SOCIETY OF ACTUARIES

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European Theater

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A common currency and regulations that apply across national borders make Europe a likely battleground for U.S. life insurers that want to expand their market.

In the 1980s, Europe did not appear as a viable business opportunity to many U.S. life insurers. Regulatory regimes varied greatly among countries. Several countries were economically unstable, and currency fluctuations hampered insurers' ability to price products accurately. Individual markets varied so much that single product platforms were impossible, and suitable distribution channels were difficult to develop.

Now, however, the launch of the euro and new regulations have converted Europe into a single market that is more uniform and more accessible to U.S. insurers than ever before.

Europe is a viable market of nearly 380 million people that is now underpinned by a currency that many economists believe will replace the U.S. dollar as the "international currency." However, Europe will not meet the business-development criteria for every U.S. insurer. Numerous caveats and anomalies still exist across the Continent and, in combination or on their own, any of these issues could undermine the success of a U.S. insurer seeking to do business in Europe.

To gain a clear and balanced picture of the potential Europe offers, an insurer must consider the current position of the market and the opportunities this presents and then consider its own profile to determine the best way forward.

Current Position

With the implementation of the 3rd Life Directive in 1994, Europe moved to a "home country regulatory system" that is far simpler and arguably more effective than the U.S. system of state regulation. The new system has removed the need for a U.K.-based company, for example, to gain German regulatory approval for a new product before it is sold in that country. In contrast to the U.S. system of state-by-state approval, this has removed one of the major constraints to product innovation and greatly reduced the time required to bring a product to market.

The second major byproduct of the directive has been the creation of a cross-border market in Europe where none previously existed. In years past, only German companies wrote business in Germany and only French companies wrote business in France. However, since the directive has been implemented, cross-border business has grown rapidly as companies began to take advantage of the economics of scale offered by manufacturing products from a single base. In less than five years, the cross-border business has grown in size to 60% of the German market. This is a new area of growth in Europe that is

Market Comparison

	United States	Europe (EU)
Population	263 million	371 million
Total life premium Income 1996 ($million)	$379,307	$312,845
Life Insurance per capita 1996	$1,459	$836
Currency	U.S. dollar	Euro for initial 11 membee states, country currencies for non-members.
Political structure	Led by federal government but supported by state governments.	Country governments lead but supported by increasing powerful federal government.
Language	English dominant	Multiple languages
Culture	Homogenized but increasingly segmented.	Highly segmented with increasing homogenization.
Life insurance Regulation	At state level with each state regulating products/activities of companies active in that market.	At country level with Home country regulator retaining supervision of cross-border operations.
Corporate tax structure	Standardized at federal level. Some differences at state level.	No federal level. Different regime in each country.
Personal tax structure	Standardized at federal level. Some differences at state level.	No federal level. Different regime in each country.

Source: A.M. Best Co., JBI Associates (Luxembourg)

ideally suited to a U.S. company looking to develop business.

The launch of the euro currency is another factor that is having a dramatic impact on the market. With the launch of the euro, insurers can now manufacture a life contract in Spain and sell it in France without worrying whether currency fluctuations will erode their margins. This will greatly reduce the uncertainty in pricing products and should help cost-efficient operators develop a competitive advantage.

The introduction of the euro has also helped to stabilize the economic situation for the initial 11 member countries, and there are clear signs that the rest of Europe may follow. The interest rates in the nonmember countries are now beginning to drop in line with the euro rate as these countries seek to bring their economies in line with their main trading partners. This means Europe is no longer a collection of disparate economies but is becoming a single economic entity with a single monetary policy.

If Eastern European countries enter the monetary union, the euro will be supported by a market with a population of over 450 million, nearly twice that of the United States. If this happens, it becomes even more likely that the euro will replace the U.S. dollar as the international trading currency. In preparing for such a situation, U.S. companies may want to consider how their business would be affected in a world where the statements of the European finance minister have a greater impact on their balance sheet than those of the chairman of the Federal Reserve Board.

The tax differences between the various countries at both the personal and corporate level have combined to create what is probably the most complex area of the European market. This has led to the situation whereby a German's tax position on a pension is completely different from an Italian's. As a result, it is still impossible to design a single product platform that can be replicated from country to country. A German product may need significant changes before it can be sold in the Netherlands, for instance. Likewise, the computation of corporate tax for a French life insurer is entirely different from that of an Irish or Spanish life company.

To what extent there will be true tax harmonization in Europe is unclear. While the Germans are pushing harmonization as a major item on the European agenda, the other countries appear eager to retain their existing freedoms in this regard. While nothing is clear at this stage, it seems unlikely that Germany will be successful in the short term and even so, any changes would need years to be phased into existence.

While global brands, television, music and now the Internet have dramatically homogenized European culture, one key difference remains — language. As long as the French speak French and the Spanish speak Spanish, products will need to be tailored for each market. In fact, the 3rd Life Directive requires companies to provide policy terms and conditions in the policyholder's native language. Likewise, cultural or market conditions often require a company to use, for example, a different waiver of premium definition in Italy and Greece.

Developing effective distribution is likely to be the make-or-break issue for any insurer exploring expansion into Europe. While the main distribution channels operate in a manner similar to their U.S. equivalents, this is a complex area and the relative importance of each channel varies greatly from country to country.

At a general level there are two key issues worth noting. First, bancassurance has grown rapidly in the 1990s and now accounts for upwards of 50% of new business in most of southern Europe. Secondly, the financial services industry is experiencing a wave of new entrants that pose a major threat to insurers.

In the United Kingdom, these new entrants include the major supermarkets, drugstores and just about anyone else who has a customer database. The resultant battle to develop and retain effective distribution is intensifying, with many of the insurers finding themselves left on the outside looking in.

Market Opportunities

The most promising market opportunities for U.S. companies include:

- **Pensions and long-term savings products**
  Over the next 10 to 20 years, the pensions market is likely to be a growth market. While the same demographic pressures now facing most industrialized nations will drive this growth, the European problem is exacerbated in comparison to the Untied States because European countries have traditionally provided a higher level of state pension. The market has grown rapidly as these countries have sought to reduce this burden and have offered more incentives for private pensions. However, as lower interest rates have exposed the inefficiencies of the traditional European product designs, insurers are now struggling to develop products that can meet the growing demand of the new pensions market. The resulting gap may be fertile ground for U.S. insurers who have developed innovative and flexible pension products and who can administer them efficiently.

- **401(k) equivalent**
  An interesting offshoot of the pensions market is the emerging European equivalent of the 401(k) market. This is one area where Europe believes the United States got it right, and most countries are now seeking to establish some form of similar equity-backed retirement savings vehicle. As these schemes are introduced, margins around administration are likely to decrease. This could create opportunities for efficient U.S. companies that are comfortable operating in such an environment.

- **Health care**
  While most European countries are loath to allow the development of an expensive private medical system like that of the United States, they now realize they can no longer support the cost of their own state systems. As a result, the market is now opening up to private medical and long-term care insurance, product areas where numerous U.S. insurers have great experience.

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- **Variable and universal life products**
  For some time, the majority of the European market has been dominated by the sale of "with profits" products similar to participating products sold in the United States. While in recent years investment-linked products have begun to establish a toehold in the Continental market, they account for only 5% of new business in markets such as Germany. The reason for this slow acceptance seems to be a general consumer reluctance to move away from the more guaranteed nature of participating products. However, in the current low interest-rate environment, insurers are now cutting bonus rates. That is forcing advisers and consumers to consider the merits of other product structures. In terms of opportunity, it seems worth considering whether the U.S.-style variable and universal life products could be adapted to fill this product gap.

- **Credit Insurance**
  This is a niche area in Europe that is relatively underdeveloped in comparison to the United States. Consumer spending and therefore consumer lending, are expected to increase across Europe as economic conditions improve. These factors should, in turn, fuel the need for credit insurance. However, to date, only GE Capital's Consolidated Financial Insurance has developed a significant multicountry presence in this market.

- **Internet products**
  The Internet represents a new frontier for the marketing of life insurance in Europe and one that is ideally suited to single-site manufacturing and cross-border marketing. However, only a few companies have developed their Web sites to the point that an individual can apply directly for a product, and those that have tend not to market this function openly. What does seem certain is that the Internet will increase in importance as a distribution channel. If this holds true, U.S. companies with experience in developing business through the Internet may be able to gain an advantage over their European competitors.

Top Tier Comparison

Leading European Companies	U.S. Operations
Allianz (Germany)	Allianz, Jefferson of New York, Fireman's Fund
ING (Netherlands)	Equitable of Iowa, Life of Georgia and other life companies.
AXA (France)	Equitable Life and several fund management companies.
Fortis (Netherlands & Belgium)	Several life and fund management companies.
Prudential (UK)	Jackson National Life
Aegon (Netherlands)	Multiple life and fund management companies.

Top U.S. Companies	European Operations
Prudential	Operations in Italy.
Metropolitan Life	Sells in Portugal and Spain through Genesis Seguros Generales, a joint venture with Banco Santander.
Principal	Principal International Espana, Spain
New York Life	None
Northwestern Mutual	Frank Russell Co., an investment management firm, with an office in London and 90 associates in Europe
John Hancock	John Hancock International Services in Brussels, Belgium; Hancock International Private Equity Management, London; John Hancock Advisors International, London and Dublin.

Source: Company Web sites

Comparing Europe's Largest Insurance Markets

	FRANCE	GERMANY	ITALY	SPAIN	UNITED KINGDOM
1996 Population (in thousands)	55,652	81,818	57,269	39,742	57,881
Life premium Income 1996 ($ million)	$81,784	$54,826	$15,606	$11,519	$89,098
Life premium income per capita 1996	$1,232	$557	$206	$222	$1,182
Currency	Euro	Euro	Euro	Euro	Pound Sterling (Euro by 2002)
Primary distribution channel	Banks	Tied Agents	Banks	Banks/Agents	Brokers
Main product lines	Life Investment products	Regular premium participating endowments	Single Premium, participating endowments	Tax incentive savings plans	Even split between participating and unit-linked products
Market comment	Tax incentives for life products being removed. Incentives for pension products likely to increase. Banks and unit-linked products continuing to increase market share with unit-linked products likely to grow in prominence.	Tax treatment for life products likely to change under new government. New entrants focusing on large and relatively under-insured market. Brokers, direct marketing companies and unit-linked products gaining market share.	Banks continue to dominate distribution but financial consultant channel beginning to emerge. Sales dominated by investment products with some movement to emerging unit-linked product types.	Banks dominate distribution through tax incentive savings plans. Low interest-rate environment is forcing insurers to develop more unit-linked products. Pension reform now becoming major issue.	Europe's leaders in product innovation now face uncertain status in their home market as pension reforms highlight industry inefficiencies. Continued consolidation of companies in short term with battle for distribution key.

Source: Bacon & Woodrow, JBI Associates (Luxembourg)

Acquire or Start Anew

A U.S. company that wants to enter Europe has two options: acquire an existing business or start a new company. Which route a company chooses is likely to be governed to a large extent by its own profile and the scale of its ambitions. To illustrate this point, consider the example of two very different insurers that sought access to the German market.

CGU, then called Commercial Union, is a U.K.-based multinational composite insurer. The company decided that the most effective way to enter the German market was to acquire a company established in the market, which it did after identifying the right target. On the surface, the case seems to be a typical example of how big companies do business. What is not apparent is that the company first identified Germany as a market where it wanted to be and then began considering how best to enter. During the review, executives considered their strengths in their home market and concluded they had nothing new to bring to the German market. They simply wanted to take their share of what they considered a market primed for growth.

On the other hand, Scottish Amicable, a mid-sized mutual life company that is also based in the United Kingdom, was constrained by its limited access to capital. The company realized that Germany was a market with numerous niche product opportunities that matched many of Scottish Amicable's product strengths in its home market. The company's limited access to capital ruled out acquisition as a viable option. The company then considered the development of a new life company that could market in Germany and other European countries further down the line. After a complete review of the pros and cons of numerous options, the company elected to base its new "international" life subsidiary in Ireland's tax-free zone. Three years after launch, the company was writing over $18 million in annual new business premium.

The key point for American companies is that neither CGU nor Scottish Amicable was better acquainted with the German

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market than most U.S. insurers. Other than proximity, their European base gave them no specific advantage when considering how best to develop business in Germany, but both companies saw an opportunity in Germany, assessed their options and moved forward accordingly.

While each case required a very different level of capital, it seems likely that each company employed similar criteria, perhaps 15% return on capital, to approve such a commitment. The difference is that a large company usually buys its way into a market while a medium-sized or niche company may find a start-up operation a more suitable way to develop business.

In the case of acquisitions, there is no standard template that can be provided to guide a company when assessing the value that can be gained from acquiring another business. A company must be clear about what it hopes to gain from an acquisition and value this accordingly. However, keep in mind that any acquisition that provides a base for future cross-border expansion may be more attractive to a U.S. company than a rival European company.

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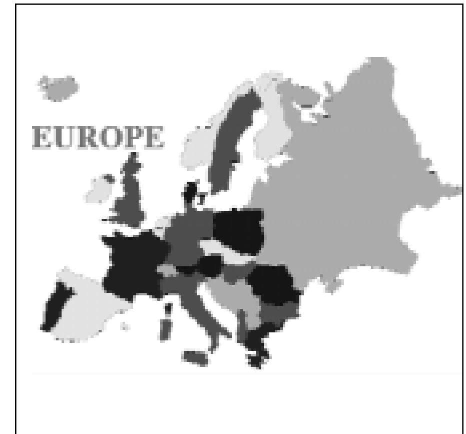
While U.S. companies must consider numerous issues before deciding where to base a cross-border start-up company, the decision usually hinges on selecting a tax-efficient base with a business-friendly regulator. In this regard, Dublin and Luxembourg have emerged as the most likely choices for foreign companies looking to set up a new company within Europe. The centers offer equal access to the entirety of the European Union. An English-speaking culture and numerous tax advantages are the positives for Dublin's International Financial Services Centre, while Luxembourg offers a more Continental culture and easier access to German, Dutch and Belgian markets. Ireland has benefited from its strong links with the U.S. and is now home to the pan-European operations of American International Group Inc., Beneficial Financial and Western Life. Luxembourg is the base for the likes of Massachusetts Mutual Insurance Co., Standard Management Corp. and The Hartford Group.

Opportunities Abound

Many of the traditional barriers that prevented U.S. companies from doing business in Europe have been reduced or even eliminated in recent years, and while numerous obstacles remain, Europe as an insurance market is arguably more open to U.S. companies now than at any time in history.

A balanced view of the issues is required before the decision to expand into Europe can be made. In considering these issues, companies must focus on their own strengths and weaknesses and what they bring to the market and contrast this against the opportunities available. From this assessment, the company can then develop its preferred route to market, be it acquisition or start up, and work to minimize the business risks inherent in each.



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