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The Geneva Association - General Secretariat - 53, route de Malagnou - CH-1208 Geneva
Tel.: +41-22-707 66 00 - Fax: +41-22-736 75 36 - secretariat@genevaassociation.org - www.genevaassociation.org

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Layout & Distribution: Valéria Kozakova & Bernadette Curty

EU-US INSURANCE/REINSURANCE MARKET INEFFICIENCIES

Study by John Cooke

Study Outline

Introductory

Current Context

This Study Outline updates and expands the Study Outline of November 2004, presented at the 20th PROGRES International Seminar (4-5 November 2004). It provides an outline of the Study's preliminary findings. As in 2004, it invites comments, now or in due course, from PROGRES colleagues.

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

As indicated at the last PROGRES meeting, the required research is potentially very extensive in nature; and has 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.

The second element ideally required the development of some kind of quantification methodology to be applied to the inefficiencies identified in the first element, preferably robust enough to allow the analysis to move from mere description and assertion to systematic and evidence-based demonstration of the extent to which certain practices (principally but not exclusively in the field of regulation) may create measurable market inefficiencies. In the event, it proved impossible to apply such a quantification methodology to all chosen regulatory practices: some are simply not amenable to quantification, while others are only quantifiable through the use of excessively arbitrary imputed values, open to dispute. As the study has moved forward, choices have had 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 has been conducted against the general background set out in the opening paragraphs of this paper. More specifically, the research has had 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 has taken 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 has had 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 examining the case for various types of “Federal Charter” for insurance regulation, notably in the FAME Report commissioned by the US Council of Insurance Agents and Brokers, and the Bair Report). In many areas however, deeper research has proved necessary, re-examining specific, chosen regulatory elements, particularly among 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) have offered 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) have also had to be examined.

Quantification of the Costs of Inefficiencies and Benefits of Reducing Them

This second part of the research has logically depended on the findings in the first. The object of the second part of the study has been to quantify the impact of the inefficiencies identified in the first. This appears never to have been successfully done hitherto in a comprehensive way: it has therefore proved to be largely ground-breaking work, which has been very difficult.

Progress to Date (I): General Analysis of Inefficiencies

It became clear, early on, 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 expected, with the evidence being interrogated in unexpected ways.

The study notes general points in common and points of difference between the EU and US systems. Some of these reflect their different origins: the EU system springs from a consciously agreed programme of liberalisation and structured convergence, while the US system is to a great extent the result of different tensions (federal and state) underlying its historical development.

These different origins have produced some significantly different effects. First, the EU system is, to a significant extent, a system of mandatory mutual recognition of insurance supervisory authorities within the EU, at least as regards prudential supervision (regulation of market conduct remaining with EU member-states): this is reflected in the EU “passporting” system, under which an insurer, once authorised in one member-state, may “passport” into others. By contrast, the US system does not require mutual recognition among state Insurance Commissioners, some of whom do not recognise each other’s regulatory decisions. Secondly, the EU system has evolved, relatively recently, into a system based on commonly-applicable legislation focusing largely on prudential supervision of insurer soundness, without regard to product-control or price-control. By contrast, the US system still relies quite significantly on price- and product-control (reflected in the rating and filing systems operated by Insurance Commissioners) originating in pressures on state governments to ensure the availability and affordability of certain lines while responding vigorously to fraud.

(1) Fragmentation of Regulation and Removal of Internal Barriers

The interim report to PROGRES in November 2004 posed three opening general questions:

- 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 and will, after further enlargements, have closer to thirty-five or forty?
- 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?

The study offers a tentative answer. The EU and US regulatory systems share some common features. Both are regulatory systems involving dispersed supervisory authorities (twenty-five in the case of the EU; [fifty] in the case of the US) operating under a degree of co-ordination (EU legislation, in the EU; NAIC model laws in the US). Both cover large markets, in terms of both population (EU: some 422 million; US: some 310 million) and GDP (some \$9 trillion each in 2002). Both address - in different ways, and albeit for different reasons - the problems of geographical dispersal. Both face questions of convergence in financial services markets, and corresponding demands for regulatory convergence. Both impose considerable compliance burdens on insurers operating in more than one state, whether of the EU or the US, because of lack of harmonisation over the entirety of host-state requirements.

The study suggests that fragmentation of regulation need not be, in itself, of crucial importance. But it is important for there to be a clear policy reason for fragmentation (e.g. nearness to the market, within the EU), combined with a clearly understood policy objective for reducing barriers between regulatory jurisdictions, and a means for achieving that objective. In the cases of the EU and the US, both suffer imperfections and intra-market barriers resulting from regulatory fragmentation. But there a different dynamics for removing these barriers: in the case of the EU there is a treaty-based momentum towards doing so, with the Commission, as executive authority, exerting continuing pressure towards the creation of a Single Market. In the case of the US, the dynamics appear more diffused, and evidently spring from a different history, including a long period when insurance was not regarded as inter-state commerce.

(2) Barriers to External Competition

Turning to the effects of the two regulatory systems in erecting barriers to external competition, the interim report to PROGRES in November 2004 posed some further questions:

- 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?

Again, the study offers a tentative answer. It suggests that the EU (where the Commission is responsible both for the drive towards a Single Market and for the EC's Common Commercial Policy) probably benefits from a clearer policy stance favouring open insurance markets than does the US (where state Insurance Commissioners are less clearly oriented towards a single US insurance market and have no direct responsibility for the market's external profile). In areas such as surplus lines, the US system appears to have been originally based on a state-by-state economic needs test, elements of which remain, even though systematised: likewise, there are other US interstate requirements (citizenship, residency, restrictions on intermediaries' licences, "seasoning" and "retaliatory laws") which have external effects on market access and national treatment. In market conduct matters, however, both the EU and the US display a wide mix of varying host-state rules which are a potential barrier to entry, at least in terms of their complexity.

(3) The External Championship Role

The interim report to PROGRES in November 2004 posed some further questions on the capacity of regulators in either system to enter into international negotiations. 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. It had been expected, given the treaty-based structure of the EU, with its division of responsibility between member-states and EU institutions (developed by ECJ case-law) that the EU might have a more coherent system of representation, and be better equipped to implement international obligations. But there are complexities in the international profile of either system. Both - for different reasons - have certain problems ("competence" in the EU; and the disjunction between federal and sub-federal systems in the US) over representation in international discussions on insurance regulation, whether at the intergovernmental level or in non-governmental fora.

Taking financial services as a whole, however, it can be hazarded that the US has a more prominent external championship role than the EU in international discussions among regulators. The US federal government has a seat in the Basel Committee, unlike the Commission and most EU member-states. The US has corresponding influence in other international bodies (the Financial Stability Forum (FSF), the G8 Finance Ministers, and others), the International Organisation of Securities Commissions (IOSCO) and the Basel Committee (all of which are represented on the FSF), to which the Commission, and most EU member-states, do not belong.

Progress to Date (II): Quantification, with Particular Reference to "Credit for Reinsurance"

The interim report to PROGRES in November 2004 posed some related questions 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?

Again, the study suggests some tentative answers. It contrasts developments in the EU reinsurance regime (where the Reinsurance Directive will bring to an end collateralisation in the two EU member-states in which it operates) with the widespread nature of collateralisation in the US system, and the range of arguments advanced for its continuation. It suggests that the EU and US regimes are not alike in the extent to which they allow international/global considerations and desiderata to be taken into account, and that their internal dynamics make for differences in this regard.

The study has borne out the suggestion in the Interim Report that imprecise quantification of the costs and inefficiencies associated with collateralisation can be offered 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, is much harder. Nonetheless, the study offers some quantitative approaches, including a time-line illustration of the effects of collateralisation in securing a preferred position for US cedents in the unlikely event of a reinsurer insolvency; the costs of collateralisation in terms of reinsurers' investment income reduced or foregone over selected periods; and the likely money costs of collateralisation and its administration.

Using these quantitative approaches, the study suggests some general conclusions as worthy of further study and elaboration. There are clearly certain direct costs for reinsurers arising from the collateralisation requirements that form part of the US "credit for reinsurance" regime. Even though these direct costs may, in themselves, be relatively low in relation to volumes of business transacted, they are cumbersome, inconvenient, discriminatory and a barrier to business. They also appear disproportionate, as a prudential remedy, to the low risk (a reinsurer-driven insurance insolvency) that they are designed to counter. More damaging, the study suggests, may be the systemic effects of collateralisation requirements for the global market, when imposed in the largest insurance market in the world, with a pervading influence on the world reinsurance market. In essence, these represent a series of gearing effects, creating distortions, both within and outside the US market. These distortions may adversely affect, in interconnecting ways, competition, free capital flow, and reinsurers' investment freedom. They may also contribute to enhanced reinsurance premiums, enhanced volatility, enhanced cost of capital, and reductions in profitability and the scope for growth in reinsurance worldwide.

Given the size and influence of the market where they originate, the study hazards that these effects have damaging consequences in all markets. But there is also a possibility that they may be most deleterious for those countries with poor risks, under-developed insurance industries and unsophisticated underwriting skills - i.e. emerging markets, for which the world's residual reinsurance markets, operating cross-border, are important. Emerging markets do not have the same access to other risk-sharing options (such as securitisation, currently representing some five percent of the risk-sharing market) as developed markets (in practice they have no access at all). They therefore depend on the development of traditional insurance in their own markets, backed by traditional reinsurance; and there is evidence that they account for a disproportionately high share of reinsurance demand (22%, as against their 14% share of the world direct insurance market, in 1998), mainly as a result of a much smaller capital base and a higher weighting

of industrial and commercial risks. Given that the world insurance and reinsurance market is cyclical, raising the cost of reinsurance, however marginally, could amplify the effect of the insurance cycle in a way that may bear down most heavily on emerging markets. It is on these markets that the burden of increased volatility and higher insurance and reinsurance costs is most likely to fall.

Next Steps

As before, this is only an indicative progress report, not least because, as expected, the study has identified a number of areas as needing further careful elaboration and substantiation. Observations and suggestions from PROGRES colleagues would be greatly welcomed. Contact details for this purpose are given below.

JOHN COOKE

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J A COOKE
29 The Avenue, Kew, Richmond, Surrey TW9 2AL, UK
Tel: +44 20 8940 6712 Fax +44 20 8332 7447
e-mail: cooke.ja@virgin.net