The Structure and Regulation of Insurance Markets in Europe

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Despite the huge upheavals in financial and industrial structure of the past decade, the European insurance markets, with the partial exception of the United Kingdom and Switzerland, have traditionally remained highly fragmented national markets. In contrast to the banking and securities sectors, they have been overprotected and have not been part of any globalization process. This may be explained partly by the specificity of the insurance business, which has historically given rise to excessively restrictive regulatory systems, and partly by the existence of cultural differences and practices, which by themselves have restricted domestic competition and made foreign penetration difficult.

In view of this situation, the limited impact of the first attempt by the European Community in the 1970s to open insurance markets through the freedom of establishment is not surprising. In recent years, however, the process of insurance market integration has been set in motion, to some extent by autonomous factors such as the blurring of frontiers in financial services and the linkages between financial sectors, but mainly in the context of the European Community's plan to complete the internal market by the end of 1992. An important part of this ambitious project is the creation of an integrated financial area, with full liberalization of capital movements and the free supply of

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financial services across borders in the field of banking, securities, and insurance.

The first section of this paper highlights the basic structural characteristics of the European insurance markets. The following section analyzes the current balance between insurance regulation and competition in the context of the European Community's financial integration program, the proposals relating to insurance, and the outlook for effective opening of the markets. This is followed by a discussion of the regulatory interactions of the insurance sector with the banking sector at the production, distribution, and ownership levels, and some concluding remarks.

Basic Indicators

Market Share

The insurance business is well developed in several European countries. After suffering declines in the early 1980s, insurance markets in Europe have been expanding, although not as quickly as in Japan, which has seen its share of total world premiums rise steeply (partly at the expense of the United States) from only 2.2 percent in 1960 to 24 percent in 1988. Europe's share that year is estimated to have been about 30 percent, compared with 37 percent in the United States. The European Community (EC) accounted for 23 percent, while Switzerland and the non-EC Scandinavian countries accounted for most of the remainder of Europe's share.[1]

In line with population size, the largest markets in Europe are Germany, the United Kingdom, and France, jointly accounting for more than 75 percent of the EC total direct insurance production in 1988. Italy, a country with a similar population size, participated with a bare 7.5 percent, implying a much less developed market.

Relative Size

Two frequently used indicators of the development of the insurance sector in a country are shown in Table 1. The first relates the level of annual premiums to national income and measures the flow of savings through insurance expenditure. The second relates the level of annual premiums to population and measures the concentration of insurance in

[1] The relative shares in world GDP are: 20 percent for the United States and for the European Community, and 11 percent for Japan. Thus, Japan's share of premiums is very large compared to its economic importance.

Table 1
Basic Indicators of Development of the Insurance Industry, 1988

Country	Annual Premiums[a] as a Percentage of GNP	Per Capita Premiums[a] (U.S. Dollars)	Average % Growth of Premiums 1984–88	Insurance Employment[b] as a Percentage of Total
Ireland	11.4	938	4	n.a.
United Kingdom	9.3	1,358	13	1.34
Netherlands	7.5	1,180	14	.83
France	6.4	1,123	20	.97
Spain	6.3	546	64	.53
Germany	6.2	1,241	12	.91
Denmark	5.6	1,128	18	.52
Belgium	5.1	775	14	1.59
Luxembourg	3.1	762	19	n.a.
Portugal	3.0	122	26	1.27
Italy	2.9	415	20	.61
Greece	1.4	76	18	.98
EC Average	5.7	805	20	.95
United States	10.0	1,965	7	1.76
Japan	9.9	2,292	26	2.67

[a]Direct business plus reinsurance accepted
[b]Includes intermediaries
Source: *Sigma*, publication of the Swiss Reinsurance Company; OECD Insurance Statistics; and *EUROSTAT.*

a country. The higher the indexes, the higher the development of the country's insurance industry.

Differences in operating costs and investment efficiency, as well as exchange rate considerations in the case of the second indicator, may distort comparability. Table 1 shows, however, that the insurance sector is highly developed in the United Kingdom and the Netherlands, compared to that of the southern EC countries. France, Germany, and Spain stand in the middle. The position of Ireland is partly explained by preferential tax treatment of life insurance premiums, in conjunction with high marginal rates of income tax, and that of Japan by the preponderance of single-premium business, motivated by low interest rates on deposits. Among the non-EC countries (not shown in Table 1), the ratio of premiums to GDP is very high (12.1) in Switzerland, and the ratios in Sweden and Finland are somewhat higher than the EC average.

Financial Intermediation

The role of the insurance sector in the financial intermediation process can be indicated by the value it adds to national income or by its contribution to total employment, the latter also shown in Table 1. It appears that for EC countries the sector contributes relatively more, in terms of employment, in the United Kingdom, Belgium, and Portugal. Since the latter two countries have a relatively underdeveloped insurance sector, more employment suggests a certain degree of inefficiency.

Another measure of the importance of the life insurance industry in the domestic financial market is the ratio of life funds (that is, reserves and other liabilities to policyholders) to national income. Data are not readily available, however. It has been reported that this ratio is about 30 percent in Switzerland, the United Kingdom, and Japan, and about 20 percent in Germany, the Netherlands, and the United States (Vittas and Scully 1990). Such ratios imply that life funds represent a substantial pool of resources. It should be noted, however, that interactions with pension fund regimes (substitutability, cultural aspects, fiscal treatment and the like) should be taken into consideration if precise comparisons are to be made.

Efficiency

Comparisons of efficiency are difficult because any single indicator cannot capture all explanatory factors, such as regulatory intensity, operating costs, investment returns, business mix, and so on. In general, the performance of the insurance industry in Europe is considered to have been better than in the United States or Japan.

The ratio of life funds to gross premiums could be used as a proxy for the efficiency of the life insurance industry. It takes account of operating costs and investment returns, but it can be distorted by differences in the business mix or in reserve policies. Over the period 1986–88, this ratio fluctuated between 6.5 and 7.0 in Germany and Switzerland and between 6.0 and 6.5 in the United Kingdom and the Netherlands, and around 5.0 in the United States and 4.0 in Japan. The high ratios in Germany and Switzerland probably reflect conservative reserve policies, that for the United Kingdom probably reflects investment efficiency, and that for the Netherlands low operating costs. The relatively low rates in the United States and Japan reflect high operating costs and low investment returns as well as a business mix that requires a lower volume of reserves (a large proportion of single-premium life policies).

The rate of return on investment of assets of life insurance companies may be a better indicator of efficiency, but data are not available. It is estimated that U.K. companies achieve average rates of 15 to 20 percent, against 7 to 8 percent for German companies. Even if allowance is made for differences in the inflation rate, the U.K. companies appear to be more efficient, mainly as a result of their greater freedom to invest in domestic and foreign equities.

Profitability

Comparisons between countries are difficult because of differences in accounting, tax, and prudential regimes, and many other factors. Only a few general trends can be observed.

In the nonlife subsector, underwriting has resulted in constant losses (negative ratio of underwriting income to premiums), with the only exception being Germany. All other European countries have incurred losses averaging about 10 percent a year over the period 1983–87 (de Lecea 1991). These losses, however, were more than compensated for by the sharp increase in asset values. Thus, nonlife insurance undertakings appear to survive because of a pure financial intermediation role, that is, collecting funds in order to invest, rather than by performing a profitable economic activity.

In the life subsector, yields have been positive. The shareholders' profits as a percentage of annual premiums vary substantially, however, from one country to another. This is explained by the different statutory rules regarding the allocation of profits between shareholders and policyholders. German companies are mandated to rebate 90 percent of any surplus to policyholders, whereas in the Netherlands, the United Kingdom, and Spain, shareholders receive most of capital gains.

A survey conducted by the EC Commission regarding the performance of composite versus specialized life insurance companies showed that over the 10-year period since 1979, out of 4,000 companies authorized within the European Community, only four cases of winding up of specialized life companies occurred, along with several failures of specialized nonlife companies. No failures of composite companies occurred.

It has been reported that in 1990 (not a representative year from which to draw conclusions), the United Kingdom's five big composite insurers revealed a combined pre-tax loss of more than $1 billion, compared to a profit of more than $1.5 billion in 1989 (*The Economist*, February 9, 1991). Falling property and share prices, where U.K. insurers predominantly invest, as well as bad past decisions are the main reasons for this performance. In general, however, U.K. insurers have enjoyed profits. They have been involved in less damaging competition than their U.S. counterparts, but in more risk-taking than the other European insurers.

Regulation and Competition

With the exception of reinsurance, which has an international market,[2] European insurance markets have traditionally remained isolated in national markets. Legal barriers to cross-border trade, on grounds of consumer protection, and restrictive regulatory frameworks, country-specific distribution channels, and differences in customs and practices have prevented both external and domestic competition. As a result, different products, but also wide price differences, have prevailed between countries.

Regulatory intensity has not been the same in all European countries. Germany followed by France and the southern EC countries are considered to be highly regulated. Last on the list could be the Netherlands and the United Kingdom, which rely strongly on market forces and keep regulatory intervention to the absolute minimum. This can also be supported by the number of employees in regulatory agencies in 1990: 320 in Germany, 250 in France, 116 in the Netherlands and only 73 in the United Kingdom (Finsinger 1990). The regulatory intensity seems to be closely correlated with the price levels of life and nonlife insurance, as contained in a 1988 Price Waterhouse report. Italy and France reported the highest prices while the Netherlands and the United Kingdom reported the lowest. Prices in Germany appeared lower than those in Italy and France, but this was probably due to the fact that German companies are mandated to rebate 90 percent of any surplus to policyholders, and not due to more competition.

More recently, and especially since 1988, the regulatory and competitive situation has started to change. Country-driven deregulation, new products, new methods of distribution, and the creation of new spheres of power are taking place through mergers, acquisitions, establishment of bank/insurance subsidiaries or participation links, and cooperation agreements between insurance companies and between insurance companies and banks. Out of the 40 most significant bank/insurance acquisitions in the EC between 1985 and 1990, ten deals involved institutions of different countries (Thomas 1991). The main motivation for such changes is preparation for increased competition in view of the EC's project to create a Single European Market by the end of 1992.

The First EC Directives: Freedom of Establishment

The first attempts of the European Community to open up competition in direct insurance markets go back to the 1970s. Two pieces of

[2] An EC directive of 1964 requires all member states to remove all restrictions upon freedom of establishment and freedom to provide services relating to reinsurance.

legislation, the First Non-Life Insurance Directive, adopted in 1973, and the First Life Directive, adopted in 1979, laid down some basic rules for setting up branches and agencies throughout the Community.[3] In addition, the Life Directive introduced the principle of specialization, that is, a company could carry out either life or non-life business. It allowed existing composite companies to continue to operate, however.

The integration impact has been insignificant. Over the period 1975–86, the share of foreign companies remained virtually unchanged in the four largest EC countries. In 1986, it ranged from 3.7 percent in Germany to 4.8 percent in the United Kingdom, and none of the four countries had shares of foreign companies above 13 percent, even if domestic companies with foreign majority interest are added. The corresponding shares in Spain and the Netherlands were twice as large. The number of foreign insurers increased at first but decreased dramatically in the 1980s (Finsinger 1990).

The absence of an appreciable impact of the freedom of establishment on integration and competition could be attributed to the substantial differences in the domestic regulatory frameworks that the foreign undertakings had to comply with. It could also partly be attributed to a series of obstacles that have prevented foreign establishments from operating freely: country-specific distribution channels; the general rules concerning accounting, company law, and contract law; and the existence of state monopolies for certain lines of business.

In recent years, however, a wave of intra-Community mergers and acquisitions (one element of the insurers' strategies to exploit the expected advantages of the 1992 single market) has taken place, in particular in the rapidly growing markets of Italy, Spain, and, to a lesser extent, France: that is, in countries where regulation has traditionally been high. Substantial foreign penetration, but mainly from outside the Community, has also been observed in the United Kingdom, which was probably chosen as a base from which non-EC insurers can operate throughout the European Community after 1992.

The EC Financial Integration Plan

The adoption in 1987 of the Single European Act institutionalized the European Commission's program—known as the White Paper—to complete the internal market by December 31, 1992: that is, to create an area without frontiers in which goods, services, capital, and persons circulate freely.[4] An essential part of this project is the creation of an

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[3] The Insurance Directives mentioned in this article are listed in the references.

[4] The Single European Act modified the Treaty of Rome. Besides updating the internal market provisions, the most important of which are the 1992 deadline for its completion

Table 2
Program of Financial Integration

I.	*Basic Requirements*
	Freedom of all capital movements
	Freedom of establishment of institutions
	Free cross-border supply of services in the
	Banking sector
	Securities markets (investment services)
	Insurance sector
	Harmonization of prudential rules
II.	*Other Parameters*
	Relations with third countries
	Stability of exchange rates
	Fiscal aspects
	Approximation in company taxation
	Approximation in interest income taxation
	Elimination of tax-preferential treatment in favor of domestic securities and domestic institutions
	Pension funds: review of prudential rules, in particular of restrictions on investment of assets abroad
	Payment systems: improvement in terms of efficiency and cost
	Social aspects: prevention of the use of the financial system for money laundering

integrated financial area, the two main components being the full liberalization of capital movements and the free supply of financial services in the field of banking, securities, and insurance. As with economic integration, financial integration is expected to bring important efficiency gains through more competition and exploitation of economies of scale, thus implying a wider choice, at lower prices, of financial products for the consumer and increased international competitiveness of the financial sector of the EC economy.

The requirements for financial integration are listed in Table 2. Freedom of insurers to establish operations in another member state and free cross-border supply of insurance are essential elements. But these freedoms cannot be effective for integration and competition without harmonization of prudential and regulatory systems, which vary enormously between the member states. Harmonization is a difficult task,

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and replacement of unanimity by qualified majority (56/74) vote for many decisions, it introduced Community powers in new fields, such as economic policy cooperation, social and economic cohesion, research and development, and the environment. Moreover, it formalized the status of the European Council (meetings of Heads of State) and upgraded the role of the European Parliament in the EC decision-making. The White Paper is a list of about 300 measures needed to complete the internal market that the Commission proposed to elaborate, mostly in the form of directives, and submit to the Council for adoption.

Table 3
The Approach of the EC Commission to the Harmonization of Prudential Rules

Objectives:	Liberalization and integration of markets Protection of investors and depositors Solvency of financial institutions Equal conditions of competition (level playing field)
Principles:	Single license, permitting a financial institution to set up a subsidiary in the other states without new authorization and new capital endowment Few basic definitions and rules, in particular those concerning capital adequacy and the covering of risks Mutual recognition of rules and standards not harmonized at the Community level Home country control, that is, supervision of subsidiaries abroad by the country where their head office is located

especially in the insurance field, because it is characterized by many particularities. Table 3 shows the conceptual approach of the EC Commission to this central issue. The principles of "single license," "mutual recognition," and "home country control" play a crucial role in solving the problem. They are designed to ensure consumer protection, solvency of institutions, and "level playing field" conditions in a flexible market environment.

The Second EC Directives: "Large" versus "Mass" Risks

The basic principles in Table 3 have already been applied to banking legislation[5] and have been incorporated in a proposal for a directive concerning the securities markets.[6] In the insurance sector, while staying within the general harmonization framework, it has been necessary to follow a two-stage approach because of a landmark judgment of the European Court of Justice.[7] While confirming the right to provide cross-border insurance services, the Court argued for a greater degree of harmonization for the protection of small policyholders ("mass risks") than for industrial or commercial customers ("large risks"). The distinction has been crucial in the subsequent legislative work regarding the application of the principle of home country supervisory control.

Two pieces of legislation, the Second Non-Life Directive, adopted in

[5] Second Banking Directive: 89/646/EEC, OJ/L/386 of 30.12.1989.

[6] Commission Proposal for a Directive on Investment Services: COM (88) 778, OJ C 43 of 22.2.1989.

[7] Judgment of 4 December 1986 in Case 205/84: Commission versus Germany, France, Ireland, and Denmark—Freedom to provide insurance services.

1988, and the Second Life Directive, adopted in 1990, liberalized cross-border supply of insurance in cases deemed to require relatively less protection: the former liberalized large commercial risks, as of January 1, 1990; the latter liberalized insurance sought by individuals from abroad on their own initiative, as of January 1, 1993.[8] Home country control is applied to these cases, while the provision of "mass risk" nonlife services and the marketing of life insurance abroad are to continue to operate under the regulations of the host country.

The Proposals for Complete Freedom

Two more recent far-reaching framework proposals for third non-life and life directives generalize the free supply of insurance under home country control in all cases.[9] They introduce coordination rules in regard to technical provisions, the representation of assets, the contract law, the abolition of state monopolies, and other aspects. An important feature is the ending of specialization between life and nonlife business, which had been imposed by the First Life Directive in 1979 for all newly created companies.

Although a number of supplementary directives may be necessary concerning the accounts of insurance companies, distribution aspects, intermediaries and so on, the adoption of the above framework proposals will complete the legislative work concerning the integration of the EC insurance markets and indeed that of financial integration in general.

Outlook for Effective Integration

In view of the above developments, the balance between regulation and competition is expected to shift rather quickly from isolated national markets to Community-wide integrated markets, and from highly protected industries to a competitive environment. A deregulation–reregulation process is taking place in such a way as to ensure consumer protection and financial stability as well as market flexibility.

The Second Non-Life Directive has already established a Community-wide market for large commercial risks, though its impact may turn out to be limited since barriers in this line of business were relatively lower and, in any case, much of the activity was already international. The impact of the Second Life Directive should presumably be larger but again, cultural differences may limit it. In addition, transitional periods

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[8] Greece, Portugal and Ireland may defer the application of these directives until January 1, 1999, while Spain may defer until January 1, 1997 and January 1, 1996, respectively.

[9] COM (90) 348 final of 31.8.1990 and COM (91) 57 final—SYN 329 of 22.3.1991.

have been arranged for countries where life insurance growth potential is very high. For both directives, specific distribution networks entrenched in each country may be an indirect obstacle.

However, these directives and the prospect of the third proposals, as well as the integration in the banking and securities markets, have prompted the important structural changes that are now taking place in the European insurance markets. Mergers, acquisitions, joint ventures, cross-sector subsidiaries and direct participations, bank-insurance conglomerates, and network distribution alliances are part of the strategies of the operators in order to compete in the new environment that is being shaped.

Legal Frontiers with Banking

The structural, regulatory, and competitive environment of the insurance industry in Europe is changing, not only because of EC financial integration but also because of the phenomenon of convergence between the insurance sector and the other financial sectors, especially banking. Autonomous forces, such as demographic developments, declining savings, changing consumer habits, and new communication and information technologies, have led to interpenetration of markets and have reduced the fragmentation of activities. The convergence, however, has been accelerated by the EC integration plan.

Banks have been challenged by life insurance companies and other nonfinancial institutions and have lost part of their market share of savings. In response, they have sought to expand their product range into insurance and other areas, taking advantage of their distribution networks and their huge customer bases. It is too early to assess these strategies; nevertheless, the different cultures and sales skills in these two lines of business suggest they may not lead to results that accord with theoretical expectations.

Despite the growing interactions, insurance companies in Europe remain legally distinct from banks and other financial institutions. This section looks at the regulatory aspects of such interactions at the production, distribution, and ownership levels.

Production

In all European countries, the business of insurance underwriting is regulated under special law. Banks are not permitted to write insurance business directly. The first EC directives on the freedom of establishment limit the activities of insurance companies to insurance and to operations directly linked with it. Such directly related operations may bear similarities to non-insurance products, for instance, the granting of a loan on the basis of an insurance policy or life insurance products with a financial component. Nevertheless, they are considered to be included in the definition of insurance products.

Symmetrically, the production of banking services is confined to banks. Thus, insurance services do not figure in the list of activities annexed to the Second Banking Directive, which is the central piece of legislation for the creation of the common market in banking. A few exceptions, however, are observed in Italy, Spain, Greece, and Ireland where for historical reasons certain banks, or all banks on a limited scale, can directly produce insurance services.

Thus, the concept of production in general remains legally separated between insurance and banking institutions, the rationale being the different specificity of each sector (nature of risks, inverted production cycle for insurance, and the like). Arguments against bank production of insurance include the avoidance of tied-in sales and other practices as well as conflicts in supervisory responsibilities.

In the European Community, separation of production is also imposed within the insurance sector. The First Life Directive of 1979 established the principle of specialization, that is, either life or non-life activity, for any newly created insurance company, while the Second Life Directive of 1990 specifies that the existing composite companies cannot benefit from being free to supply either form of services beyond the end of 1995. Although the specialization is conceived as offering more security to policyholders, the tendency towards the creation of large financial groups has circumvented the effectiveness of specialization. In fact, the proposal for a third life directive suggests the ending of such an obligation.

The legal distinction between banks and insurance companies, however, has not prevented convergence at the product level. The financial (savings) component traditionally incorporated into most life insurance products has swelled, especially through new products (such as variable capital and insurance-capitalization products) and through group life insurance. Some of the new products have grown very rapidly in the United Kingdom, France, Italy, Spain, and Portugal. On the other hand, an insurance component in financial products is less usual.

Distribution

The distribution of insurance products by banks is generally allowed in most European countries, though under specified conditions. For instance, in France, bank employees must qualify as an insurance intermediary, while in Portugal distribution is permitted on the condition that no advice is involved. In Greece, distribution by banks is allowed only in towns with less than 10,000 inhabitants, and in the United Kingdom, banks can distribute only life insurance. On the other hand, most European countries limit the distribution of financial products (other than insurance) by insurance companies.

Ownership Linkages

The convergence between the insurance and banking sectors is also taking place at the company or institution level. Ownership linkages can take various forms, such as minority or majority participations, establishment of a subsidiary, joint ventures, and the constitution of a holding company. The regulatory frameworks in this regard vary substantially from one country to another and are constantly changing at the prospect of the EC single market. Nevertheless, certain trends can be identified at the EC level concerning the establishment of subsidiaries and direct participations.

Subsidiaries. With the exception of Belgium, all EC member states allow banks to establish a subsidiary insurance company. (All but Belgium also permit the establishment of a subsidiary bank by an insurance company.) Such operations must comply with the specific prudential rules and the general regulatory framework regarding participations, thus ensuring legal independence. Both the bank and the insurance supervisory authorities control the operation.

Cross-participations. Similarly, with the exception of Belgium, all EC member states authorize direct participation of a bank in an insurance company, though specific limits and requirements may be imposed in order to avoid concentration of power and distortions in competition. The EC Second Banking Directive limits shareholding participation of a bank in a nonfinancial enterprise to 15 percent of own funds, but it does not impose any limit on such participation in an insurance company.

Direct participation of an insurance company in a bank is also allowed, but some member states (France, Germany, Greece, the Netherlands, and Portugal) apply stricter rules and limits because of the role banks play in the payment systems of a country, and in order to ensure the sound financial position of insurance companies and, hence, protect the policyholders. For instance, in Belgium and Germany, the authorities regulate insurance companies' participations in banks under the criteria for the amounts of incorporating insurance companies' technical reserves, while in the United Kingdom an insurance company's assets must be held in a certain form. The situation in the EC, and in Europe in general, is to be contrasted with that in the United States, where such operations are strictly limited, and in Japan, where they are prohibited.

Bank–insurance conglomerates. Cross-participations and establishment of subsidiaries have given rise to the formation of bank–insurance conglomerates. This is one of the most striking features of recent trends in European financial markets, while in the United States and Japan, where banks' domestic activities are more strictly circumscribed, the bank–securities firm or group is predominant. Even without ownership linkages, the two components can be brought together under a holding company with central management.

The regulations of virtually all EC countries permit the formation of such conglomerates. Economies of scale and of scope are the main advantages, while the risks include tied-in sales, dominant positions through excessive concentration, internal credits avoiding prudential rules, profits transfer, and so on. This is why some countries impose limits on different aspects of inter-sector activities. For instance, Germany, Denmark, and the United Kingdom limit internal credits.

At the EC level, the question of ownership linkages has been discussed since 1985 under the general heading of "financial conglomerates." The most important issue appears to be that of cooperation of the supervisory authorities. In a draft directive on the consolidation of accounts of insurance companies, close cooperation among competent supervisory authorities is required if a bank or a holding company controls a subsidiary insurance company.

Conclusion

Traditionally fragmented and protected from external and domestic competition, the European insurance markets are currently undergoing important structural and regulatory changes. Market forces are playing a role, as shown in the convergence of insurance with other sectors, especially the banks, at the product, distribution, and institution levels, but the main drive is the EC financial integration plan for the areas of banking, investment, and insurance, and the single European market in general, which has in turn accelerated the phenomenon of convergence.

As a result, 1992-induced strategic operations are taking place at a vigorous pace, leading to the formation of bank–insurance conglomerates by way of subsidiaries, participations, and distribution alliances. The balance between the advantages and risks is not yet clear. But the need for cooperation of supervisory authorities at both the national and international levels is evident.

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Main EC Insurance Directives
(OJ = Official Journal of the European Communities)

Reinsurance	:	64/225/EEC, OJ L 56 of 4. 4.1964
Non-life insurance	:	73/239/EEC, OJ L 238 of 16. 8.1973 88/357/EEC, OJ L 172 of 4. 7.1988
Life insurance	:	79/239/EEC, OJ L 228 of 16. 8.1979 90/619/EEC, OJ L 330 of 29.11.1990

Discussion

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Foreign investment in the United States exceeds American investment overseas by much more than previously was thought. The U.S. Department of Commerce estimates the shortfall at a minimum of $281 billion and possibly as high as $464 billion in 1989, the latest year for which such data are available. This investment shortfall occurs as well with regard to the U.S. and overseas insurance industries.

What is the significance of these numbers? Some will say they simply prove that the United States is a good place to invest and that the international capital markets are doing their proper job by sending money here. Others will argue that the United States is no longer competitive in world markets and we are rapidly mortgaging our future to foreigners.

On which side falleth the insurance industry? And does the structure of insurance industries abroad affect this growing imbalance?

In the discussion that follows, the reader will quickly detect a personal bias. Speaking objectively, however, it is clear that the structure of our industry overseas is having an increasingly profound effect here at home.

The World Market for Insurance

When last measured (for the year 1987), U.S. insurance industry direct overseas investment totalled some $11 billion. Now that is a small but measurable 3 percent of total U.S. overseas investment. Return on

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that investment was then 16.4 percent—about at the average of all industries—but climbing.[1]

The U.S. players are regrettably few. When Chubb first began its own international expansion in the late 1950s, it had a number of U.S. competitors—as many as 30 or 35. Chubb now counts itself one of only a handful of U.S. property–casualty insurers with a global underwriting and servicing presence.

In my judgment this condition is patently absurd. First of all, world premium volume today exceeds $1 trillion and real premium growth is several times that of world gross national product growth. The U.S. market share of world premium volume declined from 43 percent to 37 percent in the two-year period ended in 1988. One-half of that decline was the soft dollar, the other half was very real. And by not working overseas, U.S. insurers and brokers intentionally deny themselves access to 63 percent of the marketplace. That 63 percent enjoys a growth rate far exceeding its 37 percent counterpart in the United States, and it enjoys an insurance density (premiums per capita) only one-third of the U.S. density.

What is wrong? One of the answers could be the American insurers' domestic mind set, the fact that pressure to boost quarterly earnings per share deprives U.S. executives of the longer-term vision needed to run an international operation. Clearly, another reason could be the failure to recognize that the U.S. premium pond is shrinking as a percentage of the world market.

If some U.S. insurers are shortsighted, they are not as a class myopic. They do not fear competition, nor do they lack resources. The U.S. market is the world's largest. It is wide open and competitive. But protectionism is still a major factor in many countries. Consider, for example, that 26 countries today, all outside the Communist bloc, deny a license to operate to any foreign insurance company. India, the world's largest democracy, is a good example. In addition, approximately 30 countries mandate that all, or a portion, of ceded reinsurance be placed with a state-owned or controlled reinsurance monopoly. What is so bad about that? The government, using its monopoly, tends to set the rates, allowing for little price or form competition. And the monopoly dissuades local companies from acquiring and utilizing the latest insurance technologies developed in the more advanced markets. I might add that, at worst, several of these government reinsurers are bankrupt.

But is the playing field becoming more level so that U.S. insurers can expect to have an easier time overseas in the future? Emphatically—

[1] Data taken from U.S. Bureau of Economic Analysis, *Survey of Current Business*, August 1988.

"Yes!" First, a few major U.S. international insurers, including Chubb, have consistently found ways to offer most of their products worldwide to the U.S. exporter and overseas investor, in spite of regulatory restrictions. And second, help has become available from the U.S. federal government.

The U.S. insurance market is now responding to issues ranging from nationalization and localization in developing nations, to licensing, taxation, and market access in the industrial and industrializing countries. Our federal government has responded to barriers to trade in services by enacting policies addressing the problem. Taiwan is an example. Did you know that no United States insurance company could insure Taiwanese persons or corporations as recently as four years ago? Now more than a dozen U.S. companies are in Taiwan. Another example is Korea. Under the August 1986 agreement settling our section 301 action under the Trade Act of 1974, guidelines for licensing U.S. insurers in Korea were established, with follow-up mechanisms.

Longer term, the initiative that promises the greatest hope for liberalization in the services industries, including insurance, is the inclusion of services and insurance in the Uruguay round of the General Agreement on Tariffs and Trade (GATT) negotiations. These initiatives were launched four years ago, and until that point GATT had never negotiated services or insurance. Last December, GATT stumbled over agricultural disputes, and the negotiations stopped. Talks started again in February and if successful, the talks will make it possible to look to a future where discriminatory regulations in many markets will be reduced or eliminated. The vote in the Senate and House committees recently supporting extension of "fast track" negotiating authority for the President bodes well for a successful GATT conclusion.

Insurance industry structure abroad is changing rapidly—and nowhere more successfully than in the European Community. Sotirios Kollias has described this brilliantly in his overview of the structure and regulation of insurance markets in Europe.

The completion of the European internal market in insurance is a priority objective of the EC Commission and, if approved, will be accomplished by adoption of the Third Life and the Third Non-Life Insurance Directives. The proposal for the Third Non-Life Directive was approved by the Commission on July 18, 1990 and transmitted to the Council. Regarding life insurance, the second stage was just reached last November in the second directive, which governs freedom to provide life insurance services.

The general strategy for the third stage, as in nonlife insurance, will coordinate rules on the prudential and financial supervision of the business; provide mutual recognition, on the basis of harmonization at the Community level, of authorizations granted to insurance undertakings and of the prudential supervision systems of the different member states; and grant a single authorization, valid in all member countries, with supervision of the entire business of the entity in all 12 countries by that company's home member state (referred to as "home country control"). Such a strategy has already been used to complete the internal market in other financial services areas, and currently the insurance industry in Europe is behind the times in re-regulating to accomplish a single insurance market. The political will is there, in the form of the single European act.

Now we need adoption of the Third Life and Non-Life Directives, especially because all other Community financial products now benefit from a "European Passport," distorting competition to the detriment of those insurers, and especially life insurers, with whom other financial entities compete directly within the Community in the case of certain products. Clearly the "European Passport" for insurance will not occur by January 1, 1993. 1995 is the earliest time when some form of real market uniformity will be achieved. Reaching that stage may trigger insolvencies over the next several years, especially in Spain, Portugal, France, and Italy.

The European Community Market

When it happens, what will the insurance face of the European Community look like?

Competition

Freedom of establishment and free exchange of services will heighten competition. It has not been the custom, nor indeed the law, to shop commercial and industrial risks across borders except for the so-called "large" commercial and industrial risks. Now insurers will.

Prices

The Cecchini report (1988) demonstrated how startling were differences in insurance costs among and between the member countries. As an example, premium differences on identical fire and theft exposures covering premises and stock were found to range from 15 percent below the average in Luxembourg to 153 percent above the average in France, and a startling 245 percent above the average in Italy. If you relate those price differentials to the vision of an insurance shopping supermarket across Europe, you can begin to see the potential for wholesale price reductions.

Expenses

In principle, underwriting expense ratios will be reduced because some EC insurers will elect not to maintain expensive full-service offices in each country where the risks are located.

Product Innovation

Innovative new products will appear. Uniformity of insuring terms and conditions will appear, and this should benefit consumer, broker, and underwriter alike. Bulk buying of coverages will entice underwriters to "discount" as the result of newfound spread of risk, which did not exist before. The Green movement and growing European sensitivity to a cleaner environment have already produced regulations imposing manufacturer compliance. Environmental liability offers a new significant challenge—and opportunity—to insurers to whom European commercial and industrial firms will look for protection. One would hope that the experience of U.S. firms in areas such as product liability, asbestosis, and other environmental liability areas will be of value to European insurers.

Critical Mass

Anticipating the third directives, most of Europe's largest insurers have long since embarked on European strategic moves through acquisition or alliance. Merger and acquisition activity is way up. Geographically, Italian, German, and French companies have been especially active. The United Kingdom, with a mature but fragmented market imposing few restrictions against acquisition, is a prime target. Examples of other geographical trends would be the domination of the Belgian market by the French and of the Scandinavian market by the Swedish. Functionally, merger and acquisition activity will blend individual country underwriting and service facilities with distribution systems offered by banking members of the same financial conglomerate.

Alternative Distribution Methods

Brokers are the major distribution source in northern Europe, less so in southern Europe where exclusive or direct agents hold sway. But the lack of firewalls between financial services institutions in the European community means that even brokers and agents will not have free run. Existing bank and insurer combinations mean that insurance products, both life and property–casualty, are today being retailed over bank and other financial service counters. This trend will continue, across European borders. As such, the products focus on middle-income consumers and on credit-related standard products, capitalizing on the bank's advantage of having advance knowledge of the transaction. But many other distribution methods can be found, including manufacturers, who in Europe are often also in the financial services business. Many own their own insurance companies. The workplace has become a major channel of distribution in Europe. In addition, direct response marketing is the latest fellow on the distribution block in Europe. Print and television media, credit cards, and other direct response marketing tools are aimed at the private-passenger auto market, life products, hospital indemnity, and the like.

Accounts Directive

The European Community is striving to reach agreement on a directive covering the accounting practices of insurance and reinsurance companies. It is a complex directive and a key part of liberalization of the industry in Europe. It will introduce a uniform structure, content, and evaluation method for annual and consolidated accounts. But disputes continue. One dispute concerns the treatment of reinsurance on companies' balance sheets and valuation rules. Some countries, led by the United Kingdom and the Netherlands, are pushing for the net approach, for liabilities that are shown net of reinsurance. Italy and France object. They want a gross approach, with gross amounts only to appear under liabilities, with the reinsurance figures being accounted as an asset.[2]

How Are the U.S. Markets Coping?

First of all, the major U.S. international underwriters are already in place. For Chubb, as an example, 1992 began in 1967, when we formed our Common Market insurance company headquartered in Brussels. Chubb is licensed or has full-service branches in all Common Market countries today, save one. AIG, CIGNA, Continental, Hartford, Travelers and Kemper are broadly established as, indeed, are a handful of other U.S. international insurers. The major U.S. brokers already have a strong presence in Europe.

[2] As I write this paper, Luxembourg, which currently holds the EC's presidency, wants all these problems resolved in a directive at the June 17, 1991 meeting of the Ministers. I hope this will happen. But if it does not, the single European passport for insurance will be delayed until it does.

Will 1992 Attract Many Future Players from the United States?

It is unlikely, with the notable exception of the major U.S. life companies, which are beginning to show renewed interest in overseas markets. But if 1991 plays out as its proponents anticipate, I believe that the current lack of interest on the part of U.S. property–casualty insurers to study their opportunities in a $4 trillion economy will prove a strategic mistake. The European Community is America's chief trading partner, accounting for $145 billion annually in combined imports and exports. This is more than either Canada or Japan. If we were to include the output of U.S.-owned companies in Europe and European-owned firms here (think of the reverse flow insurance potential), the size of the relationship is $1 trillion a year. And yet, in a past survey, the bulk of U.S. insurance executives surveyed indicated a lack of interest in European operations.

Is European Protectionism a Possibility?

A significant concern is that the leveling of prices, as the pricing war seeks its own natural level, will spur a new protectionism after 1992. It is not too early—EC protestations to the contrary notwithstanding—to foresee a Europe, faced with a bleak cycle of underwriting deficits brought on by transborder competition, reacting after 1992 by refusing entry to markets outside of Europe that might then wish to enter.

The introduction of a reciprocity standard in the 1989 second life insurance directive and into the 1989 banking directive has raised some eyebrows. The concern is that Europe may not continue to provide national treatment. Should the reciprocity provisions be adopted—and the Commission denies this will happen—some U.S. markets are concerned that the national insurance authorities in the European Community might use this provision to exclude or limit U.S. company positions in the hotly competitive market predicted for European insurance after 1992. This fear has some basis. In the GATT, the EC Commission negotiators argue that the U.S. system of state regulation is discriminatory toward foreign insurers. An EC reciprocity provision, were that to occur, would encourage a national insurance authority in Europe to use the Commission's GATT position on U.S. regulation as the basis to question, delay, or possibly even refuse authorization to a U.S. company.

A second matter relates to universal banking. Europe's financial institutions increasingly operate in a universal framework. In fact, at the end of 1989, obstacles to bank ownership of insurers (and vice versa) remained only in Denmark, Sweden, and the Netherlands. And these are about to disappear. We in the United States, on the other hand, have a Glass-Steagall Act, a Bank Holding Company Act, and other provisions that keep financial activities separate. The EC Commission negotiators have raised Glass-Steagall provisions as a trade barrier in the GATT negotiations. Might our differences in internal regulatory practices, under a reciprocity standard, lead to questioning of the authorization of a U.S. insurer, using as justification the EC GATT negotiators' position? I am not concerned. I led the second U.S. insurance trade delegation to the Commission in Brussels two months ago, and the Commission verbally assured us that the Commission stands for national treatment, not reciprocity. But the threat itself seems to have had a chilling effect on U.S. interests in European insurance markets. Verbal assurances are not binding over time. Might the European Court have a view different from that of the Commission?

Now, How about the Pacific Rim?

It is a little-understood fact that the insurance markets of Asia today write well in excess of $200 billion a year in premiums. As such, they hold 23 percent of world premium income, driven by Japan, the world's second largest insurance market. In 1988, the latest year for which we have such statistics, the Asian markets grew collectively by 19.2 percent, by far the fastest growth rate in the world. The EC market grew 9.2 percent—and in that year, the U.S. market grew 2 percent. (Note that preliminary estimates for 1990 show annual U.S. premium growth back up to 6.9 percent.) Asia has hardly slowed down since 1988. While Europe 1992 makes all the headlines, the Pacific Basin exceeds the entire European Economic Community in premiums, and its current rate of premium growth is twice that of the EC. Not surprisingly, then, U.S. and other alien insurers are interested, indeed anxious, to become a presence in those markets, the more so because insurance density (premiums per head of population) runs from $4 per person per year in Indonesia and India, to $15 in Thailand, to $233 in Taiwan, to $392 in South Korea, to $2300 in Japan—all this compared with $1700 in the United States. And if you think Japan is tops, it is not. Switzerland is, with $2320 in premiums per Swiss. Yes, the expansion prospects are mind-boggling.

Effects on the U.S. Insurance Industry

Finally, we are witnessing in Europe, and in the Pacific, the development of enormous diversified financial services firms. Many of them already have capital and revenue bases that outstrip their U.S. counterparts. Their insatiable appetite for new asset deployment playgrounds has already brought many of them to our shores. Among those that could be mentioned for 1990 alone were the acquisition of the Home

Insurance Company by TVH Acquisition Corporation and the purchase of Fireman's Fund Insurance Company by a subsidiary of Allianz AG Holding. They followed the acquisition in 1989 of Maryland Casualty Company by Zurich Insurance Company, of General Casualty Company by Winterthur Swiss Insurance Company, and of Businessmen's Assurance Company of America by Assicurazioni Generali, Italy's largest insurer. Considering the strong financial services ties that most of these European insurers have at home, one must ask the question: Will the presence in the United States of entities of these foreign diversified financial firms heighten the integration process for financial services in the United States? I think the answer has to be "Yes." Indeed, non-U.S. companies, including domestic companies controlled by foreign entities, already are major participants in every aspect of the U.S. financial services market.

With respect to the banking sector, over 500 branches or agencies of foreign banks are in the United States. Over 80 U.S. banks are foreign-controlled, including some of the largest. Foreign banks from Europe and Australia with unlimited insurance and securities powers in their own countries are expanding operations in the United States. So far, and consistent with the U.S. policy of national treatment, their non-banking activities here are restricted to those permitted to U.S. banks. But how long will this continue? And even today, do their more diversified non-U.S. income streams give them a competitive advantage vis-à-vis U.S. banks? Today, multifaceted Canadian companies are running U.S.-based insurance, mutual fund, and investment banking operations, from manufacturing to wholesale and retail distribution. When the trade ministers of the United States, Canada, and Mexico began negotiations on June 12, 1991 in Toronto, the Canadians made no secret of the fact that a further expansion of Canadian visitation rights into the U.S. financial services arena was high on the Canadian agenda.

In 1986, 143 insurance branches, subsidiaries, and agencies had been established in the United States by non-U.S. entities. Those companies, in that year, accounted for an estimated $33 billion in insurance sales or about 7 to 8 percent of the U.S. market. Today about 25 percent of the membership of the American Insurance Association is foreign insurance companies, and today foreign companies write about 10 percent of total U.S. primary property–casualty premiums. Though it would not appear so judging from the lack of interest on the part of the U.S. insurance community, insurance is among the most global of financial service activities. Inevitably, then, the structure of insurance industries abroad will affect the structure of our domestic insurance industry. Anything that contributes to a more rational distribution of the available resources of the insurance industry will be good for development on a world scale. And nothing would make so large a contribution to this end as the recognition and implementation, by governments and by industry operators, of a nondiscriminatory, open-trade policy based on the principles of national treatment. In the meantime, somebody should compliment those insurance executives who embrace these global imperatives, and wake up the ones who do not.

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Discussion

*Steven S. Skalicky**

Sotirios Kollias has prepared a comprehensive paper outlining the structure and challenges facing the European insurance markets as 1992 approaches. Recent political and economic developments present the same issues to the world community.

Barriers that have created highly fragmented national markets are under attack throughout the world. Japan is currently targeting 1993–94 to remove market segregation between life and non-life companies and the financial service industries. Eastern Europe, including the Soviet Union, is in the midst of dismantling state insurance monopolies, allowing foreign participation. China has permitted the formation of a second state-owned insurer to compete with the PICC, and Hong Kong is heading towards 1997. Latin American countries are exploring the reshaping of state-owned monopolies, and Mexico has recently expanded the allowed percentage of foreign ownership of insurance companies.

While some areas will move more slowly than others, the changing face of the global insurance markets in the 1990s will present challenges and opportunities for the industry, the consumer, and the regulators (Figure 1). I would like to highlight the structure of insurers in the major growth markets aside from the European Community, and briefly point out some issues that relate to regulation and solvency and the outlook for the world's insurers.

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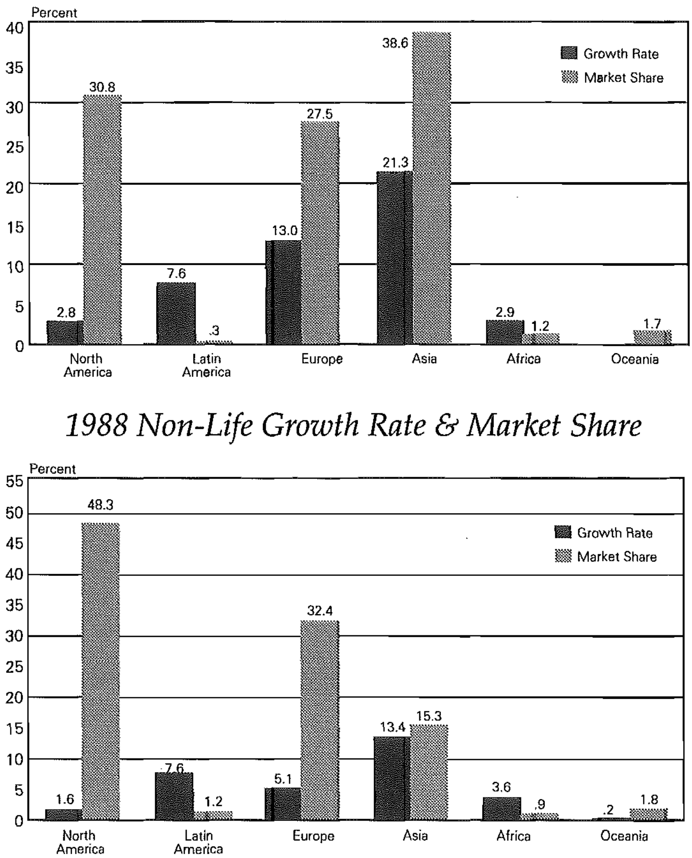
Figure 1 *1988 Life Growth Rate & Market Share*



Source: SIGMA World Insurance 1988

Asia

Asia has the potential to be the fastest-growing market with the most volume in the 1990s. With a 27.5 percent share of the total world insurance market for 1988, Asia is the third largest segment following North America's 39 percent and Europe's 30 percent. Asia's real growth rate of 19.2 percent far outpaced Europe's rate of 8.3 percent and North America's 2.1 percent. Japan is the dominant market in Asia, representing 24 percent of the world market share, and as a country it ranks first

Table 1
The World's Largest Insurers
A. The World's 10 Largest Stock Insurers, Ranked by Premium Volume, 1989
Millions of U.S. Dollars

Company/Country	Premium Income Total	Premium Income Life	Premium Income Non-Life	Assets	Market Value
Allstate/U.S. (Parent: Sears, Roebuck)	$14,345	$1,056	$13,289	$34,010	$11,533
Aetna Life & Casualty/U.S.	13,311	2,538	10,773	87,099	5,669
American International Group/U.S.	11,524	2,995	8,529	46,143	12,358
CIGNA/U.S.	11,494	1,494	10,000	57,779	3,676
Zurich Insurance/ Switzerland	9,592	2,311	7,281	37,191	5,566
Prudential/U.K.	9,394	7,702	1,692	63,138	8,079
UAP-Union des Assurance/France	9,204	4,710	4,494	45,835	7,457
Allianz Group/Germany	8,494	3,681	4,813	54,169	28,454
Travelers/U.S.	7,793	3,203	4,590	56,563	2,814
Swiss RE/Switzerland	7,658	1,343	6,315	23,493	3,599

B. The World's 10 Largest Mutuals, Ranked by Premium Volume, 1989
Millions of U.S. Dollars

Company/Country	Premium Income	Total Assets	Surplus
Nippon Life/Japan	$36,526	$161,743	$ 5,421
DAI-ICHI Mutual/Japan	26,404	112,427	3,716
Prudential/U.S.	25,094	163,967	4,780
Sumitomo Life/Japan	24,271	95,952	2,973
Zenkyoren/Japan	23,319	123,268	1,940
State Farm Mutual/U.S.	23,254	57,155	18,028
Meiji Mutual/Japan	16,491	62,161	1,980
Metropolitan Life/U.S.	15,193	98,740	3,787
Asahi Mutual/Japan	12,460	51,570	1,852
Mitsui Mutual Life/Japan	10,390	39,484	1,322

Source: A. Ourusoff in *Financial World*, September 4, 1990. 1989 data. State Farm data for Surplus taken from *The Wall Street Journal*, September 21, 1990.

in life business, with 35 percent of world premiums, and second in non-life, with 13 percent of world premiums.

Japan is characterized by a relatively small number of companies, fewer than two hundred, compared to the thousands in the United States and Europe, with the major companies comprising the bulk of the market. Life premiums in Japan amounted to $214 billion in 1988 and non-life business amounted to approximately $70 billion, with 37 percent of the business allocated to a savings element, which is unusual compared to the rest of the world. The top 15 companies represent 95 percent of the market, with foreign companies representing 3 percent of the total non-life market.

Companies are organized as mutuals or stock companies with a segregation of life and non-life business. Japanese mutual life companies comprise the majority of the top 10 mutual insurance companies in the world (Table 1). Business is conducted primarily through agents with affinity tie-ins to companies and associations.

The Ministry of Finance regulates the Japanese insurance industry and also controls banks and the securities industry. Premiums, investments, and surplus requirements are strictly supervised. Companies are required to maintain assets locally equal to technical reserves, and certain types of assets, such as equities and real estate, are restricted. No solvency fund is maintained for the benefit of policyholders.

Current proposals are directed at freeing the distinction between life and non-life business and banking and securities companies. Reforms are also directed at easing restrictions on the composition of assets, including real estate, equities, and foreign currencies.

Recent deregulation of premium rates to a range rather than one fixed rate resulted in all companies choosing the lowest premium rate. Allowing banks to pay a higher interest rate created a net outflow from the insurance industry. Nippon Life is as big as the entire Japanese non-life industry. Japanese banks rank as the largest companies in the world, with the top five being three times as large as Nippon Life (Table 2). Given the propensity of the Japanese consumer to save, and the savings feature inherent in most insurance products, deregulation will likely increase competition for the consumer's savings, thus reducing margins.

The market is technically open to foreign competition; however, with licensing requirements taking up to two years and the affinity relationships of agents, it is a difficult market to enter. Recently some movement to speed up approval of foreign companies has occurred as a result of political pressure from other nations.

The Japanese property–casualty insurance market has high expense ratios, approximately 40 percent, with loss ratios of approximately 50 percent, low compared to the United States and Europe. Litigation is minimal; however, companies are becoming wary of overseas liability. Expansion to overseas markets has generally taken the form of participation retaining local management, or branch office operations to service Japanese business operations in local markets. The one exception was the acquisition of Iowa National Mutual Insurance Company by Toyota Motor Corporation with the intent of insuring autos produced in the United States.

Its size and growth potential obviously make Japan a major market for companies that hope to be global insurers. And the resources of

Table 2
The 10 Largest Companies in the World, Ranked by Assets, 1990

Company	Country	Assets (Millions of U.S. Dollars)
Dai-Ichi Kangyo Bank Ltd.	Japan	$472,223
Sumitomo Bank Ltd.	Japan	470,699
Fuji Bank Ltd.	Japan	469,086
Sanwa Bank Ltd.	Japan	450,180
Mitsubishi Bank Ltd.	Japan	410,815
Industrial Bank of Japan Ltd.	Japan	331,326
Tokai Bank Ltd.	Japan	285,843
Barclays PLC	United Kingdom	241,210
Mitsui Taiyo Kobe Bank Ltd.	Japan	237,981
Bank of Tokyo Ltd.	Japan	234,771

Source: *Forbes*, April 29, 1991, p. 165.

Japanese companies could make them global insurers, if their strategy changes.

Life and non-life are generally segregated in Asian countries and distribution systems are primarily agency with rates set by tariff, although compliance varies. Supervision and regulation are fairly strict and foreign participation is subject to restrictions. Aside from South Korea, which represents 1.4 percent of the total and 2.2 percent of life insurance, no other country in Asia approaches 1 percent of world premiums. However, the growth rates in China, the Philippines, Singapore, South Korea, Taiwan, and Thailand are all in double digits, ranging from 10 percent to 23 percent. Life insurance growth has been higher than non-life.

The attraction of these markets is not the current premium but rather the potential that will be generated as the consumer's per capita income increases and industrial production expands. China's insurance density is currently 2.5. If China were to approximate Japan's 2,320, the market would be twice the size of current total world premiums.

Latin America

The insurance market in Latin America represents less than 1 percent of the world's total and has been characterized by state monopolies, restricted foreign entry, and a limited number of companies in each country. The growth potential, however, is significant as economic growth and per capita income increase.

Perhaps the most optimism centers around Mexico, which will benefit if the North American Free Trade Agreement (NAFTA) takes effect in 1993. Joining Canada, the United States, and Mexico, the aggregate GNP and population of this free trade zone would exceed those of the European Community. If successful, NAFTA could prompt other Latin American countries to speed free market reforms currently underway.

The insurance industry grew by 15 percent in Mexico in 1989. Forty-three companies were in operation; 37 were privately owned, two were mutuals, two were reinsurers and two were state-owned. Plans are underway to sell the state-owned companies to private investors. The allowable foreign ownership of companies was recently increased to 49 percent, resulting in four outside purchases. Seven companies dominate 80 percent of the market.

Since deregulation in 1989, the insurance market in Mexico has seen downward pressure on rates. Only one of the five largest companies reported a positive result in 1990. Distribution channels are mass marketing and agents. The General Directorate of Insurance and Securities regulates the industry and requires 35 percent of technical reserves to be deposited with the Central Bank.

Other countries in Latin America are also reviewing the easing of restrictions on insurance markets. Uruguay is considering a bill that would eliminate the national monopoly. Reforms are being debated in Peru, where the market is dominated by the state-owned insurance company. Venezuela anticipates changes to increase foreign equity in banks; insurance may follow. Colombia is undergoing reforms to change the restrictive tariff structure, required local reinsurance, and mandatory investments in government bonds. Chile and Bolivia already represent comparatively open markets with growth potential. Brazil and Argentina must overcome current problems with internal reinsurance monopolies before they can open to additional investment. Argentina may eliminate its reinsurance monopoly before year end. The potential for Latin America is similar to that for other emerging markets: growth.

Eastern Europe

Reforms underway in Eastern Europe are allowing foreign participation and ownership in markets that were previously state-owned monopolies. The 1988 world market share, including the Soviet Union, was approximately 3 percent. The Soviet Union represents almost 75 percent of the total, because of its size and population. As with other emerging markets, the attraction is growth potential.

Transition from state control, with its implications for premiums and for claims, will follow other political and economic changes. Changes will take time, varying by country as the economic transitions take place. East Germany, Czechoslovakia, and Hungary are furthest along.

Distribution systems in Eastern Europe have largely been through banks and other outlets with little need for agents under monopolistic, required insurance. Premiums were fixed at low rates and claims were paid with state subsidies as needed. Claims were high, with no change in premium. These characteristics will have to change in a free market. One insurer has already depleted its start-up capital of $320 million as a result of losses in the auto liability sector in East Germany.

Insurance laws are in the process of being written to set up the structure, supervision, and foreign participation in the Eastern European insurance market. Solvency regulation faces problems with the old structure for state-owned monopolies; however, new entrants will be required to meet the regulations.

As the economies expand and per capita income rises, the potential for insurance markets will grow. Eastern Europe, and the Soviet Union in particular, obviously face more problems than the European Community or Asia.

Conclusion

Globalization of the insurance industry will present unprecedented challenges to the insurance companies, the consumers, and the regulators responsible for monitoring companies. Opportunities will exist for those companies that are able to take advantage of changes that present true economic benefits. Because of the difficulty of entry and enormous start-up costs for a new insurer in a market, the major thrust towards globalization will be mergers and acquisitions. This will favor the larger companies, which have the capitalization and resources to achieve market penetration. An analyst from a major brokerage firm has suggested that by the turn of the century it is possible that no more than 12 to 15 major global insurers will be in business. Size does offer advantages for efficiency of scale as well as the ability to absorb the costs necessary for expansion. Blindly pursuing acquisitions, however, also can lead to disaster. Acquisitions in emerging European markets are currently priced in the range of 20 to 30 times earnings, whereas U.S. companies averaged 10 in 1989.

Rate competition will benefit consumers through higher rates of return for life products and lower premiums for non-life coverage. The risk to the consumer, however, is that the promise to pay may not be kept. Relying on gains in real estate and securities to offset underwriting losses, or to meet unrealistic interest rate guarantees, eventually leads to problems in the industry. We are already seeing this in the United States, and Japan and Europe may follow. Malaysia recently took control of an insurer to prevent insolvency. Allowing additional competition from banks and other institutions may only compound these issues. While financial companies have significant assets that could be used for acquisition entry into the insurance industry, such entry should be based on segregated capital, because of the additional risk undertaken.

The fact that insurance is a risk-taking business must not be forgotten. Determination of liability years after coverage makes the risk unique among financial service products. In the United States it is estimated that environmental liability cleanup will cost in excess of $40 billion, with the assignment of liability creating unparalleled litigation and costs. Anticipating the liability and costs was impossible when these products were originally priced.

Regulators will be faced with the challenge of dealing with companies that are involved in markets, products, and cultures that differ from those they have become accustomed to. Representative John D. Dingell has stated that "The regulatory system must anticipate and deal effectively with the activities of the pirates and dolts who inevitably will plague an attractive industry such as insurance, where customers hand over large sums of cash in return for a promise of future benefits."[1] While pirates must be dealt with individually, the dolts referred to were managers who pursued business with little understanding of the ultimate costs involved and the long-term impact. Regulators will have to monitor closely the international expansion of companies entering new markets, with increased competition narrowing margins and profits.

The changes taking place in the 1990s will present opportunities for companies able to adapt and take advantage of these new markets. They will also present challenges to the consumer and to the regulators, who must monitor the industry.

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