand the application of appropriate information technology and differentiated premium calculation. In commercial business, refinement and development of concepts of risk management have led to changes in the demand for insurance. Large concerns, often operating internationally, are increasingly adopting complex combinations of risk management instruments including non-insurance, self-insurance, captive insurance and professional external insurance. In this last area, where risks are placed in the traditional insurance markets, frequently only exposures to large claims or claims accumulations are insured, under excess of loss contracts similar to those of the reinsurers. This has major consequences for insurers of commercial business: premium volumes tend to decrease, claims experience is less stable, the technical insurance risk of the portfolio increases. Possible maximum losses are continually increasing in relation to total premiums.

Alternative Risk Transfer ("ART") business is a second important product development. Insurance is, in general parlance, defined as a transfer of risk in return for a fixed premium. On this definition, ARTs are not really insurance business but this is not the case in practice. There is no clear distinction between ART business and high aggregate excess of loss contracts, financial (re)insurance contracts and other contractual instruments. On the other hand use is made of many of the elements of classical financial instruments for external financing and of the new financial derivatives such as options, futures and similar contracts. In some cases ARTs are also drawn up in the form of securities and regularly traded on financial markets and stock exchanges ("Risk Securitization"). In ART business, all imaginable participants in the capital market including banks, financial intermediaries and the stock exchanges are involved together with the insureds (in particular large concerns), primary insurers and reinsurers.

The basic principle common to all ART business is the fact that the risk carriers are not professional insurers but investors of capital on the financial markets. However, in the meantime large international primary insurers and particularly reinsurers are participating as investors in this business. In principle, the same basic factor applies as in professional insurance business, namely the exchange of probabilistically distributed payments against deterministic payments. Many of the transactions are no longer undertaken in the form of cash

© 1999 The International Association for the Study of Insurance Economics.

transactions with large cash flows but as insurance or financial derivatives. A significant motive is the utilization of the readiness of risk capital available worldwide to assume risk and, at the same time, to achieve a spread of risk between typical insurance risks and general financial market risks. At the present time the future development is unclear. Some experts consider that the situation is a passing fashion, others fear that professional insurance will, to some extent be supplanted by ARTs.

A third product development which should be mentioned concerns the combination of capital funded retirement provision with coverage of the risks of both premature death and also longevity. This has been stimulated primarily by the crises in state schemes for retirement provision. In this class of business, life assurance has increasingly to compete with other financial products promoted by banks, investment companies and so-called pension funds. Asset management, which is increasingly regarded as a separate class of business involving the development and management of personal or collective investment portfolios, is also included in this area. From the point of view of the insurance companies this implies an extension of classical capital investment business which is diverted from the life assurance business. Pure asset management not combined with risk coverage is, of course, not an insurance activity and therefore not authorized under the general principles of insurance supervision. This inevitably leads to financial conglomerates within which all types of risk and financial transactions can be provided.

Insurance and investment business

Alongside insurance business in the strict sense of the word, insurance companies transact investment business. This arises from the advance payment of premiums and the capital accumulation and consumption processes which typify the life assurance and health insurance sectors. Thus capital investment business was long regarded as an appendage to the insurance business which converted the funds so accumulated into income producing assets and back into monetary form when required. More recently, capital investment business, which constitutes a particular form of asset management, has increasingly been regarded as an independent business sector and risk spreading effects between this business and pure insurance business have consciously been sought. This has led to the concept of asset–liability management, whereby risk spreading measures are applied to the overall direction of the investment portfolio and the insurance portfolio.

The investment philosophy for general insurance differs, significantly of course, from that for life assurance and health insurance. In general insurance, the investment results are primarily regarded as smoothing the fluctuating insurance results. There is therefore a particular expectation that the investment risk–reward trend should be independent from that of the insurance business so that smoothing effects can be achieved. Clearly it cannot be ruled out that, whether randomly or for underlying reasons, the results from both sectors of business are simultaneously unfavourable. This could relatively quickly lead to a crisis situation for the insurance company which again suggests that the investment business should be more risk averse.

In life assurance the interest spread problem is of greater importance and a degree of similarity with the lending and deposit-taking business of the banks is evident. In the past, the average yield on the investments determined the amount of the insureds' profit participation which was credited over and above the actuarial interest underlying the premium calculation. Nowadays and in the future, the overall yield will be determined by the requirements of the market and of the competition, and the investment business must deliver the average yield

© 1999 The International Association for the Study of Insurance Economics.

thus required. To this end, hidden reserves and derivative financial instruments will be utilized. This competitive pressure will thus result in more active investment management. Another situation arises in the area of unit-linked life assurance; here the investment policy of the insurance companies is replaced by the actual fund policy of the investment companies.

New company and group strategies

The developments described have led to widespread reorganization of company and group structures in the European insurance countries. The causes were frequently take-overs of other companies, the extension of the area of operations to encompass financial transactions, outsourcing of particular service functions. The basic pattern of the new structures is very uniform. At the apex of the group there is a holding company, which controls the operating companies and maintains external relations, above all with the capital markets. Below the holding company, the operating companies are deployed for the particular insurance businesses and for particular banking, financial and service businesses as the case may be. These operating units often specialize in particular business sectors, for example for selected customer groups, selected distribution channels or other defined specialist business. In many cases even differing company or product names are used.

The situation governing the legal constitution of insurers varies in the different European countries, not least having regard to the non-uniform regulations for mutual insurance associations and public sector insurers. In large insurance and financial groups, the co-operative and public sector forms of company structure are tending to lose significance because they complicate the group control and limit the possibilities for external finance. However this does not alter the actual basic philosophy underlying the business. The connection between a particular business philosophy and the adoption of a particular legal constitution may be weakening. In particular, the limited company constitution stands out as a flexible form within which both mutual and public sector based insurance business can be transacted.

Conclusion: polarization

If one summarizes the changes in the European insurance industry over the last 25 years and considers also the scenario for the further development, the trend to polarization is clearly evident. In the past, within the national markets more or less standardized structures, processes and behavioural patterns adopted by the participants in the market and the insurance companies were observable even though there were very significant differences between national markets. At present and in the future, these uniform or common patterns will tend to disappear, and differentiation and polarization will intensify as many examples testify:

- The service providers are, on the one hand, large insurance or financial groups, frequently operating Europe or worldwide and, on the other hand, smaller or medium-sized specialist insurers operating more at a national or even regional level.
- The products on offer are either standardized "mass-market" contracts or are personalized and flexible individual contracts.
- The insurance customers are either rational, knowledgeable and professional purchasers of insurance and financial services or there are, as ever, impressionable customers with a great need for advice and service.

The observable strategies of the insurers also demonstrate polarization. Common strategic concepts adopted by many or all companies which were normal and appropriate in

© 1999 The International Association for the Study of Insurance Economics.

the old days of strict regulation are being replaced by specific strategic concepts. There are many examples which can be adduced:

- Insurers present either a standardized range of products or a sharply differentiated range whereby one can distinguish between uniform and specialist strategies, in the latter case frequently by reference to the technique of optimizing a portfolio based on business sectors.
- A similar distinction arises between generalized strategies covering all classes of insurance and financial services and specialized strategies directed to selected areas of business.
- At present it is still unclear whether there is also a differentiation between business strategies based on the principle of diversification or on core competencies. From the point of view of the insurer, the question is whether to continue to operate solely in the traditional business of primary insurance and reinsurance or whether to enter new fields of business. The empirical evidence is still nebulous.
- Similarly, the conflict between marketing, production and sector oriented strategies on the one hand and demand, utility and customer oriented strategies on the other has still not been finally resolved.

It may be that the changes in the European insurance industry are too recent for stable new structures and strategies to have been developed. This is, incidentally, not peculiar to the insurance industry. In other business sectors which are facing completely new situations as a result of the European internal market, deregulation and the opening of the Eastern European markets, it is also not possible to draw firm conclusions.

6. Conclusions regarding the theory of business management studies for insurance companies

The definition of the theory of business management studies

In the German-speaking countries, business theory, defined as "business management studies" is a specific scientific development. The substance of the theory of business management can be found in other European counties and the rest of the world albeit with other terminology and other boundaries. The German expression "Betriebswirtschaftslehre" (business management studies) is closest to the English language term "study of business administration" and in part also to "economics" (microeconomics); and to the French term "économie et commerce".

The following considerations apply principally to the concepts of German business management studies and in particular to insurance management studies. The subject-matter of these theories is the economics of insurance companies, the relationship of the company to its environment, including resources, distribution channels and financial markets.

An empirically realistic theory of business management of insurance companies proceeds from the realities of the business, incorporates these into models with a degree of abstraction and draws conclusions as to particular situations, above all as to the effectiveness of selected structures and procedures and to the decisions necessitated thereby. The realistic empirical theory of insurance management applies certain elements of the mathematical theory of risk to the insurance risk business, usually including the legal regime applicable to insurers and insurance business.

In contrast there also exists a form of pure business theory of insurance and of insurance

© 1999 The International Association for the Study of Insurance Economics.

companies. This creates entirely abstract models, often in quantitative form and with the application of the mathematical theory of risk. However this rarely or never arrives at the realities of the business because of the large number of assumptions made. This pure economic theory is primarily concerned with the insurance transactions and the necessary decisions connected therewith on the part of the policy-holders and the insurers as well as the market situation; only exceptionally, however, is it concerned with the insurance companies themselves. For this reason, this theory has only a limited interface with empirically realistic insurance management studies.

Situation of insurance management studies in the 1970s

Already in the 1970s, insurance management studies were extensively developed. Important progress had been made with the peculiarities of the insurance business remaining in the background so that the theoretical models of generalized business management studies and the developing business management studies of the service sector could be applied. The basic concepts can be described as follows:

(1) Insurance companies are productive undertakings. They procure factors of production in the market and, by means of specific insurance and administration techniques, combine these to create the product "insurance cover" which they market to purchasers. This results in an input–output relationship which can be illustrated by reference to dealings in commodities or in nominal goods (financing). The result is a commodity- or production-based theoretical version of insurance management studies.
(2) Insurance companies are autonomous undertakings which pursue certain aims and decide on the structures, programmes and methods by which these aims are to be achieved. This leads to decision-based insurance management studies where strategic and operational possibilities and efficiencies are researched. As the decisions are made by individuals, connections with behavioural or social science concepts can be observed.
(3) Insurance companies are institutions which fulfil both individual and collective missions. From this standpoint, function-based insurance management studies can be adduced which research the individual functions. These are primarily resourcing, provision of services, marketing and distribution as well as financing (each of which can be further subdivided). To the extent that the missions involve relationships between the company and its environment, these studies clearly include market-related questions.
(4) A very formalized version of insurance management studies utilizes models based on system theory and cybernetics according to which an insurance company is a system of elements with cross-relationships and governed by a system of rules.
(5) Insurance management studies based on information theory form a particular variant. As parts of a whole, insurers and insurance transactions are essentially described in terms of the resulting flows and funds of information. This is based on the idea that, from the point of view of the customers, insurance cover is, in essence, information guaranteeing non-disturbed conditions. Important questions of business management studies which can not otherwise be formulated in terms of "information" are described by means of the concept of "insurance technology".

© 1999 The International Association for the Study of Insurance Economics.

Further developments

The actual development of the insurance business in Europe has also influenced insurance management studies. In particular, the long discussion concerning the European internal market, deregulation and the increase in competition have resulted in researches into the strategies of insurers in reaction to the changes. Strategic decisions affect the overriding aims of an undertaking, the analysis of its entrepreneurial and market potential and the search for methods of achieving the identified potential for success over the long term. Thus there was increasing recourse to the theory of portfolios based on sectors of business which gave rise to consideration of differentiation and segmentation of the business activity; herein lie the early roots of the polarization presently observable. Isolated theories of product and price construction, customer segmentation, distribution systems, are also developed into a general system of controlling. "Controlling" is nothing other than the management of an undertaking in the direction of the strategic and operational aims.

A new task for insurance management studies has arisen out of the national and international mergers of insurance companies and other financial institutions. This concerns not only strategies but also the approach adopted in each individual case to its unique situations, above all the structure of such concerns and groups and the evaluation of the undertakings. Such factually based research results in a close link between business and legal questions, particularly in relation to individual and group company law and competition law. So far as the new institutional groups and financial conglomerates are concerned the questions are not settled; in particular, questions of supervision including the solvability of insurance groups and financial conglomerates on a EU basis are still open.

Particular theoretical approaches have been applied in relation to the internationalization and globalization of insurance business. So far, they are incomplete, as is the reality of an international and global insurance industry itself. The continuing development of information and communication technology has also influenced insurance management studies as most processes within the undertakings and the relationships to the environment are directly influenced by it.

Latest developments

Alongside the traditional business management theories of insurance and insurance companies a new concept has emerged in recent times, which can be described as a method of observation based on capital market or financing theories. It has a number of starting points:

- The diminishing isolation of the insurance industry as a branch of industry standing on its own and its increasing integration with the banking and financial sectors gives rise to the question whether there is a general theory for all financial institutions which, in essence, can be formulated in terms of the relationships of the undertakings to the capital and financial markets.
- Within the insurance companies themselves, this consideration is supported by the integration of insurance and capital investment, for example, in the form of asset–liability management.
- The evolution of insurance transactions in the direction of financial insurance, ARTs, and insurance derivatives reveals a certain relationship between insurance transactions and financial and capital market transactions, in particular as regards options, futures, hedge transactions, so that common interpretations are suggested.

© 1999 The International Association for the Study of Insurance Economics.

The theoretical capital market or financing concept has a certain antecedent in the theory and practice of cash flow underwriting which was developed in the 1970s consequent upon a particular supervisory situation in the United States. At that time the theory was developed that insurance was not only a risk transfer transaction but also a financial transaction as the flow of insurance premiums and the technical insurance reserves (and hence the investments) thus built up, was comparable to other forms of external financing (participation and credit finance).

By a highly abstract process, the theory was developed that insurance companies were financial institutions or financial intermediaries that take in capital from the markets by way of insurance transactions and other financial operations which they reinvest in the markets. Defined risk–reward positions would be aimed for by this overall operation. Various isolated theories are used in the formulation and exposition of this type of business activity including the capital asset pricing model, portfolio theory, investment theory and many others.

The theoretical capital market and financing version of insurance management studies operates from an extremely abstract level, usually with quantitative models and highly aggregated data. It approaches a degree of reality, albeit limited, in relation to the global financing decisions of large insurance groups and finance conglomerates, for ARTs on the capital markets and for large volume reinsurance business. Such a theory can not however describe the reality of the insurance business operations. In particular, the individual insurance transaction of an individual customer with an individual insurer is a closed book for this theoretical approach. The individual insurance transaction is not generally viewed as an investment with risk–reward aspects but is entered into to safeguard the economic situation of the insured which is a completely different factual situation from a capital market transaction. Further, the actual business activities, such as resourcing, distribution, underwriting and claims processing and administration can not readily be brought within the theoretical capital market and financing concept.

Summary

Over the last 25 years insurance management studies have kept pace with actual developments in the European and worldwide insurance industry and have developed in line with the real situation. This has given rise to a degree of pluralism which has benefitted the pursuit of knowledge. On the one hand, there is the traditional study of insurance management with both feet on the ground of the realities of the insurance industry; while on the other there is a highly abstract theory of insurance, one might say with both feet “up in the air”. When we come to the 50th anniversary of the Geneva Association we will know whether these two theoretical approaches are in any way compatible.

BIBLIOGRAPHY

1. The Development, Status and Future of the European Insurance Industry

Attinger, Peter: Internationale Wettbewerbsfähigkeit in der Versicherungsbranche, Karlsruhe 1994.

Ennsfellner, Karl C.: Internationalität von Versicherungsunternehmen, in: Die Versicherungsrundschau, 1988, Nr. 5, S. 78–84.

Farny, Dieter; Globalisierungsstrategien in der Versicherungswirtschaft?, in: Versicherung, Risiko und Internationalisierung, Festschrift für Heinrich Stremitzer, Wien 1996, S. 265–276.

Farny, Dieter: Realität und Szenarien der deutschen Versicherungswirtschaft, in: Asset Management, Stuttgart 1988, S. 3–17.

© 1999 The International Association for the Study of Insurance Economics.

Gerling Konzern Globale Rückversicherungs-AG (Hrsg.): Wachstum ohne Grenzen - Grenzen des Wachstums. Die zukünftige Herausforderung für Versicherungsunternehmen, Köln 1998.
Kielholz, Walter B.; Schanz, Kai-Uwe: The Strategic Development of Insurance Markets, in: Geneva Papers on Risk and Insurance, (23) No. 88, Juli 1988, S. 309–317.
Kalweit, Rainer; Lieber, Bernd; Jakob, Geribert (Hrsg.): Versicherungswirtschaft im Umbruch, Karlsruhe 1995.
KPMG (Hrsg.): Vision 2002. European Insurance. Trends, Challenges and Issues, 1998.
Lohéac, Francis: Die Versicherungswirtschaft im 21. Jahrhundert, in: Versicherungswirtschaft, (52) 1997, S. 8–13.
Michaels, Bernd: Die Chance des Umbruchs ergreifen!, in: Versicherungswirtschaft, (51) 1996, Beilage zu Nr. 23, S. 3–13.
Müller, Helmut: Versicherungsbinnenmarkt, München 1995.
Muth, Michael: Versicherungswirtschaft im Umbruch, in: Versicherungswirtschaft, (49) 1994, S. 288–298.
Rabe, Thomas: Liberalisierung und Deregulierung im Europäischen Binnenmarkt für Versicherungen, Berlin 1997.
Schitag Ernst & Young Unternehmensberatung GmbH (Hrsg.): Die Lebensversicherung auf dem Weg in das dritte Jahrtausend, München 1997.
Schweizerische Rückversicherungs-Gesellschaft (Hrsg.): Alternativer Risikotransfer durch Finite Risk-Rückversicherung, sigma 5/1997, Zürich 1997.
Wagner, Fred: Risk Securitization als alternatives Mittel des Risikotransfers von Versicherungsunternehmen, in: Zeitschrift für die gesamte Versicherungswissenschaft, (86) 1997, S. 511–552.
Wagner, Fred: Internationalisierung und Globalisierung: Strategien für deutsche Erstversicherer, in: Versicherungswirtschaft, (53) 1998, S. 732–740, 811–819.
Weidenfeld, Gerd: Der Europäische Binnenversicherungsmarkt und seine Auswirkungen auf die strategische Unternehmenspolitik von Erstversicherern, Lohmar, Köln 1997.

2. *Insurers' Strategies*

Berghe, Luitgard Van den: Der Wettlauf um die Zukunft in der Bank- und Versicherungsbranche, in: Versicherung, Risiko und Internationalisierung, Festschrift für Heinrich Stremitzer, Wien 1996, S. 53–65.
Farny, Dieter; Kirsch, Werner: Strategische Unternehmenspolitik von Versicherungsunternehmen, in: Zeitschrift für die gesamte Versicherungswissenschaft, (76) 1987, S. 360–404.
Moormann, Jürgen: Strategische Neuorientierung, in: Versicherungswirtschaft, (48) 1993, S. 1234–1240.
Schradin, Heinrich: Erfolgsorientiertes Versicherungsmanagement, Karlsruhe 1994.
Settnik, Ulrike: Erfolgreiche Unternehmenspolitik auf europäischen Versicherungsmärkten, Wiesbaden 1996.

3. *General Insurance Economics*

Diacon, Stephen (Hrsg.): A Guide to Insurance Management, London 1990.
Eisen, Roland; Müller, Wolfgang; Zweifel, Peter: Unternehmerische Versicherungswirtschaft, Wiesbaden 1990.
Farny, Dieter: Versicherungsbetriebslehre, 2. Auflage, Karlsruhe 1995.
Helten Elemar: Versicherungsbetriebslehre, in: Handwörterbuch der Betriebswirtschaft, 5. Aufl., Stuttgart 1993, Sp. 4598–4611.
Müller, Wolfgang: Theoretical Concepts of Insurance Production, in: Geneva Papers on Risk and Insurance, No. 21, Oktober 1981, S. 63–83.
Weber, Lukas: Integriertes Leistungsmanagement in der Versicherung, Bern, Stuttgart, Wien 1995.

4. *Recent Developments in Insurance Economics*

Albrecht, Peter: Zur Risikotransformationstheorie der Versicherung, Karlsruhe 1992.
Albrecht, Peter: Kapitalmarkttheoretische Fundierung der Versicherung?, in: Zeitschrift für die gesamte Versicherungswissenschaft, (80) 1991, S. 499–530.
Bachmann, Winfried: Leistung und Leistungserstellung der Versicherungsunternehmen, Karlsruhe 1988.
Eszler, Erwin: Betriebswirtschaftliche Versicherungsforschung auf erkenntnistheoretisch-ontologischer Forschung, in: Zeitschrift für Versicherungswesen, (46) 1995, S. 639–644.
Eszler, Erwin: Zu einer allgemeinen Theorie der Versicherungsproduktion, in: Zeitschrift für die gesamte Versicherungswissenschaft, (86) 1997, S. 1–36.
Farny, Dieter: Wissenschaft und Praxis der Versicherung, in: Fünfzig Jahre Institut für Versicherungswissenschaft an der Universität zu Köln, Berlin 1991, S. 49–74.

© 1999 The International Association for the Study of Insurance Economics.

Haller, Matthias; Ackermann, Walter: Versicherungswirtschaft - kundenorientiert, Zürich 1992.
Helten, Elmar: Insurance Economics Between Theoretical Ambitions and Empirical Relevance, in: Geneva Papers on Risk and Insurance, (16) No. 60, Juli 1991, S. 339–350.
Höller, Jürgen: Versicherungstechnologie, Karlsruhe 1997.
Karten, Walter: Erinnerungen an ein paar notorische Versicherungs-Irrtümer, in: Neue Wege des Versicherungsmanagements, Festschrift für Günter Schmidt, Karlsruhe 1997, S. 75–92.
Köhne, Thomas: Zur Konzeption des Versicherungsproduktes, in: Zeitschrift für die gesamte Versicherungswissenschaft, (87) 1998, S. 143–191.
Kotsch, Harald: The Risk Consolidation of the Insurance Industry from a Financial Perspective, in: Zeitschrift für Wirtschafts- und Sozialwissenschaften, (116) 1996, S. 359–378.
Kotsch, Harald: Der Risikoausgleich im Kollektiv auf der Grundlage des CAPM, in: Zeitschrift für die gesamte Versicherungswissenschaft, (82) 1993, S. 193–224.
Kromschröder, Bernhard: Versicherung aus kapitalmarkttheoretischer Sicht, in: Versicherungsmärkte im Wandel, Karlsruhe 1987, S. 87–99.
Maneth, Matthias F.F.: Versicherungsschutz - eine Option, in: Zeitschrift für die gesamte Versicherungswissenschaft, (85) 1996, S. 401–441.
Müller, Wolfgang: Finanzierungstheoretische Analyse der Versicherungsunternehmen und Versicherungsmärkte, in: Zeitschrift für die gesamte Versicherungswissenschaft, (72) 1993, S. 535–574.
Riege, Jürgen: Das Versicherungsprodukt, in: Zeitschrift für die gesamte Versicherungswissenschaft, (79) 1990, S. 403–470.
Seng, Peter: Informationen und Versicherungen, Wiesbaden 1989.
Smith Jr., Clifford W.: On the Convergence of Insurance and Finance Research, in: Journal of Risk and Insurance, (53) 1996, S. 693–717.

© 1999 The International Association for the Study of Insurance Economics.