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EU-US insurance/reinsurance market inefficiencies

John Cooke

Research Specification

1. **Identify**, **describe, and indicate the relative significance of inefficiencies in the insurance/reinsurance markets**. Research should address the following inefficiencies (whilst considering additions or deletions):

Research Specification (2)

(i) Fragmentation of insurance (and to a lesser extent reinsurance) regulation:

(1) Compliance costs;
(2) Time to market (product approval and/or rate/form filing);
(3) Impediments to confidential information exchange;
(4) Licensing and/or authorisation costs;
(5) Citizenship/residence requirements;
(6) Compulsory cessions;
(7) Restrictions on brokerage and agency licences;
(8) Competition between regulatory authorities;
(9) Licensing requirements for surplus lines and/or cross-border insurance of large commercial risks.

Research Specification (3)

(ii) Solvency requirements, particularly credit for reinsurance, localised collateral requirements, and other burdens on insurers/reinsurers doing business.

(iii) Surplus lines and/or cross-border business – situs funds requirements and compliance costs. Barriers to cross-border insurance business.

(iv) Residence requirements, including those for brokers and agents for surplus lines and/or cross-border business.

(v) Other market access barriers, both in the EU and US.

Research Specification (4)

2. **Quantify the costs of the inefficiencies and the benefits to be derived from reducing them.** How would insurers and reinsurers benefit? What would the wider benefits be to consumers, the economy, and society?

Research Specification (5)

(vi) Cover as many of the above areas (1(i)-(v)) as possible, citing/drawing on previous studies.

(vii) Concentrate on the specific example of 'credit for reinsurance':

(1) Consider the extent to which collateral requirements have wider impacts, limiting risk transfer and undermining the benefits of reinsurance.

(2) Review collateral requirements imposed on reinsurers writing business outside their home state and/or country.

(3) Assess/estimate the costs to the insurers/reinsurers to comply with collateral requirements.

EU-US INSURANCE/REINSURANCE MARKET INEFFICIENCIES

Current Study by John Cooke

Study Outline

Introductory

Background Proposition

There is an ongoing EU-US financial markets dialogue focusing on capital markets, accounting standards, corporate governance and insurance/reinsurance. Its objective is to improve the transatlantic financial services market, making it broader, and more efficient, adding to economic growth and raising the standard of living on both sides of the Atlantic with benefits for consumers, the wider economy, financial stability and competitive financial services providers.

The dialogue about reinsurance/insurance inefficiencies is in its relatively early stages. There is a need for an independent report to identify the inefficiencies on both sides of the Atlantic, indicate the relative significance of such inefficiencies, and quantify their impacts. Such a report will help engage the relevant parties, focus attention on addressing key issues, and move the "dialogue" beyond a basic exchange of information. (It is recognised that, in the longer term, research could usefully be done regarding the methods by which inefficiencies can be addressed and the costs of doing so, as well as on identifying the drivers and resisters to increasing efficiency. This is not however an objective of the current study).

Research on EU/US reinsurance/insurance inefficiencies has already been done by organisations in the US, EU or UK, by academics, institutions, and consultants (in particular, there is much current work focusing on regulatory models, in the context of the debate on an insurance Federal Charter, in the US, and on the Financial Services Action Plan/Lamfalussy Process, in the EU). However, it has not been pulled together or distilled in the context of drawing up an agenda for transatlantic discussion. To do so could go a long way towards moving the current EU-US "dialogue" beyond a basic exchange of information. The Corporation of London (as research sponsor) has taken the view that, to achieve this, there needs to be, as a first step, a thorough review of existing reports and data already prepared by US, EU and UK organisations.

Research Specification

Against the above background, the Corporation has specified that the purpose and objectives of the current study are to:

1. **Identify**, **describe, and indicate the relative significance of inefficiencies in the insurance/reinsurance markets**. Research should address the following inefficiencies (whilst considering additions or deletions):

i) Fragmentation of insurance (and to a lesser extent reinsurance) regulation:

   (1) Compliance costs;
   (2) Time to market (product approval and/or rate/form filing);
   (3) Impediments to confidential information exchange;
   (4) Licensing and/or authorisation costs;
   (5) Citizenship/residence requirements;
   (6) Compulsory cessions;
   (7) Restrictions on brokerage and agency licences;
   (8) Competition between regulatory authorities;
   (9) Licensing requirements for surplus lines and/or cross-border insurance of large commercial risks.

ii) Solvency requirements, particularly credit for reinsurance, localised collateral requirements, and other burdens on insurers/reinsurers doing business.

iii) Surplus lines and/or cross-border business – situs funds requirements and compliance costs. Barriers to cross-border insurance business.

iv) Residence requirements, including those for brokers and agents for surplus lines and/or cross-border business.

v) Other market access barriers, both in the EU and US.

2. **Quantify the costs of the inefficiencies and the benefits to be derived from reducing them.** How would insurers and reinsurers benefit? What would the wider benefits be to consumers, the economy, and society?

vi) Cover as many of the above areas (1(i)-(v)) as possible, citing/drawing on previous studies.

vii) Concentrate on the specific example of ‘credit for reinsurance’:

   (1) Consider the extent to which collateral requirements have wider impacts, limiting risk transfer and undermining the benefits of reinsurance.
   (2) Review collateral requirements imposed on reinsurers writing business outside their home state and/or country.
   (3) Assess/estimate the costs to the insurers/reinsurers to comply with collateral requirements.

The Study’s Research Approach

Aims and Choices

The required research is potentially very extensive in nature; and has already taken longer than the six months provisionally allowed. To keep the research within reasonable bounds, in terms of the time and budget available, it has been necessary to take stock at regular intervals, against the criterion of ensuring that the research is tied to producing results of practical value, capable of being coherently set out in publishable form.

Choices have had to be made as to the material to be covered, and the depth in which it is covered. In making these choices, the criterion has been how far the material in question seems likely to serve the pragmatic purposes of focussing attention on key issues and helping the EU-US dialogue on inefficiencies to move forward. But such choices must also have regard to the integrity of the study as a whole.

The Two Principal Research Elements

The required research is two-fold in nature, meeting two sets of related objectives:

1. To identify, describe and indicate (not necessarily in quantitative terms) the relative significance of inefficiencies in the EU-US insurance and reinsurance markets;
2. To quantify the costs of the inefficiencies identified, and to quantify the benefits to be derived from reducing them, with particular reference to "credit for reinsurance".

The first element has been essentially descriptive and analytical in the broadest sense. It has focused, in the first instance, primarily on *inefficiencies in the cross-border provision of general (i.e. non-life) insurance and reinsurance*, because it is in this field that some of the key inefficiencies identified in the Research Specification (compulsory cessions, restrictions on brokerage, surplus lines/cross-border licensing requirements, localised collateral requirements) primarily arise, particularly in the United States. As far as the European Union is concerned, research within this general field is being focused primarily on the EU's four largest insurance markets (France, Germany, Italy, the UK) which together make up some 75% of the EU market: these four markets provide a representative group and avoid the unwieldy (and linguistic) difficulties inherent in attempting to examine every local potential restriction in every EU member state.

The second element ideally requires the development of some kind of quantification methodology to be applied to the inefficiencies identified in the first element. The methodology needs to be robust enough to allow the analysis to progress from mere description and assertion to - perhaps for the first time - systematic and evidence-based demonstration of the extent to which certain EU and US practices (principally but not exclusively in the field of regulation) may create measurable market inefficiencies. It is unlikely to prove possible to apply such a quantification methodology to all chosen EU or US practices: some may not be amenable to quantification, while others may only be quantifiable through the use of excessively arbitrary imputed values open to dispute. As the study progresses, choices are having to be made between the inefficiencies that can safely be subjected to meaningful quantification and those which can be identified (and perhaps ranked) but not on a quantified basis.

External Setting for the Research

The research is being conducted against the general background set out in the opening paragraph of this paper. More specifically, the research needs to show awareness of the increased pressures, post-11 September 2001, for world markets in general insurance and reinsurance to be as deep as possible, unconstrained by artificial, outdated, or frankly protectionist regulatory practices tending to fragment the market and reduce its capacity to offer insurance and reinsurance cover on an available and affordable basis. This aspect is not incompatible with the wider study objective of enhancing transatlantic market efficiency: rather, it is a major subset of this objective, particularly relevant to maximising the combined depth of two of the largest world insurance markets.

International Regulatory Practice

The study also has to take account of current national and international trends in insurance regulation and the internationalisation of insurance supervision, particularly through the work of the International Association of Insurance Supervisors (IAIS). These trends are steadily challenging the assumptions on which earlier regulatory models have been based. To the extent that regulatory restrictions may be defended as necessary, prudentially sound, or in line with wider internationally agreed practice, the validity of such defences in terms of modern practice will need to be considered.

Identification, Description and Relative Significance of Inefficiencies

This element of the research has proved to be essentially analytical and descriptive. It focuses on the origins of the organisation of the regulation of insurance in the EU and US markets, dealing with chosen elements of the EU Single Market regulatory framework, on the one hand, and corresponding elements of the US system of State regulation, based on the McCarran-Ferguson Act, on the other. It examines the effects of these frameworks on the fragmentation of regulation in the two markets, under the subject headings listed above.

In tackling this area, the research has drawn on as much existing material as possible, including analyses of specific regulatory requirements and compliance costs already drawn up by insurance market bodies and trade associations on both sides of the Atlantic (in the US, much of this material has been brought together in the course of developing the case for various types of “Federal Charter” for insurance regulation). In many areas however, deeper research has proved necessary, re-examining specific, chosen regulatory elements in selected EU member-states and selected US States, to evaluate clearly both the compliance costs involved and the status of the practices as barriers to market access or national treatment. For such an examination of market access barriers, the US and EU commitments and reservations under the General Agreement on Trade in Services (GATS) offer an obvious starting point, although market access barriers arising from recourse to the GATS “prudential carve-out” (and therefore likely to be omitted from GATS commitments and reservations) also need to be examined.

Quantification of the Costs of Inefficiencies and Benefits of Reducing Them

This second part of the research logically depends on the findings in the first part. But it has not had to await entirely the completion of the first part: some attempts at quantification methodologies are being developed in parallel with the primary research.

The object of the second part of the study is to quantify the impact of the inefficiencies identified in the first part. This appears never to have been successfully done hitherto in a comprehensive way: it is therefore ground-breaking work. There have probably been more efforts to tackle it in the US, given its importance for underpinning the arguments favouring a “Federal Charter”, than in the EU. However the EU Financial Services Action Plan, and particularly the economic rationale that has been developed for it, also offer some useful material.

Progress to Date

General Analysis of Inefficiencies

As has been said, this study is extensive, and progress has been slower than anticipated. It early became clear that inefficiencies in the EU and US markets could not be meaningfully examined without first analysing some key features of the two markets in terms of scale, the role of international business and (in the US case) dependence on foreign reinsurance providers. The role of regulation had also to be examined in even more detail than had been anticipated, with the evidence being interrogated in unexpected ways. For instance:

- While it used to be asserted that the US system of regulation was far more fragmented than that of the EU (fifty regulators as against fifteen) can the same contrast be drawn now that the EU itself has twenty-five regulators?

- Or is the contrast rather between the degree of progress in removing barriers to inter-state commerce in insurance under the McCarran-Ferguson system in the US and to insurance services between member-states within the EU Single Market system?

- If it is, does this reflect different internal dynamics, as between the two systems, for the removal of barriers?

Turning to the effects of the two regulatory systems in erecting barriers to external competition, certain questions have arisen. For instance:

- Do both systems contain elements of economic needs tests?

- Do the US rules for "surplus lines" (particularly as regards "declinature") amount to an economic needs test?

- How far do market conduct rules (under either system) represent a barrier to entry?

- What is the approach of either system to being "least-trade-restrictive" and/or "pro-competitive", as regards both "prudential" and non-prudential requirements?

As for the capacity of regulators in either system to enter into international negotiations, a further set of questions arises. For instance:

- Is there symmetry in the way that EU and US insurance regulators are represented for the purposes of international negotiations?

- If there is not, what are the differences?

- Taking the EU or US insurance regulators, is either more directly represented than the other in the WTO, IAIS, IMF, Financial Stability Forum or other bodies?

- Is either better equipped than the other to implement internationally agreed regulatory guidelines?

The answers to these questions have proved to be by no means straightforward. Given that they logically precede attempts at quantification of the effects of burdens on insurance business, or barriers to it, much of the task of quantification remains to be completed, and will not necessarily prove easy.

Quantification, with Particular Reference to "Credit for Reinsurance"

Related questions arise over the more detailed part of the study, relating to credit for reinsurance and collateralisation. For instance:

- What comparison can be made between the EU and US regimes for reinsurance, credit for reinsurance, and collateralisation (to the extent that collateralisation is required under both regimes)?
- What account should both regimes take of the need for insurance capital to be freely available world-wide?
- Do both regimes allow international/global considerations and desiderata to be taken into account, or do their internal dynamics make for differences in this regard?
- What approaches to quantification can be adopted?

Work so far suggests that it may be possible to produce imprecise quantification of the costs and inefficiencies associated with collateralisation, without undue difficulty, to the extent that these are expressed and ranked in broad orders of magnitude. But more precise evidence-based quantification of the more significant costs and major inefficiencies, and their cumulative economic effects, using an elaborate and sophisticated methodology, may prove much harder. And, as noted above, it may be counter-productive to resort to quantification relying on the use of excessively arbitrary imputed values open to dispute.

Next Steps

This is only a progress report. Observations and suggestions from PROGRES colleagues would be greatly welcomed. Contact details for this purpose are given below.

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