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The New European Union

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Summary: The year 1999 marks the start of new economic relationships in Europe and the introduction of the Euro dollar. This development presents new challenges and opportunities for American insurance and financial institutions.

The panel considers the various challenges and opportunities presented by the new European Union, including:
- *Investment challenges and opportunities in the new "European Empire"*
- *Impacts on the insurance and pension markets*
- *Increased competition from European companies*
- *Hedging with the new currency*

Ms. Angelica B. Michail: The inclusion of "new" in the title for this session is perhaps confusing since the integration of several European countries in the European Union (EU) has been in the making for about 50 years now. But every step toward our integration brings its own challenges and opportunities, so the descriptive word "new" continues to be appropriate. Every step brings new ways of relating, thinking, working, living. The changes and results will affect not only the EU, but many countries beyond its borders.

We have a very distinguished panel of speakers and, as they share their knowledge and insights, we hope to be able to get a better understanding of the recent development in the EU and their implications for companies and actuaries on both sides of the Atlantic. Our first speaker will be Peter Kuys, the chief actuarial officer

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Note: The chart referred to in the text can be found at the end of the manuscript.

of the ING Group in Amsterdam. He is responsible for worldwide actuarial and insurance risk controls and internal actuarial consultancy in three ING regional offices. He is currently the chairman of the Insurance Regulation Committee of the International Actuarial Association (IAA) and director and treasurer of the demographic institute of the Netherlands.

Mr. Peter H.M. Kuys: First of all, what is the EU? The EU is really an idea in the sense that we still have Europe, we still have nations, and the question is what is that union? I will cover that in five subsections: member states, aims, resources, institutions, and facts and figures.

The EU is composed of 15 member states: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, The Netherlands, Portugal, Spain, Sweden, and the United Kingdom. And there are 12 other countries on the way to joining the EU at some future point in time. Among those 12 are countries in Eastern Europe and Middle Europe; even Turkey is being considered as a new member state of the EU. Some of the member states—Denmark, Greece, Sweden, and the United Kingdom—are not yet part of the European Monetary Union (EMU), but may be at some future point in time. Greece has already decided that it will join the EMU in 2001.

The aim of the EU is a closer union among the peoples of Europe. The notion of an EU was mentioned by Winston Churchill around World War I as an idea that would take away the tensions in Europe, thereby avoiding war. Unfortunately, it took World War II to promote the idea of a EU. In 1956, there was the Treaty of Rome, the constitution of the EU. That constitution was amended in two cities in the Netherlands, one in Maastricht, the other in Amsterdam, where these treaties were being amended. It really is about an economic and monetary union. The concept of having a union between the people of Europe was to make sure that wealth and welfare would be spread equally across the European nations. It is hoped that that would create a bond between people and avoid the horrible wars that Europe has been suffering in the first half of the century.

Another aim is to create a common foreign and security policy, which is at the moment one of the weakest aims, by the way, as we have experienced in the Balkan situation around Kosovo and Bosnia. The unity among the European members of the EU was not as it should be and, hopefully, that will take a better shape in the future.

Also, the aim is to create common citizenship, because an economic union means that people will be able to move around Europe without having to go into customs and all that. Finally, we're aiming to develop a cooperative justice in home affairs, so that wherever a problem pops up in the union, we will be able to manage it throughout those countries.

With respect to the resources of the EU, we have community law. There is legislation applicable to all the nations and all citizens of the nations that members of the EU, which is one of the tools to really exercise the aims of the EU. It has a

budget of over $100 billion (U.S.), which averages 1.2% of gross national product if you add all the numbers together. David will undoubtedly go into further details. The budget is almost half spent on the agricultural policy of the EU, and the other half is used to equalize regions in Europe that are economically set back, for example, the South of Italy and parts of Ireland.

There are a number of institutions that are used for the EU. We have a Parliament directly elected by the people, or a proportional representation by the people who are citizens of the members of the EU. The Parliament holds the purse, so it has budget rights, but it also has to approve legislation around common law to be introduced in the EU. There's a European Commission, which is really the executive branch of the EU. It puts in place all the decisions that have been made There's a Council composed of the heads of state of the EU, which decides on the main framework, and there's a revolving presidency every six months. Another country appoints the president of the Council, and the current President is from Finland.

There's a Court of Justice to make sure that the common law in Europe is properly taken care of and to give people in the countries a place to go for a final appeal in case they run out of appeal possibilities in that particular country. There's a Court of Auditors, which is comparable to the U.S. General Accounting Office that keeps track of the spending in Europe—whether it's justified or not, whether it's efficient, and so forth. And we have a central European Bank to deal with the common currency that we will have as of Jan. 1, 2002. We need the central bank to take care of all that is needed to support the currency. Finally, there is an ombudsman with whom you can file a complaint. If you, as a citizen of Europe, are unhappy about the way you are treated by the EU, you can file complaints and the ombudsman will take care of them.

Now for some facts and figures. I have made some comparisons with the U.S. With respect to population, it's 375 million people in the EU against 266 million in the U.S. One of the problems that is popping up is the demographics. We have a larger component of people over 65–16% compared to 13% in the U.S. The gross domestic product, just to compare the economic size, is not that far off. If you divide it by the number of people, the U.S. is ahead in terms of gross domestic product per capita by quite a gap, so we have some way to go. Insurance premiums are almost equal, but if you divide it into the number of people, then we still are, let's say, premiums per capita lower than the U.S. And just to give you an idea of what interest rates are at the moment in Europe, because we do not have one currency, it's around 5.5% for 10-year Treasuries against 6.1% in the U.S.

Another striking difference between the U.S. and the EU at the moment is unemployment. The unemployment rate in the EU is around 10%, but it differs greatly by country, and the U.S. rate is around 4.5–5%. This gives you an idea how the EU as an economic entity compares with the U.S.

My next topic is the single insurance market. As you are probably aware, the objective of the EU is to create freedom of choice for goods and services. Therefore, the idea of having a single insurance market is to create more

competition and offer a greater choice of products throughout the community. The end result should be a lower cost to the consumer. The history of the single insurance market is that we started to work with common solvency rules in property and casualty in 1973 and with life in 1976. And 1994 was really the breakthrough because of a series of changes in regulations and directions to create a single insurance market throughout the EU. That single insurance market uses a traditional framework, and Duncan will go into more detail on this during his part of the presentation.

It has to promote a free flow of insurance services. There should be no obstacle at all for buying or selling insurance in one member state or another, so we have a system called "single licensed home country control." An insurance company that has a license in one of the countries of the EU can do business in any other country in Europe. And the prudential supervision is done by the country that provided the license and the prudential supervision by the member states. One of the main changes that took place, particularly in markets like Germany and France, and even in Italy and Spain, was that it abolished control of premium rates and policy conditions, and that was a major step forward in freeing up the market.

There is also legislation underway on supplementary pensions. Supplementary pensions are what we would call the second pillar in our retirement system, with the first pillar being the Social Security system. There is now a proposal for a directive under way to safeguard pensions when people move within the EU or change jobs, so that they do not lose out on their pension rights. An analysis reported that losing pension rights could be an obstacle for the free movement of labor between the EU countries, so this has to be taken care of. The directors will deal with the preservation of acquired pension rights, a guarantee of across-border payments, and continued funding for an expatriate within the EU. That last feature means that, even if an employee is being sent by his employer to another country, he or she can expect that the pension rights will be funded in the country of origination.

This is our progress to date on the single insurance market. I think there has been gradual increased competition, not really much, but the most change has taken place in countries that were very regulated like Germany, France, Italy, and Spain. A wider range of products was introduced in 1994. It was quite noticeable, but there is a strong concentration going on, both national and across-border, and Duncan will tell you a lot more about that. The across-border supply of insurance services is mainly going to international customers, so corporations that have business in many different countries in the EU benefit, but so do wealthy people who live in another country, for example, for tax purposes. Those are the most important clients for across-border supply. However, there is a noticeable increase in to start across-border business in the retail selling, but it is going very slowly. I think it is only about 7% of the business at the moment that is being sold on the across-border basis. We have a long way to go to come close to the idea of the single insurance market.

The main reason progress is limited is because we still have different taxes, different Social Security systems, different cultural systems, and legal obstacles that limit progress in developing into a single insurance market.

One of the things that needs to be done is to liberalize distribution channels, particularly the independent intermediaries or the general agent type of distribution because the regulations for being qualified to act as general agents are quite different among different members of the EU. This is one of the remaining obstacles that has to be removed in order to be able to sell business across border.

The other thing that needs to be done, and we already have seen proposals for change, is the supervision of insurance groups. Many groups have a holding company with different in different parts of Europe, and what needs to be done is to create supervision of that holding company. One of the main issues to be dealt with is how the holding company and the subsidiaries will handle the kind of transactions they do in terms of providing capital, and also in providing special dividends, so that we don't run into situations where holding companies are depleting surplus out of their subsidiaries.

The Euro is coming. I will make a few comments on, first of all, the timetable. As of Jan. 1, 1999, the conversion rates were fixed, so now the currency rate between the German mark and the French franc and the Dutch guilder are at least fixed forever. We have a European Central Bank and the start of production of Euro notes and coins. And all the banks and security exchanges in Europe have converted their listings and their statements to their clients into Euro. Now I get a bank account statement with the amount in guilders and Euros, and if I am dealing with my stockbrokers, I get my settlements done in Euros. On Jan. 1, 2002, we will start the circulation of Euro notes and coins, and six months later, all existing legal tender will be invalidated. After July 1, 2002, you can only pay with Euro notes and coins in Europe, or at least in the member states of the EU.

What are the affects on insurance? We believe there will be little impact in the near future. The main issues are really operational, because all the policies and systems will have to be converted from the local currency into Euros. All the policy documents, the premium notices, the accounting, and the filings have to be changed. The main issue is to get that done as of 2002.

Because we have created, through the Euro, much wider capital markets in Europe, the menu offered to life insurers to match their liabilities has been expanded tremendously. We have seen already many examples of that in connection particularly with the risk of lower interest. For example, the Italian government has issued a special bond geared to life insurers to match their liability profile, and it was in Euros. You only have to worry about the credit risk, but it is in Euros, and it is available, which is we believe is a great step forward in allowing insurance companies to manage their assets and liabilities properly. We'll have larger and more liquid financial markets. Of course, the currency risk is being eliminated, but it also puts greater significance on the credit risk control of the insurance company and makes across-border guided marketing a lot easier than it is at the moment.

With respect to future developments, the EU is recognizing that financial markets are integrating, at least on the distribution side. Therefore, they are working on a single framework for financial services, but tax harmonization is key to any major future development. If the tax systems remain as they are, it will pose an important obstacle to further harmonization.

Also, we need integrated supervision and by integrated supervision, I mean supervision for all financial institutions and not separate supervision for banks, insurance companies, pension funds, and so forth. We already see examples of that in Britain, where we have a single or, at least, are on the way to a single supervisory authority, and we will see much of that in Europe promoted by the EU because that is one step forward in integrating the financial markets as well.

We will also see internal risk models to measure the solvency situation, and the risk profile translated into capital needs will go further and further. That will be influenced by the banking regulators who allow, at the moment, the use of internal models to set the minimum solvency margins. We see more of that migrating into the insurance business.

The demographics will substantially push the growth mainly in pensions, health, and what I would call "new risk." We will see over the next 30 years a doubling of those over age 60 in Europe. And, the age-dependency ration—the number of people younger than 20 and older than 60, divided by the number of people between 20 and 60—is moving from 80% in 1995 to 120% in 2025. That is a major, major challenge both for the community and the national governments to take care of the implications for that. But I think it means an enormous potential for life, pension, and health insurers.

By "new risk" I mean those risks coming from, for example, product liability, professional liability, and that kind of stuff. That will pose an enormous potential for the property and casualty market in Europe, and we will see further concentration and demutualization. We had 5,000 insurance companies in 1994 in the EU, and we now have 4,000. We're already at a 20% decline in the number of companies in four years time, which gives you an idea of how fast concentration is going on in Europe. Duncan will tell you a lot more about that. Bancassurance is spreading quickly and, particularly with the changed legislation over here, there are a few interesting case studies to be looked at, so that you, in the U.S., can at least have an idea of what bank insurance might bring to your market.

I'd like to say a few words about the European actuary. I think the European actuaries have been very successful in lobbying within the EU, particularly on the solvency margins rule and the new regulations that are on the way through the Group Consultatif, which is a lobbying body from the European Society of Actuaries with the European government. We are migrating quickly to what I would call the Anglo Saxon role model—the appointed actuary, valuation actuary kind of an approach. We're moving quickly toward integrated risk management. The actuaries are taking a look at the risk profiles of the business on a holistic basis. In other words, they're looking at all the risk and not just the actuarial risk, and

thereby are able to put together all these risk and translate that into capital needs and performance measurement.

Actuaries on the continent of Europe who traditionally had a very strong mathematical background will move much more to what I would call business economics, to look at the fundamentals of the business and translate for management what needs to be done. I think that is a major step forward that also will help in migrating to the Anglo-Saxon role model. Of course, we will have competition from financial engineers. There are several other professions that do similar activities, but I think we have much more to offer than financial engineers. However, I think we should take this big-tent approach and take these people under the larger umbrella of our activities. If the integration of the insurance and financial markets continues to go on, there will be a need to have a lobbying body not only on the European level, but even for the a European Society of Actuaries.

In conclusion, the EU is moving toward becoming what I would call the third largest insurance market in the world, with No. 1 being the U.S, No. 2 being Japan, and No. 3 being the EU. The full market potential for insurance has not yet been developed, so further concentration will come and higher productivity gains will be looked at. There will be strong European players in global markets. The movers and the shakers of this world will play a very strong role not only on the continent of America or in the Far East, but also in mainland China and in Eastern Europe. We will see an ongoing integration of financial services, which is really promoted by the EU, because they believe that integration will offer a wider range of products to clients in an easy and less expensive way.

Ms. Michail: Peter certainly gave us a good background of the EU, the Euro, and an impact of those on insurance. Our next speaker is Duncan Ferguson. He is a senior partner with Bacon & Woodrow, which is an affiliate of Milliman & Robertson in London. He was president of the Institute of Actuaries from 1996-98 and is currently a board member of the Halifax Bank and the chair of Woodrow, Milliman. He has done actuarial work in 34 countries in the 34 years since leaving college in Cambridge.

Mr. Duncan G.R. Ferguson: This question is for the non-Europeans here: How many of you have lived and worked in Europe? Okay, that's about five. And how many of you worked for companies that have operations in Europe and you're involved with those? That's about half the audience. Of the remainder, how many work for companies that are looking at doing something in Europe? Okay, that leaves about one-third of you.

Of the four things that I'm going to say, I have to tell you that one of them surprised me, although I've been working in a number of the European markets for a very long time. It was only when a colleague helped me put some facts together for this paper that I realized I'd been under a bit of a misapprehension. The first fact is that the European market is very large. It's a big market with a lot of characteristics that make it a very attractive market which is going to grow fast.

The second thing is that there are huge differences between the markets in the different countries that make up Europe and certainly, to date, the differences far, far outweigh the similarities. As Peter said, the dream is that we will have a single European market, but it's a very long way away.

The third thing, and this is the one that surprised me, is that there is a massive amount of merger and acquisition (M&A) activity going on all of the time involving the largest companies nationally and across borders. But, surprisingly, when you look at the statistics, you'll see that we do not have a resultant consolidation in the markets. That is, the market share of the top five, 10, or 20 companies, at any point in time, is not growing. The consolidation is happening among big players as well as smaller players, but all the time new people are coming on. If there are any consulting actuaries in the audience who are concerned like me that one day the M&A boom might come to an end and there won't be quite so much work to do, don't worry because it's a continually recycling thing. We're not ending up with a more consolidated market.

The fourth fact is that we are seeing the emergence of quite a number of European "superstars," as I call them. These are insurance companies based mainly in mainland Europe, that have become very international in the way that they operate. They have major operations and leading companies in their groups in a number of different countries, and boards of directors which are multinational and multilingual. That usually means that they hold their board meetings in English. A surprising number of companies in countries where the national language is not English hold their board meetings in English, their management is in English, and they have an enormous amount of international experience.

Those are the four themes that I want to leave you with. I also have two questions that I'd like you to bear in mind as we go through. First, do you think that there is going to be at some time in the medium or longer-term future a single pan-European insurance market? A lot of the enablers are in place, and there are some signs, but it hasn't really happened yet. When you go into your companies and start looking at it, will it affect your judgment if you think that you will have to have a number of different operations in different countries, each one of which is discrete, or do you think that you're going to be able to have a single market with one operation across borders. That's the first question.

The second question I'd like to ask you to bear in mind is: Do you think that any U.S. companies are going to be significant players in the European market in the future? Give that a little bit of thought as we continue.

I'll touch on the size of the major European markets, discuss some of the things that are common, but also what's different, between the different markets say a word about this M&A activity and consolidation, examine the emergence of the European superstars, and then give a brief summary.

If we start with the world life insurance markets, according to 1997 figures, the U.S. has 28% of the world market and Europe has 30%. Our two markets are

about the same size. If we look at the European segment, you'll see that it's broken down into a number of different markets.

The U.K. has 26%, France 24%, Germany 15%, and the other markets are quite a bit smaller. If we now look at long life segment, the U.S. is almost half the world market, about 50% greater than Europe. If we break down the European part, Germany has 27% of the total, the U.K. 19%, France 14, and Italy 9. Although the markets are quite different with a relatively small number of countries, if you just take the U.K., Germany, and France, you can get to about half of the life and the non-life markets.

Moving on to what's common in the EU, there are three things which are conceivably bringing about commonality. The third life and non-life directives emanating from Brussels had to be brought into national legislation to create the single European insurance market that Peter was talking about. Second, we have the Euro, which is going to be a major facilitator of business across countries in a large part of Europe, and we still need to decide what Britain's going to do about it. Third, as Peter mentioned, the demographic changes are all signs for growth. The governments won't be able to support the aging population, which increases need for private pension provision.

Treating each of those in turn, the third life and non-life directives allow a U.S. company, for example, to set up or purchase a U.K. or a European company in one country, and that's the only license that you need. You can then operate through branches or without an establishment across borders throughout the European community. Many people believed that, when this legislation was fought over about 12 years ago and finally came into force in 1990, it would enable a single market to be created.

There are many reasons for supposing that the Euro is going to facilitate a single European market. And then there's the increased need for a private pension provision as states are, in theory, forced to withdraw from welfare, including pensions. In fact, this happens very slowly. Since the war, more governments have fallen in Italy on the single subject of revision of state pensions than any other cause. I think the average life of an Italian post-war government is measured in months, if not days, rather than in years. Every time they try and tackle this problem, there's a huge fight against it. The problem gets worse and worse, but the problem is there and if it isn't tackled, then a number of economies are going to break. As that level of government support is decreased, there are opportunities for the private sector. It's possible that this might become as the market develops a competitive issue between countries, and we might even see migration of labor from countries that are unable to support the high taxes for Social Security to countries where the demographics are better.

Those are the similarities, but there's a much larger list of things that are different—tax, language, culture, distribution systems, regulation—and all that flows through into products. It remains to be seen whether we will ever get tax harmonization in Europe. The systems are incredibly different and, as you know, tax forms a major

part of the design of insurance products and the salability of those products. It's very easy to sell an insurance policy if you can demonstrate that will help to save taxes whether it's inheritance taxes or whatever.

At the moment, the tax systems are very different and those tax systems are different from the way in which insurance companies are taxed. Some are taxed on profits, some on premiums, some on a proportion of investment income, some classes of business are free of tax, and so on. Where you are domiciled as the insurance company affects the tax that you pay as an insurer. Then there are different taxes for individuals in each country—whether they get tax relief on their premiums, the way the benefits are taxed, and so on. And in a number of countries, the governments, despite the harmonized legislation, do tax people differently according to whether they take out insurance contracts with a national company or with a company selling across borders under the freedom rules. Until all those things are sorted out, and tax is a fairly political issue with us in Europe, there are major obstacles.

Language, obviously, is a problem. It's necessary for the sales activities, but it's also important for the back-office and administration. A number of companies thought that, with a harmonized Europe, you'd be able to have a single back office and get economies on the systems and the support. That hasn't happened at all. If you're selling business in different countries, there's a massive increase in cost as well as legal interpretations. And you need the back office staff to support the different languages. We do have a number of European countries—Belgium, Ireland, and one or two others—that have more than one official language, and people have found it difficult enough to deal in two languages.

With respect to culture, the insurance markets are very different. Part of this stems from historical reasons, such as different attitudes toward the family and who needs to provide. In southern Europe, with big extended families, insurance hasn't been necessary because it's always been the fit looking after the unfit members of the family and people in old age being looked after by the family. In northern countries, first the nuclear family and now single parent families have meant that there's a greater insurance need. The types of products also have been affected by habits of either savings, payoff mortgages, or whatever. On top of that, there's a fair amount of market evidence that people are more comfortable putting long-term savings away with national companies then they are with foreign companies.

There are huge differences in distribution. For example, the U.K. is dominated by independent intermediaries and salaried agents. There's quite a bit of growth in telephone sales and a number of banks have been quite successful. In Germany, which is still dominated by the single-company-tied agency system built up over generations, telephone sales have been less successful and bank assurance hasn't taken off to any great extent. Distribution systems don't migrate and, as we all know, success for an insurance company is very heavily dependent upon getting your distribution right.

Regulation is different in each country. One of the reasons that British companies didn't take advantage of the doors which were opened and the directives is that they are beset by burdens from regulators. Peter talked about the creation of the financial services authority, tough rules on the sale of financial services products, and the regulation of insurance companies—quite an onslaught on the industry. For misselling practices this meant insurance companies had to spend an enormous amount of time dealing with regulatory issues, which has made the U.K. a less attractive market to foreigners who are accustomed to a more lenient regulatory regime. And, in Germany, things are changing slowly.

All of this comes back to products and product design is still predominantly national. Attempts to introduce new products across borders—even when there's an obvious need for things like term insurance and temporary insurance, where you think they're directly comparable and people just look at the premium rates—have met with great difficulty. Some countries have more sophisticated products, so you need to adapt to that. For others, it's no good having a sophisticated product because people are suspicious about something that is more detailed, has more variety, and gives them more choices to make than the things that they're used to.

It is my firm belief that, currently, the differences between all of these markets vastly outweigh the similarities. Do you think that the advent of the Euro in a large proportion of Europe is going to change that? Is it going to result in tax harmonization and turn this market into one?

In the six largest countries by population and by insurance market, there's been a massive increase in M&A activity in recent years. In 1998 alone, the value of the top 30 financial services deals was $84 billion U.S., and I don't know a company that isn't considering its position. Is it going to be taken over? Should it be taking somebody else over? Should it be diversifying across corridors? and so on. The drivers are a concern that everything else is going global. When you talk to multinational manufacturers and service companies, they're all thinking globally; it's high on their agenda, so it's fashionable to do so. People think doing that will spread their risks. All markets are getting more and more competitive and people think that the grass is always greener. There might be a market where they can make bigger margins.

Another reason is diversification. The barriers between insurance companies, banks, pension funds, fund managers, and so on are all breaking down. Everybody is going into everybody else's patch. (Should you diversify with greenfield operations?) There have been some examples in the U.K. of insurance companies starting banks and writing a huge amount of business in a very short space of time. (Or do you buy?) And then there's consolidation with the pressure on costs. (Can you take costs out by putting two very large companies together and getting economies of scale?)

Here's some conventional wisdom about what's in the future. The winners are going to fall into two categories: (1) the superlarge players providing a complete range of services across all different types of clients and all distribution systems and

(2) niche operators focusing on one particular market segment, one particular product, and one particular distribution channel. I'm not sure whether that conventional wisdom is going to be right. Certainly, the changes that have taken place in recent years and the market shares of new players coming in and shooting up with all this consolidation lead me to guess there are a myriad of successful strategies out there. But I do believe that, if you're going to be successful, you need a local establishment, effective local distribution, and a strong and accepted brand.

Let me give you a flavor of some of the major deals that have taken place in the U.K. recently. If you look at the life market, the five largest companies in 1991 had about 34% of the market; the five largest in 1997, after some major mergers took place, were smaller. In general, insurance where most of the major insurance players have merged—Royal merging with Southern Lines, General Accident merging with Commercial Union, Eagle Star merging with this Euro group, the BAT operations—the market share of the big players has gone down, and that pattern repeats itself in every country, except France. The largest five French life companies have gone up slightly. But it's the exception that proves the rule.

In general insurance, casualty insurance, it's gone down. And the same thing has happened in Germany. In Italy, you've seen Generale and Ena, the two largest companies in the Italian market, merge In 1991, for the life companies, Ena was No. 1 and Generale was No.2. They had a combined 45% share of the market in 1991. In 1997, Generale and Ena together had less than a 20% market share. One of the reasons they're merging is to get some economies of scale by cutting some of the back-end costs.

The Netherlands has been pretty static, although there's been a little increase in the non-life, casualty market but not much. In Spain it's the same, with a reduction in life. Many mergers are taking place between the large players, but new entrants are continually eating into their market share. There are lots of opportunities, but there are threats once you're in the market as well.

Finally, if you look at the list of the major companies that are leading players, that's to say one of the top three in three markets in the world, the vast majority of them are continental European. And, as you know, some of those have a significant presence in North America. There are few U.S. companies in Europe. AIG has been a niche player in Europe for a very long time, and it has not been on the acquisition trail.

My second question for you was whether you think that there are any implications for the U.S. insurance industry, in general, and for your companies in particular. Do you think that these big continental European insurance companies building up the experience of operating in a number of different countries (which requires a whole new culture and approach) are going to pose a threat because they've got the international experience when they come to the U.S.? And, conversely, do you see that U.S. companies in this very large European totality of markets have a role to play?

To conclude, the EU market is big, but it's nationally very diverse. I think the Euro may change that, but I think that change is likely to be quite small. Meanwhile, European superstars are emerging. Their policy is "think global and act local," and they are interested in North America.

Ms. Michail: It is now my privilege to introduce Dave Durbin. Dave is the senior vice president with Swiss Re in New York and head of its economic research and consulting practice in North America. He is responsible for directing a wide range in research programs for understanding the relationships and interactions between the general economy, capital markets, and the insurance and reinsurance markets in North America. He has published extensively on economic factors affecting insurance markets, and has testified on insurance issues including profitability and the cost of capital.

Mr. David Durbin: Peter and Duncan have certainly done a nice job outlining some of what I would call institutional and business characteristics of the marketplace in Europe. My aim is to drill down a little deeper. I note with a bit of irony as the non-mathematician or non-actuary in the room, that I'm the one who's going to talk about numbers. What I hope to do today is address four issues.

First, I want to talk about the European insurance market in context and, in particular, make some worldwide comparisons. I'm going to give you the economist's twist on that with a couple of facts and figures. Economists like to talk about structure, conduct, and performance. I'm going to talk about conduct and performance in the European insurance markets, globalization of markets and risks, and then leave you with three hypotheses about the impact of the EMU for the future. Let me say that, without necessarily disagreeing with some of the other panelists, I see some changes beginning and I think it's a question of time as to when those changes will fully emerge.

We've heard from both Duncan and Peter about the evolution of the European single insurance market and whether, in fact, it will become a single insurance market. There are two major things happening now: the introduction of the Euro in 1999 and the remaining hurdles to overcome. We also heard about the four macro issues. First, there are legal differences across countries, in particular, settlements of disputes and contract law issues. Second, fiscal treatment varies across countries. As we move to the single currency and the Euro, basically it takes monetary policy away from governments in the EU. It leaves them with fiscal policy as the only lever to affect economic growth by themselves. And, as we know, fiscal policy takes a little bit longer to have an affect than monetary policy. Finally, there are some specific rules and regulations countries have to follow to get into the EU and maintain their status.

Social Security systems are also a very important issue. On a technical basis, a number of countries have basically insolvent Social Security systems, and people don't like the prospect of either benefit cuts or tax cuts. We'll see how that plays out in the next 20–30 years. Finally, there are significant tax differences across

countries, and that will affect the timing of the emergence of the single European insurance market.

As was noted, the EU and the U.S. are roughly comparable in size. The Japanese market has been growing a great deal, especially the life business, although I expect in the short term, during 1998–99, we're going to see the Japanese market slow because of the problems they've had with their economy. Where growth is obviously occurring is in the rest of the world, and that's the emerging markets in Latin America and Eastern Europe. Roughly, there is an the emergence of three major insurance markets in the world when you aggregate countries in the EU.

Economists like to talk about premium penetration or premium dollars per gross domestic product (GDP). It provides the flavor or feel for how developed the insurance marketplace is and how much growth there might be in the insurance markets in the near term. If you look at premiums per GDP, for both life and non-life, for a few European countries, the EU combined, the U.S. and Japan, the figures suggest, at least as of 1997, that insurance penetration is in the neighborhood of 7–9% of GDP in the very industrialized and well-developed world. However, there are countries, like Italy, where, for a host of reasons, perhaps culturally as well as economically, the GDP penetration rate is a great deal slower.

With respect to the insurance penetration for life insurance over time, in France, Germany, Italy, and the U.K., again I would note that, in the more industrialized economies, you have higher insurance per GDP than you do in countries that are less-developed. But we've seen significant growth over the last 20 years or so.

In terms of the driving forces, let me talk more specifically about the financial markets and their impact on the insurance markets. First, we've had a significant reduction in interest rates over the last 20 years in Europe and the U.S. that has certainly had an impact on the markets. There have also been booming stock markets, at least until Alan Greenspan's comments last week, in most of the major economies of the world. As a result, there is excess capital that's growing in the marketplace. Capital is growing much faster than premiums are in virtually all the major regions of the world, including Europe. This capital is a facilitator; it provides the currency for the M&A activity that we see and, yet, we haven't seen an increase in market concentration. This is an interesting dichotomy: We've got excess capital resulting in increased M&A activity, but we have this incredible competition going on in the marketplace.

I think that can be explained in part by another economic concept that's related to the GDP penetration, what I call the "GDP elasticity of demand." Basically, it refers to how fast or how much the insurance markets will grow for every percent of growth in the underlying economy. A GDP elasticity of 1 means the insurance markets grow in proportion to the underlying economy. A GDP elasticity of greater than 1 means the insurance markets grow faster than the economy. As you might expect, in most of the countries of the world today, Europe as well, the GDP elasticity demand is greater than one. But over time it comes down and diminishes towards 1 as the economy becomes more developed.

For example, in the U.S., the GDP elasticity of demand is actually less than 1 right now. And in certain areas in Europe, we have countries like Germany, France, and the U.K. where this GDP elasticity of demand is moving down towards 1.

What does that mean? It means you're not going to be able to grow your market share very much through organic means. You're going to be able to keep constant with the growth in the economy. In order to grow your market share to show your investors that you're a viable opportunity, you're going to have to look for other ways of gaining market share. The way you're going to do that is through significant price competition and M&A activity.

In contrast, you have countries like Spain, Portugal, and Italy where the GDP elasticity is still much greater than 1, on the order of 1.3–14 in some countries. That suggests there are still opportunities for companies to grow market share or to grow there through organic means.

Interest rates are certainly a big part of the story. Since the 1980s, throughout the world we've seen this downward trend in interest rates. In the period of the 1990s, interest rates have declined by half in all these regions of the world. Right now, in the U.S. and perhaps elsewhere, we may be starting to see a turning point, a tick back up in interest rates.

The growth of capital relative to the growth in premium can be seen in France, Germany, U.K., Japan, and the U.S. Japan is obviously a special case, considering the problems it has had in its markets over the last couple of years. From 1996–98 we saw tremendous growth in capital in the marketplace far outweighing the premium growth. The technical solvency ratios that the regulatory authorities and rating agency look at were well above all historical norms in virtually all the markets around the world.

We talked earlier about the M&A activity, and Duncan had some figures by country about the ongoing consolidations. In Europe, the number and the volume of M&A activities actually outstripped the U.S. market over the last couple of years. Something on the order of $80 billion of M&A activity in the last year alone occurred in the European markets.

The point here is that, in the past, regulated markets, in Europe especially, have led to cartel-like pricing behavior and distinctive but uniform products within particular countries. Regulation has also tended to smooth the results in those countries. What we've seen in countries that begin the deregulation process, and the U.K. is a good example of that, is that profit margins tend to decline, competition goes up, and interestingly enough as you might expect, the volatility of underwriting results tends to increase fairly dramatically. I think that's one of the major points I want to make is that, as this deregulation process continues in Europe, there's going to be continued and increased volatility in the marketplace. Of course, associated with that, there will be risks and opportunities for companies in that environment.

Let me just show you for the sake of argument a couple of illustrations of what I'm talking about. Chart 1 shows the performance in the U.K. non-life market over the last 12 years. In the below zero we have the technical or underwriting results, in the above zero we have the investment results, and in the black line we show the total yield. What we see is a fairly volatile marketplace. The results are cyclical and they do vary fairly dramatically year by year. For Italy, the results aren't so wonderful, but the volatility is a little tighter. In France, which has a more regulated marketplace, the results are more uniform, but again in a lower band. In Germany, which has a fairly highly regulated marketplace, we see not only less volatile results, but also quite profitable results.

In looking at the technical underwriting results in Table 1, I've sorted them by declining standard deviation over the last 12 years. From 1985–97, I looked at the underwriting results year-by-year, their means and their standard deviation, and then looked at their autocorrelation, the degree of persistency in results year-over-year. What I take away from this is the middle column in terms of the standard deviation result. When you rank order the volatility measures, it gives you a loose ordering of the degree of regulation in the marketplace, with the U.K. being the least regulated market, and perhaps France and Germany being the most regulated markets.

TABLE 1
TECHNICAL RESULT STATISTICS
(table is sorted by Standard Deviations)

	Mean	Std. Dev.	AutoCorr. Previous year
U.K.	-9.0	7.5	0.60
Italy	-13.4	4.5	0.73
France	-11.2	3.7	0.57
Germany*	-0.4	1.9	0.71

* German figures include technical interest income.

As deregulation occurs, my expectation is we're going to move much more to the U.K.-type of model, with much wider swings in results year-to-year. Looking at the total yield results, it's the same story. You have the standard deviation, or the volatility of results, much higher in a deregulated marketplace than in the other markets. I would also note that the persistency of results (i.e., the autocorrelation) is also higher in the regulated markets, but that's going to go away as the markets start to open up a bit more.

Now I'd like to turn to the investor side of the equation, and just share with you some results of work that we've been doing over the last few months. Table 2 shows cost of capital estimates for a few European countries by line of business and over the time period 1989–98. These are drawn from a fairly standard application of the capital asset pricing model where we wanted to see the trends and the patterns over time. Just by way of review, there are three major parts to the capital asset pricing model. There's the risk-free rate. There is the measure of systematic or undiversifiable risk, the so-called beta, which is a volatility measurement, and there is the equity risk premium, which is the amount by which stocks perform better than bonds in a particular marketplace. I'll comment on beta and the equity risk premium in just a moment.

TABLE 2
INSURANCE INDUSTRY COST OF CAPITAL ESTIMATES
FOR SELECT EUROPEAN COUNTRIES

Cost of Capital	U.K.		Switzerland		France		Germany	
	non-life	life	non-life	life	non-life	life	non-life	life
1989	18.98	18.96	9.34	n/a	14.62	14.62	11.48	9.98
1990	21.22	21.31	14.03	n/a	17.52	17.59	14.19	12.92
1991	20.25	20.31	13.56	n/a	15.93	16.08	14.78	14.44
1992	17.52	17.38	13.00	n/a	16.11	16.41	14.85	15.14
1993	14.48	13.91	11.66	n/a	16.76	17.29	13.96	14.32
1994	13.09	12.37	9.49	8.20	11.50	12.32	10.93	11.40
1995	14.60	13.51	9.10	7.44	11.66	12.31	10.05	10.88
1996	14.73	13.29	6.49	4.81	10.60	11.14	8.39	9.29
1997	14.19	13.13	6.69	4.96	8.69	8.51	7.92	8.28
1998	15.23	13.74	6.85	6.06	8.43	8.54	8.81	7.81

Before I go through the trends in the cost of capital, let me ask two questions associated with that. First, just scanning down the columns and examining the results over time, what we see is a fairly dramatic decline in the cost of capital in all of these markets. We also see that, in the U.K., the cost of capital is much greater than it is in the other markets which, given the volatility in that marketplace, is not altogether surprising. The questions that I ask myself are: (1) What's driving these trends? and (2) As you go to the Euro and we end up with the same risk-free rate across Europe, what are the implications going to be for the cost of capital in insurance?

To get a handle on that and decompose the results into the three parts, I looked at the betas for the same markets over time (Table 3). We saw that there was a huge drop in interest rates across all these markets, which affected the overall cost of capital. In addition, there were some variations in the betas (i.e., the variation in the perceived volatility in the marketplace). In the U.K., the betas are going up. I think that's a consistent story with deregulation and volatility, and investors are perceiving that as well. In Switzerland, the perceived riskiness is also going up a little bit, but there are declines in the German and French betas. We have a different story going on here but, again, I think it's consistent with the view that, as markets deregulate, you're going to see more volatile results. And investors are also going to start factoring that into their decision making. When the common

risk-free rate across the EU markets is introduced, then differences in betas are going to be all that more important because that will drive the differences in the cost of capital.

TABLE 3
AVERAGE BETAS BY COUNTRY AND YEAR

Cost of Capital	U.K.		Switzerland		France		Germany	
	non-life	Life	non-life	Life	non-life	Life	non-life	Life
1978	12.68	18.96	4.50	n/a	13.75	13.75	6.41	5.51
1979	18.94	20.58	3.00	n/a	10.06	10.06	7.17	6.09
1980	23.94	24.77	8.82	n/a	14.25	14.25	11.95	11.56
1981	22.10	22.81	9.70	n/a	11.31	11.31	12.51	11.93
1982	22.34	22.79	13.51	n/a	21.53	21.53	13.99	14.17
1983	16.61	16.95	7.16	n/a	29.49	29.49	9.70	10.07
1984	15.31	15.05	8.22	n/a	17.90	17.90	10.28	10.07
1985	15.69	15.06	9.48	n/a	15.59	15.59	10.68	9.16
1986	17.52	17.21	9.35	n/a	18.30	18.30	10.66	7.87
1987	17.47	17.12	9.28	n/a	15.77	15.77	11.08	8.48

In the near-term to medium-term, I think the introduction of the single currency will lead to a more uniform market in insurance. I also think it's going to increase competition between the insurance companies and bring parallel development in the insurance industry. Insurance company cultures and skill sets are going to start to converge over a period of time. Right now, the individual markets and individual cultures are quite important but, as we get into a single currency, the financial skills are going to become much more important. Skills like financial engineering and financial risk management are going to be much more important.

In addition, insurers are not going to be able to hide behind the skirts of regulation. They're going to have to compete in that marketplace, so entrepreneurial skills are going to become much more important. Also, I think that European insurers are going to have to pay a great deal more attention to the asset side of the business. There will be a greater ability to invest in a broader class of assets, potentially diversifying the portfolio a great deal, while mitigating or eliminating a great deal of foreign currency risk. When you have the single Euro, you won't need to worry about the Deutsche mark and the Italian lire exchange rate any more. Those issues go away.

Currently, there are differences across countries in the typical composition of the asset portfolio. In the U.K., consistent with the need to manage the asset side of the business much better to show profits, a greater proportion of assets are in equities as opposed to fixed-income type of instruments. I would expect to see countries like Germany, Italy, and others start to be a little bit more aggressive by increasing equity investments in their portfolio. Of course, the implications are that, by paying more attention to the financial and asset side of the business, the skill sets involved are going to need to change and grow. Tools such as asset liability management and dynamic financial analysis, which we're starting to see here in the

U.S. and in Europe, are going to be of much greater importance in the medium term.
Finally, and this relates to my cost of capital figures and analyses, with the introduction of the single currency, we're going to see much greater competition for investor dollars. This will also affect the volatility results, which has implications for the asset side of the business. Historically, a number of the European insurers have been able to hide behind their balance sheets in some fashion. There hasn't been a great deal of transparency in the balance sheets, and I think we're going to see a greater demand for GAAP-like accounting statements, which will change the picture for a great many insurers and change the smoothness that they want to portray to the marketplace. I think that this will be an interesting change over the next several years. Again, with the expected increase in volatility, the increased transparency will continue to fuel M&A activities. The risks and opportunities are going to continue, and insurers who don't make their cost of capital are going to become targets for takeover.

In closing, I believe that, as the transparency in the marketplace continues to increase and as investors become more knowledgeable, there will be a tremendous amount of excess capacity and capital in the marketplace. I think the opportunities for dramatic changes in the marketplaces are going to be there. There will be a need for significant restructuring, that is, for significant capital movement in the marketplace for a great many companies to remain profitable.

CHART 1