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Beckmann, Rainer and Eppendorfer, Carsten and Neimke, Markus

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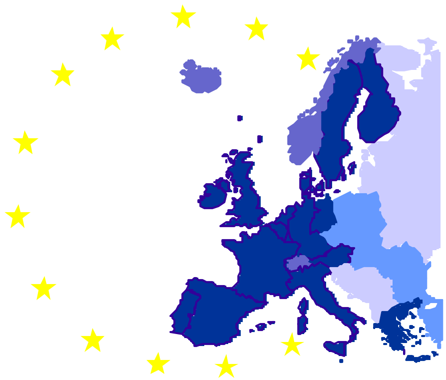

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Anschrift der Autoren:

Rainer Beckmann
Lehrstuhl für Theoretische Volkswirtschaftslehre I
GC 3/147
Tel.: 0049-(0)234/32-22776
email: rainer.beckmann@ruhr-uni-bochum.de

Carsten Eppendorfer
Lehrstuhl für Internationale Wirtschaftsbeziehungen
GC 3/142
Tel.: 0049-(0)234/32-22899
email: carsten.eppendorfer@ruhr-uni-bochum.de

Markus Neimke
Lehrstuhl für Internationale Wirtschaftsbeziehungen
GC 3/143
Tel.: 0049-(0)234/32-22898
email: markus.neimke@ruhr-uni-bochum.de

Ruhr-Universität Bochum
Fakultät für Wirtschaftswissenschaft
Universitätsstraße 150
D- 44780 Bochum

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Ruhr-Universität Bochum
Universitätsstraße 150
Gebäude GC 3/150
D-44780 Bochum

Telefon: (0234)/32-28888
Telefax: (0234)/32-14258

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Financial integration within the European Union: Towards a single market for insurance*

*Rainer Beckmann, Carsten Eppendorfer and Markus Neimke***

Ruhr-University Bochum

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Abstract: Our study analyses the extent of integration of the EU market for life and non-life insurance. The main integration indicator used is the market share (premium based) of foreign companies in domestic markets. For the calculation of this indicator, three different kinds of foreign presence are taken into account: foreign presence through merger and acquisitions, through branches and agencies and direct cross-border sales without physical presence. Whereas the static view reveals a high degree of national fragmentation the dynamic view indicates advancing integration. The results also show that integration is even less advanced for life than for non-life insurance and that mergers and acquisitions are the dominant strategy to access a foreign market. Besides summarising the liberalisation history of the European insurance sector and discussing consumer benefits from further integration, the study contributes to a better understanding of obstacles to insurance market integration.

JEL-Classification: G22, G34, K23

Keywords: European Union, financial services, insurance, internal market, taxation

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"Evidence of a growth in cross-border trade in insurance is mixed - possibly due to an acute scarcity of data." (OECD, Financial Market Trends No. 75, 2000)

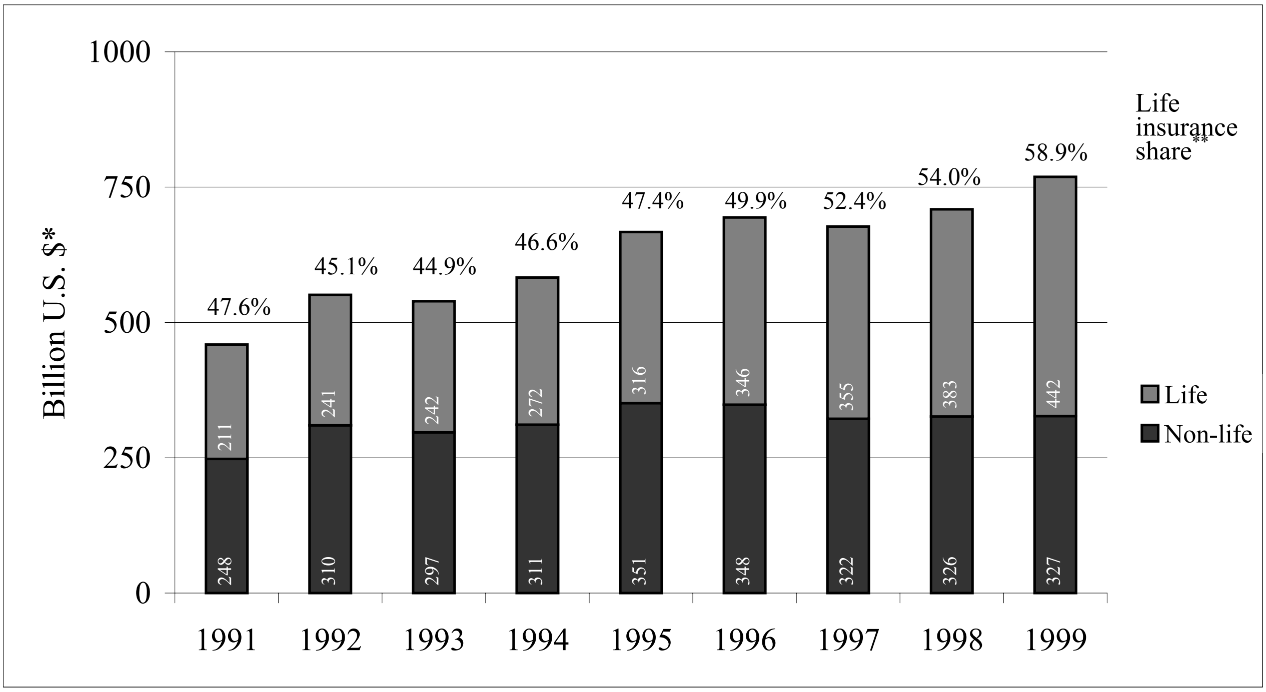
1. Introduction

There is overwhelming agreement among market observers that the European insurance industry has made a ground-breaking step towards a single insurance market by the implementation of the Life and Non-Life Third Insurance Directives on 1 July 1994. Among the EU countries since then legal barriers to cross-border insurance business have been minimised.

Conducting insurance business in a unified European market offers advantages to both market sides compared to a situation of national fragmentation. Suppliers benefit from improved regional diversification of insured risks, the realisation of economies of scale and a wider area for investing assets. Consumers benefit from a larger choice among insurance companies and products and a higher degree of competition. Provided that antitrust policy is effectively safeguarding a competitive situation policyholders should therefore get a better ratio of “insurance value for premium”.

But also the EU economy as a whole should benefit from insurance market integration given the increasing weight of insurance services for growth and employment. Some data in figure 1 point to this increasing weight.

Figure 1: EU-15 life and non-life premiums and life insurance share 1991-1999



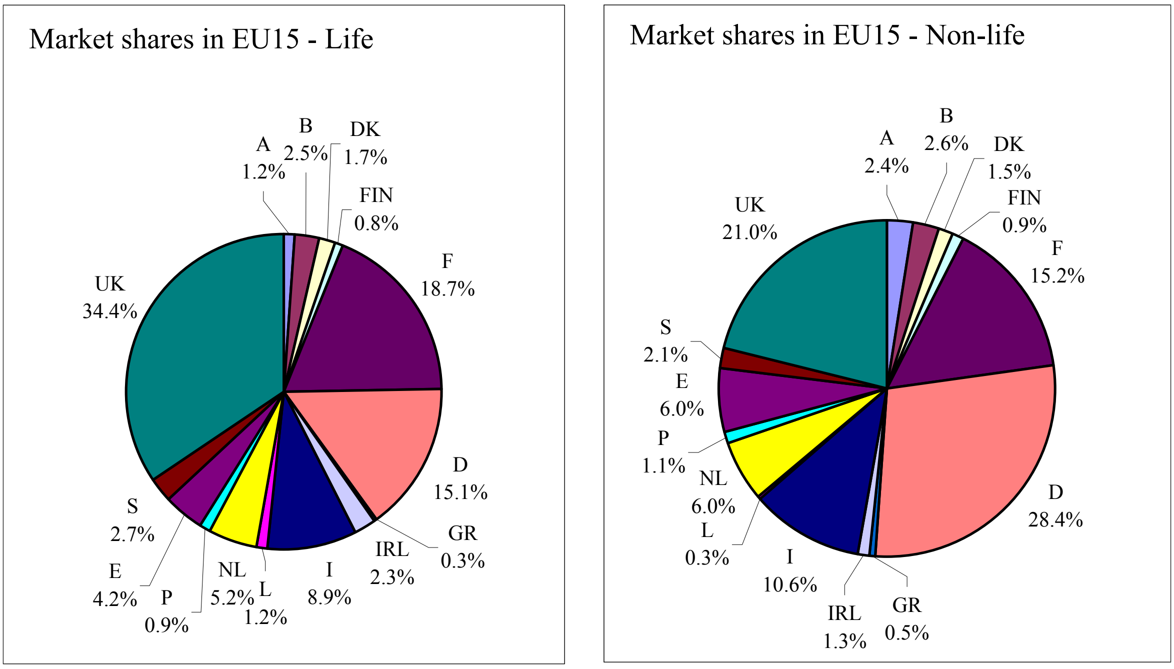
Source: OECD Insurance Statistics Yearbook (2001) and own calculations, *converted from national currencies into US dollar (average exchange rates for the reference year); ** Life insurance share is defined as the share of life insurance premiums with respect to the whole insurance market premiums.

Taken together, life and non-life business in the EU-15 countries account for a total premium income - serving as the major indicator - of 769.2 billion US $ in 1999 indicating a 8.2%

share of EU-15 GDP. In 1990 this share amounted to merely 5.8%.[1] This enormous increase has been unevenly distributed among life and non-life business. While the share of non-life premiums to GDP increased from 3.0% to 3.2% the correspondent life insurance share underwent a boom almost doubling the share from 2.8% in 1990 to 5.0%. Consequently, the share of life insurance with respect to the whole insurance market (life insurance share) surpassed 50% for the first time in 1997 resulting in 59.0% in 1999. Non-life business has been almost stagnant partly due to the massive competition in a saturated market while life volumes benefited mainly from their increasingly important role in private pension schemes.[2]

Further general information on the EU-15 insurance market is given in figure 2 in terms of national market shares for the life and non-life market segments.

Figure 2: EU-15 insurance market shares in 1999



Source: OECD Insurance Statistics Yearbook (2001), own calculations.

However, these data on market size and structure do not provide much insight into the degree of market integration. More than seven years after the Third Insurance Directive and three years after the introduction of the Euro the reality of European insurance is still far away from representing a highly integrated market. The cases that consumers from EU countries shop around and chose the best insurance contracts based on a pan-European comparison still are extremely rare. Volumes of direct cross-border business is still low – even in the internet age. While integration is undoubtedly high on reinsurance markets and the market for industrial risks, the same does not hold for retail insurance markets. With this background this study

[1] Most figures that are comparable between countries are on a US $ basis since the main data pool, OECD's Insurance Statistics Yearbook, employs this standardisation, too. Furthermore, life and non-life business is categorised in accordance with normal EU and OECD conventions; that means accident and health insurance are classified as non-life business.

[2] See Swiss Re (2000c).

tries to contribute to a better understanding of the present degree of and the remaining obstacles to integration.

After reporting on main provisions of the EU regulatory framework for cross-border business (section 2) the second step of the analysis places emphasis on openness as a possible indicator for measuring integration (section 3). It is shown that M&A activity has indeed led to stronger cross-border ties in the insurance sector judging from foreign controlled market shares. In contrast to that, business through office branches and direct cross-border insurance business is still marginal, though not declining. In a third step (section 4) those policy induced and natural obstacles are discussed that are particularly relevant for the European insurance market. Here, taxation and regulation issues on the supply side and consumer confidence on the demand side are at a prominent place. Section 5 concludes and briefly refers to possible effects of e-commerce on insurance market integration.

2. Building up the Internal Market for insurance

In general, the single market for financial services is founded on the fulfilment of the three indispensable basic freedoms provided by the Treaty of Rome (1957): the freedom of establishment, the free movement of goods and services and the free movement of capital. With respect to insurance, three generations of insurance directives have been issued between 1973 and 1992 (figure 3) to enforce these principles.[3,4]

In the first stage (1973-79) the freedom of establishment was realised. Insurance companies were allowed to open up subsidiaries, branch offices or agencies in every EU Member State. Though, the national authority of the host country was held responsible for prudential supervision (host country control).[5] During the second stage (1983-90) the freedom of services was set up. Since then it was possible to do insurance business without having a fixed branch or subsidiary. The host country control, however, was abolished only for certain industrial risks (e.g. industrial fire) while for private business most EU member nations made use of their option to leave the host country control unchanged; exceptions to this rule were the Netherlands and the United Kingdom. One benevolent explanation for this may be found in the authorities attempt to maximise the protection of the private policyholder. But also protectionist motivations most likely played a role for sticking to host country control. This regulatory regime left the domestic insurance industry being in the more comfortable situation not to operate in a contestable international market environment.

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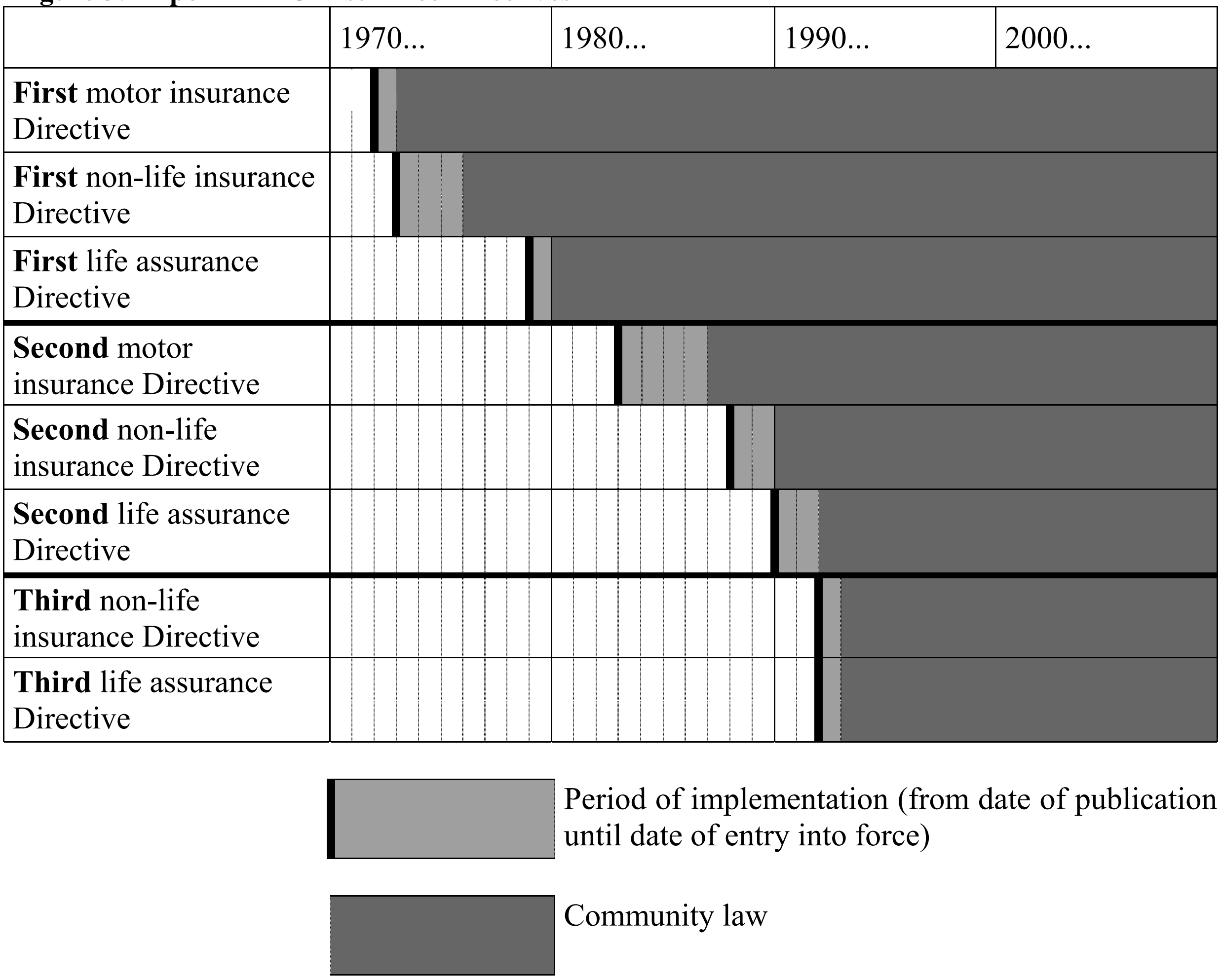
[3] In this study no special focus is being laid on the reinsurance business that already has been liberalised in 1964, including the freedom of services principle. Like MAT insurance (Marine, Aviation and Transport) this segment is in general a widely internationalised business.

[4] See Swiss Re (1996) and Swiss Re (2000a).

[5] According to a market participant that answered our questionnaire (see box on page 19) the seventies marked the first of three phases by the setting up of branches.

Figure 3: Important EU Insurance Directives



The third generation of insurance directives (1992) was thought to unfold the desired quantum leap for wholly liberalising the retail business, too. It consisted of the subsequent key elements:

- abolition of price and product regulations,
- restriction of host country supervision to solvency control,[6]
- establishment of the principle of minimum harmonisation,
- introduction of a single EU licence (+ mutual recognition) and
- home country control for all insurance classes.

The most important step was the establishment of the home country control principle since market observers held the opinion that foreign suppliers were reluctant to establish a branch office under the control of the host country. Since then, companies only need a licence from their home country supervisory authority to conduct insurance business all over the EU, either under the rule of freedom of establishment or under the rule of freedom to provide services. However, the business of subsidiaries remains regulated by the host country. Additionally, the

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[6] The first two elements apply only to those countries where such systems still existed, e.g. Germany and Italy.

competent home authority of their head office country has to be notified of their intended business scheme. Documents indicating the member country in which the branch is to be established, the name and address of the agent or branch and a scheme of operations have to be submitted. With respect to the provisions on the freedom of services it is simply required that the competent home authority is being informed about the member country in which they intend to carry on business and about the risks they intend to cover. The respective home country authorities pay attention to the exchange of information between the supervisory authorities.

These efforts for liberalisation and deregulation led market observers to expect a strengthening of European cross-border competition and market consolidation. Yet, the ideal of a single insurance market by far has not been achieved during the time thereafter. Insurance enterprises now have to cope with both newly emerged and well known obstacles. Many uncertainties have arisen from the exact scope of the freedom to provide services and from the extent to which the *general good* principle can be invoked by national authorities. The latter principle has been developed by case law. It enables national authorities even now to set individual national rules that possibly deny market access to foreign companies if certain public interests are claimed to be violated. This claim can be based on consumer protection, prevention of fraud or worker protection, for example. The Commissions' communication on "Freedom to Provide Services and the General Good in the Insurance Sector" - announced to be published in 1997, but indeed issued only three years later – should clarify its view of the freedom to provide services and the general good principle. However, since the general good principle is being evolved by case law legal doubts persist and hinder insurance companies to approach foreign EU markets without frictions.[7]

3. An evaluation of the present degree of integration

3.1 Method and data

Two main problems arise in the assessment of the degree of EU insurance market integration. First, very different indicators are conceivable and partly may lead to contradicting results. Second, the data base is small and incomplete and does not allow to draw a detailed picture of cross-border activities in the EU insurance industry.

Important indicators to assess market integration are:

(a) The degree of openness based on an import view and measured as the foreign companies market share in the domestic market, i.e. premiums written in the home country by host insurers.

(b) The magnitude of the home country bias in the asset structure of insurance companies.

(c) The convergence of product prices, product types and market indicators (i.e. life insurance shares, premiums/GDP, companies' efficiency and concentration).

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[7] A more detailed overview about relevant obstacles is given in section 4.

(d) The size of the reinsurance share: a higher share indicates lower integration (i.e. the small diversification of insured risks results in a stronger shifting of risks to reinsurers).

The convergence in the design and the pricing of insurance products would best qualify to derive implications for the final customer. Unfortunately, these figures are not available. This analysis rather focuses on the first indicator, the openness of EU/EEA countries. If prudently considered the level and the dynamics of the degree of openness provide a measure for the contestability of a national market: The higher the share of foreign companies acting on a national market the better is the choice of products and companies for the final consumer.

For both the life and non-life sector market shares of foreign companies in total domestic business are described. Three basic categories are applied for foreign companies holding shares in the domestic market:

- market shares of foreign controlled undertakings,
- market shares of branches and agencies of foreign undertakings, and
- market shares of direct cross-border insurance business without a permanent physical presence.

Unfortunately, these data are only partly available. If possible, the foreign companies market share is subdivided in EU/EEA and non EU/EEA participation.[8] We forego analysing strategic alliances and co-operations as yet another type of penetrating a foreign market since quantifying this issue is hardly possible.

The main data source is the OECD Insurance Statistics Yearbook 2001 that contains data for the period 1992-1999. This yearly updated OECD publication is an extensive pool of insurance data covering major market indicators, obtained from the governments of the OECD members. A significant effort has been made to achieve comparability among OECD countries; definitions, classifications, calculation methods and units have been standardised as far as possible.[9] The OECD data set is partly augmented by information of national and European insurance federations and by research data of Swiss Re.

Some caveats have to be taken into consideration. First, concerning the dynamics of integration an increase in cross-border operations may also be an indicator of heterogeneous tax, regulatory and supervisory structures. For example, motivated by tax avoidance strategies, insurers set up business in “tax havens” like Ireland or Luxembourg. Second, with regard to cross-section comparisons, small countries ceteris paribus possess a higher degree of openness if activities are related to their size. This objection is mitigated by executing the relevant scatter plots. Third, if assessments are made with respect to the impact of the EU Third Insurance Directives one has to take into account that certain markets like UK, Netherlands, Ireland and France already prior to 1994 have been subject to a less regulated

[8] Some analysis includes Norway as an EEA country since the same EU rules for insurance business are applied in EEA countries.

[9] For further methodological information, see OECD (2001a, pp. 255ff.)

market.[10]

3.2 Non-life insurance

The structure of the analysis corresponds to the main options available for entering a foreign market: 1. merger & acquisitions and 2. establishment of branches and agencies. In a third step the combined shares of 1. and 2. are computed and analysed adding further information to the degree of openness.

Foreign controlled companies

As a starting point (OECD, 2001a, p. 42f) data on market shares of foreign companies in the markets of OECD member countries is employed. Yet, the raw data have to be treated with caution due to a structural break. As a consequence of the regulatory changes introduced through the Third Insurance Directives, since 1995 data of EU/EEA countries do not include data on branches and agencies of foreign companies whose head offices are situated in other EU/EEA countries. Therefore, table 1 presents corrected data of the pure market share of foreign controlled undertakings in total domestic business.[11] For reasons of data availability and comparability we compute only a sample of nine EU/EEA countries. Thereby in 1999 still 67% of the overall EU/EEA market in non-life insurance are covered.

At first sight a very heterogeneous picture emerges. Market shares of foreign controlled companies differ widely both in the cross-section but also with respect to national trends. While Portugal, for instance, shows an almost continuous rise starting from the lowest level of 5.1% in 1993 to 26.7% in 1999, Austria displays a very high but constant share of about 49%. Foreign companies in Spain and Luxembourg in contrast even lost ground. Also regarding the differentiation between big and small countries no clear-cut picture arises. In Germany the presupposed small share for a big country applies whereas in the UK as yet another big country the share of foreign controlled companies in 1999 was more than 20 percentage points higher than in Germany; this could be due to the fact that in the U.K. already prior to 1994 regulation has not been so intense. Also the Netherlands and Luxembourg both representing small countries differ by 20 percentage points with the latter showing a relative small share of 13.9%.

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[10] See Swiss Re (1996).

[11] The definition of foreign controlled companies is specific to the countries individual arrangements. Though, most countries apply the standard measure: „foreign majority interests over 50 per cent“. For exact definitions and further notes by country, see OECD Insurance Statistics Yearbook, 2001, pp. 259ff.

Table 1: Non-life insurance, foreign controlled companies in total domestic business (gross premium basis) in %

Host Country	1993	1994	1995	1996	1997	1998	1999
Austria	47.9	49.1	47.4	49.2	49	50.7	48.7
Denmark	30.5	18.7	30.4	29.1	26.9	28.4	42
Germany	14.1	6.3	6.2	12.4	12	11.5	12.9
Luxembourg	N.A.[2]	N.A.	N.A.	20.3	16.8	13.2	13.9
Netherlands	20.1	18.4	19.2	18.4	34.1	34.3	33.7
Norway	15.2	N.A.	N.A.	17.5	18.2	20.1	18.3
Portugal	5.1	5.5	14.7	14.2	14.3	25.7	26.7
Spain	35	25.4	29.3	26.1	23.9	26.6	25.1
Utd. Kingdom	N.A.	N.A.	N.A.	N.A.	29.9	29	34.5
Average share[1]	19.6	12.9	13.6	17.4	22.2	22.3	24.7

Source: OECD Insurance Statistics Yearbook (2001), own calculations by subtracting the numbers of OECD's table IX.2.2 from the numbers of table IX.2.1. [1]weighted by the resp. market share. [2]N.A.=Not Available

Despite these ambiguous view of each singular country it can clearly be stated that on average the involvement of insurance companies from abroad has risen noticeably from 19.6% in 1993 to 24.7% in 1999. The slump to 12.9% in 1994 - mainly explained by the high weight of Germany where the share declined sharply to 6.3% - does not invalidate this conclusion. These increasing foreign linkages in the European insurance industry result from the merger & acquisition dynamics of the nineties. The rise in cross-border mergers is rather a bit surprising since M&A activities predominantly have been executed on a national scale.[12] Although the OECD data basis does not make a distinction between "European" and "non-European" market shares one has to assume that most part of that shares indeed are domiciled in the EU/EEA.

EU/EEA branches and agencies

The second step of the analysis broadens the picture of foreign companies market share. Import data of European cross-border activities on a branches and agencies basis is calculated. Since the OECD was aware of cross-border data shortcomings they installed a Working Group that together with Eurostat tries to improve the data base (OECD, 2001a, p. 259). As a result of this work, since 1997 the OECD provides numbers for direct gross premiums earned by EU/EEA insurers through branches and agencies abroad. An import-export matrix measured in the respective local currencies of each exporting home country is presented by the OECD for the life and the non-life business. This matrix, though, has to be standardised on a US $ basis in order to extract import values and import quotas. Table 2 displays the resulting absolute values and shares of non-life premiums that have been written by EU/EEA insurers through branches and agencies in 16 EU/EEA countries for 1997–99.

[12] This point all the more applies to the banking industry where cross-border mergers so far are more seldom. See Group of Ten (2001) and Eppendorfer, Beckmann and Neimke (2002).

Table 2: Non-life insurance, business written through foreign EU/EEA branches/agencies in EU/EEA countries

Host Country	1997 $ value of imports (million)	1997 import share[1]	1998 $ value of imports (million)	1998 import share[1]	1999 $ value of imports (million)	1999 import share[1]
Austria	47.61	0.56	51.78	0.63	49.07	0.61
Belgium	208.74	2.74	180.45	2.39	186.52	2.46
Denmark	101.63	2.14	142.29	2.68	295.75	5.88
Finland	7.90	0.32	10.07	0.38	14.37	0.56
France	452.17	0.94	551.41	1.14	537.80	1.13
Germany	295.01	0.3	318.31	0.29	293.87	0.27
Greece	37.17	5.38	42.92	3.81	50.45	4.11
Ireland	56.59	1.75	68.56	1.88	76.21	1.76
Italy	228.54	0.8	284.38	0.94	315.86	1.02
Luxembourg[2]	29.31	6.33	56.11	7.44	63.92	8.43
Netherlands	205.29	1.39	185.01	1.15	193.61	9.6
Norway	56.48	1.54	52.08	1.41	857.16	21.95
Portugal	141.93	5.15	118.53	3.96	106.74	3.52
Spain	318.61	2.07	268.90	1.68	183.86	1.08
Sweden	83.86	1.37	95.86	1.7	102.39	1.52
Utd. Kingdom	1569.15	2.44	1360.73	2.01	1400.45	2.09
Total EU15/EEA	3839.98	1.18[3]	3787.40 (-1.4%)[4]	1.15[3]	4728.04 (+24.8%)[4]	1.43[3]

Source: OECD Insurance Statistics Yearbook (2001), own calculations. [1]Import share is measured in % as the computed absolute $ value of imports to total gross non-life premiums written in the respective countries. [2]Exports of Luxembourg are not available. [3]Ratio of total EU15/EEA import value to total EU15/EEA premiums written. [4]Year-on-year growth rate.

Again, cross-country patterns are not homogeneous ranging in 1998, for example, from 0.29% in Germany to 7.44% in Luxembourg. The shares of business written through foreign EU/EEA branches and agencies tend to be higher in smaller countries like Denmark, Greece, Luxembourg, Portugal. On the whole, it stands out that on average (see the last row of table 2) only a small share of slightly above 1% of total EU/EEA non-life insurance business is conducted by foreign EU/EEA branches and agencies. Comparing table 1 and table 2, as a first result it emerges that the strategy of foreign companies to overtake domestic companies or to acquire majority stakes is obviously dominant in spite of the relaxation of host country control. Table 2 as well indicates, however, that the share of branches and agencies grows, too. Contrary to the generally stagnant non-life market (figure 1) the business through EU/EEA branches and agencies increase by 12% per year on average (1997-1999).

Total foreign presence

The third step regards total foreign presence. For that purpose, the sum of three components is calculated: the market shares of foreign controlled companies, EU/EEA branches and agencies and non-EU/EEA branches and agencies. Results for 1997 and 1999 are presented in table 3.

Table 3: Non-life insurance, overview of total foreign presence (in % of total domestic business)

Host Country	1997				1999			
	Foreign contr.	Branches and Agencies		Sum of columns 2-4	Foreign contr.	Branches and Agencies		Sum of columns 6-8
		EU/ EEA	Non-EU/ EEA			EU/ EEA	Non-EU/ EEA	
Austria	48.99	0.56	5.00	54.55	48.67	0.61	6.41	55.69
Denmark	26.91	2.14	1.73	30.78	41.99	5.88	1.62	49.49
Germany	12.04	0.3	0.66	13	12.93	0.27	0.67	13.87
Luxembourg	16.8	6.33	14.94	38.07	13.93	8.43	10.01	32.37
Netherlands	34.13	1.39	2.50	38.02	33.69	9.6	2.12	45.41
Norway	18.18	1.54	2.84	22.56	18.25	21.95	2.82	43.02
Portugal	14.29	5.15	0.74	20.18	26.66	3.52	0.05	30.23
Spain	23.91	2.07	3.38	29.36	25.12	1.08	0.06	26.26
Utd. Kingdom	29.94	2.44	7.40	39.78	34.52	2.09	9.93	46.54
Avrg. share[1]	22.18	1.35	3.36	26.88	24.74	2.41	3.90	31.04

Source: OECD Insurance Statistics Yearbook, 2001, own calculations. [1]weighted by the resp. market shares.

The numbers in the fourth and eighth column of table 3 show market shares of branches/agencies of non-EU/EEA undertakings in domestic business that have not been mentioned above. They add information on international openness in general.

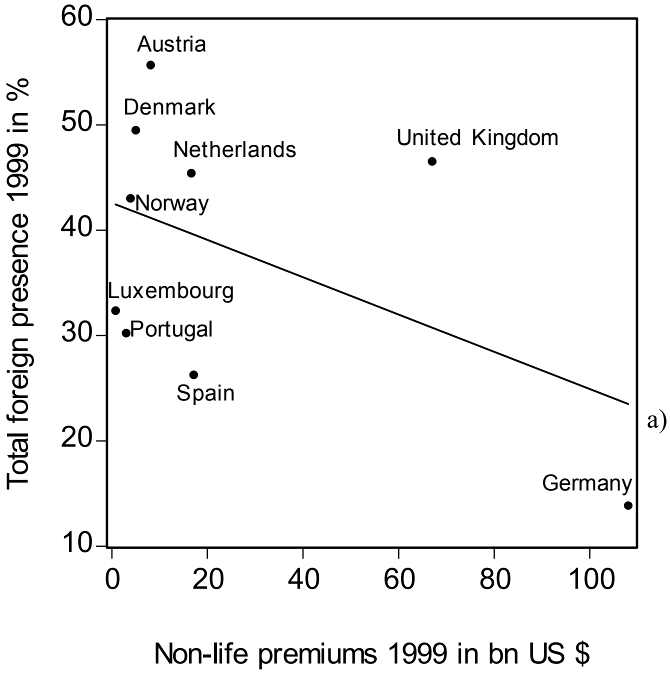
In contrast to the pure growth figures of the non-life sector (figure 1) it should be stressed that in no way a stagnancy with respect to integration dynamics is reported. Judging on basis of country averages (last row of table 3) foreign companies market share climbed from 26,9% in 1997 to 31% in 1999. This relatively high share has to be interpreted even as a lower limit since OECD data do not contain direct cross-border transactions without having a physical presence. Through other sources it is reported, though, that direct cross-border business remains marginal representing a 1.9% share of non-life business in 1999.[13]

To complete the descriptive analysis of non-life insurance in the EU/EEA area it is shown in figure 4 that countries coming up with a greater market size - measured in premiums written - tend to be less open to foreign companies. Beyond this expected finding it is interesting to observe that countries like the Netherlands or UK that already prior to the 1992 Third Insurance Directives abstained from controlling insurance policy terms, premiums and tariffs illustrate a relatively higher degree of openness. On the other hand, Germany representing a country with formerly strong control with respect to the so-called material supervision has a rather low share of foreign companies acting within its borders even though considering its size.[14]

[13] See Swiss Re (2000c).

[14] See Vollbrecht (2001) for details concerning the differing history of supervision in EU countries.

Figure 4: Scatter plot of market size vs. total foreign presence (non-life)



Source: OECD (2001a), own calculations; a) computed linear regression line.

3.3 Life insurance

Turning to the prospering European life insurance industry the analysis (tables 4-6) runs analogously to that presented above for the non-life sector.

Foreign controlled companies

Also for life insurance there is no uniform pattern across the 9 EU/EEA countries referred to. While Spain, Portugal and Austria point to a decline of foreign controlled companies in total domestic business the Netherlands, Denmark, UK and Germany move towards the opposite direction. Furthermore, massive particular shifts are remarkable: The share of foreign controlled companies increases for example in Denmark from 5.9% in 1998 to 17.6% in 1999 while decreasing in Portugal from 23.5% in 1994 to 9.9% in 1995. It is reasonable, though, not to place too much emphasis on the partially volatile national figures since they can easily be provoked by singular merger & acquisition transactions and thus partly offsetting each other. To get an overall EU picture rather the average (last row of table 4) should be taken into consideration. While in 1993 11.7% of total gross life insurance premiums - for data available - have been written by foreign controlled insurance companies this share decidedly increased to 20.8% in 1999.

Table 4: Life insurance, foreign controlled companies in total domestic business (gross premium basis) in %

Host Country	1993	1994	1995	1996	1997	1998	1999
Austria	33.3	37.44	34.62	34.36	35.03	32.49	30.28
Denmark	5.95	7.99	6.96	7.00	6.48	5.92	17.61
Germany	8.33	7.15	7.05	6.38	6.48	5.5	15.07
Luxembourg	N.A.[2]	N.A.	N.A.	89.42	80.14	80.38	63.14
Netherlands	16.34	16.68	16.58	15.27	29.09	30.04	27.31
Norway	1.77	N.A.	2.48	2.78	2.81	3.43	3.55
Portugal	15.87	23.46	9.93	10.18	10.83	12.99	10.37
Spain	21.62	12.32	23.02	17.62	16.78	27.78	15.00
Utd. Kingdom	N.A.	N.A.	N.A.	18.44	17.43	21.5	22.01
Average share[1]	11.7	10.8	11.4	14.0	16.4	19.1	20.8

Source: OECD Insurance Statistics Yearbook (2001), own calculations. [1]weighted by the resp. market share; in 1999 64% of the EU/EEA market is covered. [2]N.A.=Not Available

If life and non-life figures are compared similarities as well as important differences are striking. Interestingly, for an individual country e.g. Portugal, the change in the life segment did not appear related to the change in the non-life segment. With respect to non-life insurance the share of foreign controlled companies in Portugal rises gradually (table 1) but in the life insurance sector it shrinks on average. If instead the focus is on the group as a whole the direction and the speed of foreign companies participation in domestic EU/EEA countries on average is similar to the non-life sector. The major difference is that it runs on a significantly lower level.

EU/EEA branches and agencies

An important distinction has to be made with respect to the life insurance business that is written through EU/EEA branches and agencies (tables 5 and 2). On average only 0.18% (1997) resp. 0.22% (1999) of total premiums are written through EU/EEA branches and agencies. This means less than the sixth part compared to the non-life sector (1.18% in 1997 vs. 1.43% in 1999. see table 2). Significant shares of business through established entities only come about in Luxembourg (2.51%). Portugal (3.16) and Sweden (3.8%) for the year 1999.

Table 5: Life insurance. business written through foreign EU/EEA branches/agencies in EU/EEA countries

Host country	1997 $ value of imports (million)	1997 import share[1]	1998 $ value of imports (million)	1998 import share[1]	1999 $ value of imports (million)	1999 import share[1]
Austria	4.62	0.11	8.76	0.19	35.46	0.69
Belgium	0.51	0.01	0	0.00	1.14	0.01
Denmark	0	0.00	6.26	0.82	9.27	0.13
Finland	0.15	0.01	0	0.00	15.14	0.45
France	2.37	0.003	26.74	0.04	31.78	0.04
Germany	57.95	0.09	9.07	0.02	49.91	0.07
Greece	3.11	0.04	3.31	0.23	0	0.00
Ireland	0.03	0.001	1.54	0.02	1.35	0.01
Italy	48.89	0.21	57.54	0.18	2.43	0.01
Luxembourg[2]	20.49	0.47	25.74	0.54	127.61	2.51
Netherlands	1.37	0.01	7.68	0.04	20.25	0.09
Norway	3.54	0.10	12.80	0.36	23.59	0.70
Portugal	294.73	2.75	289.04	9.62	123.28	3.16
Spain	98.04	0.75	35.67	0.26	4.72	0.03
Sweden	0	0.00	140.31	1.48	439.13	3.80
Utd. Kingdom	92.59	0.09	115.72	0.09	86.55	0.06
Total EU15/EEA	628.38	0.18[4]	740.19 (+17.8%)[4]	0.19[4]	971.60 (+31.3%)[4]	0.22[4]

Source: OECD Insurance Statistics Yearbook (2001), own calculations. [1]Import share is measured in % as the computed absolute $ value of imports to total gross non-life premiums written in the respective countries. [2]Exports of Luxembourg are not available. [3]Ratio of total EU15/EEA import value to total EU15/EEA premiums written. [4]Year-on-year growth rate.

Total foreign presence

The same tendency evolves from business through non-EU/EEA branches and agencies (table 6, columns 4 and 8). Though on average it is significantly higher than the EU/EEA counterpart (2.53% in 1997 and 3.27% in 1999) it is lower than the corresponding non-life values (3.36% in 1997 and 3.90% in 1999). Also the fraction that is not directly covered through this analysis due to missing data, i.e. direct cross-border transactions without a physical presence, indicates much lower shares of life insurance (0.6%) compared to non-life insurance (1.9%) in 1999.[15] Concentrating the entire information available into table 6, the "lower limit" of a 19.1% (1997) and a 24.2% (1999) stake in foreign participation in the domestic EU/EEA countries materialises. The respective figures for the non-life sector (table 3) are 26.9% (1997) and 31.0% (1999).

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[15] See Swiss Re (2000c).

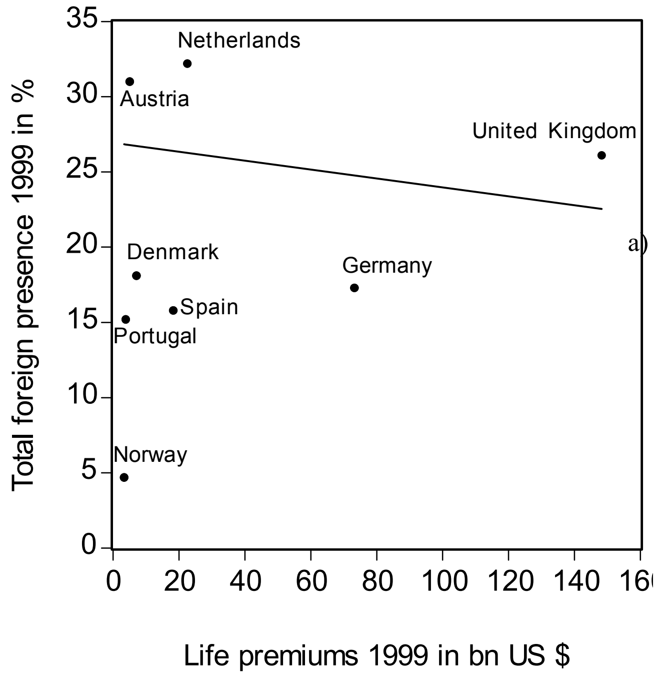
Table 6: Life insurance, overview of total foreign presence (in % of total domestic business)

Host Country	1997				1999			
	Foreign control	Branches and Agencies		Sum of columns 2-4	Foreign control	Branches and Agencies		Sum of columns 6-8
		EU/ EEA	Non-EU/ EEA			EU/ EEA	Non-EU/ EEA	
Austria	35.03	0.11	0.00	35.14	30.28	0.69	0.00	30.97
Denmark	6.48	0.00	0.40	6.88	17.61	0.13	0.31	18.05
Germany	6.48	0.09	2.10	8.67	15.07	0.07	2.14	17.28
Luxembourg	80.14	0.47	2.28	83.43	63.14	2.51	7.83	73.48
Netherlands	29.09	0.01	5.14	34.24	27.31	0.09	4.77	32.17
Norway	2.81	0.10	0.01	2.92	3.55	0.70	0.45	4.70
Portugal	10.83	2.75	2.33	15.91	10.37	3.16	1.66	15.19
Spain	16.78	0.75	3.63	21.16	15.00	0.03	0.75	15.78
Utd. Kingdom	17.43	0.09	2.51	20.03	22.01	0.06	4.05	26.12
Avrg. share[1]	16.40	0.16	2.53	19.07	20.75	0.17	3.27	24.19

Source: OECD Insurance Statistics Yearbook, 2001, own calculations. [1]weighted by the resp. market share.

The country specific degree of openness derived in table 6 is slightly negatively correlated to the size of the corresponding markets as revealed in figure 5. This negative correlation is not as clear-cut as in the non-life sector presented above (figure 4).

Figure 5: Scatter plot of market size vs. total foreign presence (life)



Source: OECD (2001a), own calculations; a) computed linear regression line.

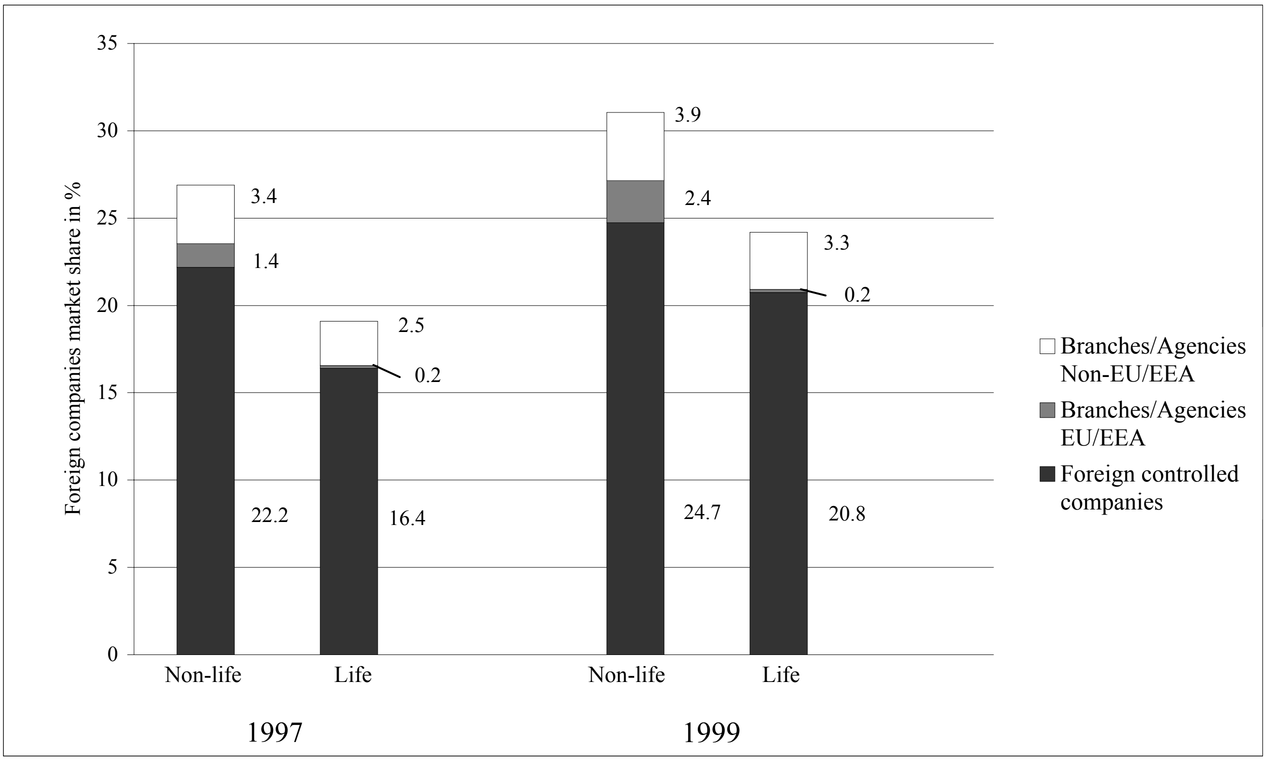
But again, countries that already prior to 1992 had less severe regulations with respect to product and price control (UK and the Netherlands) prove to have a relatively high presence of foreign companies business within their borders.

3.4 Conclusions from descriptive analysis

The main results emerging from the descriptive analysis are condensed in figure 6:

- The involvement of foreign insurers in national EU/EEA markets runs mainly through cross-border mergers and acquisitions.
- Branches and agencies play only a minor part as an entry strategy.
- The share of foreign controlled companies has risen significantly in the nineties, especially in the last three years.[16]
- The share of non-EU/EEA branches is even higher than for EU/EEA branches.
- The non-life sector generally is more open for all types of market entries analysed.
- The relative difference of the non-life compared to the life sector concerning different entry strategies is highest for EU/EEA branches and agencies.

Figure 6: Non-life and life insurance, foreign companies market share 1997 and 1999 in %



Source: OECD Insurance Statistics Yearbook (2001), own calculations.

One important aspect has not been mentioned so far. The three types of entering a market from abroad (majority stake or take over, branches/agencies, direct sales without physical presence) differ in their potential to break up the structures of the once strongly nationally segmented insurance industry. That is to say that it makes a difference whether a foreign company acquires a domestic company or whether it decides to set up a new establishment or to do direct cross-border business. For the last two cases the decision is mostly combined with

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[16] In a similar study focusing on Germany Farny (2002) elaborates an even higher market share of foreign insurers for 1999 while using firm specific micro data instead of aggregated OECD data.

new insurance products being offered in the respective countries. Thus, new products have to compete with existing national products. In contrast, the sole change of ownership structures does not necessarily change the diversity of products. An acquirer simply buys the knowledge of local peculiarities. Consequently, benefits for the informed customer are more likely to be reached if the entering company builds up new establishments or enters the market for instance through the internet.[17]

The results on the limited integration of EU insurance markets also hints at the relevance of obstacles to cross-border sales of insurance products. The fact that M&A strategies are dominant can also be interpreted in this way: A merger with a foreign insurance company has the crucial advantage to acquire the necessary know-how about national conditions. Thus, a large extent of regulatory and other national peculiarities should favour M&A relative to greenfield investments. Furthermore, the fact of lower integration of life compared to non-life insurance markets suggests that obstacles to integration are particularly severe for life insurance.[18] Therefore, in the next section it is tried to explain these findings by looking at potential obstacles.

4. Remaining fragmentation and policy priorities

Although it has been verified in the previous section that the degree of integration in the European insurance industry is growing it is remarkable that the volume of insurance premiums written by national or local enterprises that are not a part of an insurance group operating on a pan-European scale still amounts to 55%.[19] Even though no benchmark exists for an optimal degree of openness the European insurance market for private risks is still segmented. Furthermore, it has been shown in section 3 that the life and non-life sectors differ in their degree of openness so that one could suppose barriers being more important with respect to life insurance. This section therefore presents major obstacles to a truly integrated EU insurance market.

In general, obstacles can be grouped into policy induced obstacles and natural obstacles. While it is illusory that natural obstacles will disappear in the medium term and at best fade out in the very long term policy induced obstacles can be diminished by policy action already in the short to medium term. In table 7 the most relevant obstacles relating to the integration of the single European insurance market are displayed.[20]

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[17] The latter point is touched upon in the last section when assessing the impact of e-insurance on insurance market integration.

[18] Since the OECD data set regrettably does not facilitate splitting up the non-life sector into industrial insurance (wholesale business) and the insurance of individual consumers (retail business) the analysed patterns of the non-life sector, especially with respect to the branches/agencies figures, include a combination of an internationalised industrial fraction and a hardly pan-European fraction.

[19] See Gesamtverband der Deutschen Versicherungswirtschaft (2001), p. 49.

[20] A questionnaire directed to leading EU insurance companies delivered important insights into this topic. See the box on page 19 for details.

Table 7: Obstacles to the integration of the single European market for insurance

Policy induced obstacles	Natural obstacles
▪ Tax treatment of insurance ▪ Regulation and supervision (incl. consumer protection/general good) ▪ Contract law ▪ Marketing rules (distance selling) ▪ Accounting rules	▪ Consumer preferences ("all business is local"): language, culture, loyalty ▪ Information asymmetries ▪ Legal system and tax system in general ▪ Conventions, e.g. the renewal of contracts

Source: Own analysis that based primarily on the ZEW survey 2001 (see box on the next page).

Natural obstacles

Since insurance is essentially based on trust, i.e. the customers confidence in the ability of the insurer to honour its obligations, the average consumer is extremely risk averse. Preferences thus are highly biased towards local structures and established channels of distribution.[21] The more complex an insurance product the lower is the willingness of a customer to sign a contract with an unknown foreign supplier or even without "handshake". According to the ZEW questionnaire (see next page) global players in the European insurance market regard consumer interest in buying products on a cross-border scale as extremely small. Only corporate clients are reported to buy their insurance coverage internationally from one of only a few global insurance companies. Additionally, consumer loyalty to domestic companies, language and other cultural differences are regarded as highly relevant barriers.

On the other side of the market suppliers miss a reliable information basis. Problems that are relevant for every single insurance contract such as information asymmetries are reinforced with a growing spatial and cultural distance between the insurer and the customer. The legal and tax systems in general are yet additional obstacles that hinder the evolution of a level playing field for the insurance industry. The ZEW survey, though, indicates that some market participants consider solutions to these problems as illusionary.

Conventions regarding the terms of insurance contracts also have an influence on the readiness of policyholders to switch to a rival product, let alone if produced from abroad. Price sensitive behaviour, for instance, is favoured in the UK where customers must actively take steps to renew their policies each year. In continental Europe on the contrary the renewal of contracts for the most part is automatic unless a contract is cancelled one to three months ahead.[22]

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[21] This assessment of course does not hold for the insurance of industrial risks and reinsurance.

[22] See John Kirwan (2000).

Policy induced obstacles

Taxation

The responsibility for tax policy mainly lies with the EU Member States. With respect to insurance one has to differentiate between the taxation of insurance companies and the taxation of an individual policy holder. Since taxation is not harmonised on an EU scale a diversity of both different tax rates and different taxation systems exist.

Questionnaire

A survey among a few leading players in the European insurance market has been conducted in September/October 2001 by the Centre for European Economic Research (ZEW, Mannheim Germany). The questionnaire contained questions regarding the strategy of market access to other EU markets and the relevance of specific barriers to enter these markets. The analysis in this section partially rests upon information given in the questionnaire.

In fact, the treatment of premiums paid by individuals varies widely among EU countries, e.g. by way of different rates for indirect taxes relevant for premiums. Determined in the Third Insurance Directives, these indirect taxes have to be paid to the host countries and EU Member States may even require that a fiscal representative of the insurance company is appointed in the country of the final consumer. The advantages of shopping across borders can be offset by the fact that the taxation regime remains that of the country where the consumer has his residence. The latter aspect has been pronounced by an insurance company in the questionnaire.

Since life insurance products to a significant extent resemble interest-bearing instruments issued by banks the uneven taxation of interests adds to the diversity. Also regarding to the taxation of insurance companies a variety of ways in which countries tax insurance business, particularly life insurance, are usual.[23] In 2000, for example, there has been a variation in the income tax rate running from 28% in Ireland and Finland to 40.2% in Belgium. Furthermore, there are many different rules to the deductibility of certain insurance companies reserves (e.g. equalisation reserve and catastrophe reserve).[24] In addition, to avoid double taxation in some EU/EEA countries (Austria, Denmark, Sweden and the United Kingdom) there are differences in taxation treatment between domestic and foreign insurers.[25]

This anecdotal evidence demonstrates that cross-border taxation issues obviously are costly in fields that show no EU harmonisation. Taxation issues therefore are of fundamental strategic importance for an insurance company to either build up offices or subsidiaries, alter their domicile or undertake direct cross-border business. The creation of the International Financial Services Centre (IFSC) in Dublin can be deemed as a logical outcome. The IFSC represents a dynamic place for the development and management of cross-border insurance products.

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[23] See OECD (2001b) for a detailed analysis of policyholder and insurance company taxation.

[24] See OECD (2001b), pp. 49ff.

[25] See OECD (1999), Liberalisation of International Insurance Operations, 1999, p. 83.

Between 1997 and 1999 cross-border life insurance business through companies domiciled in Ireland quadruplicated.[26] Besides motives of mitigating the tax exposure for pan-EU insurers the IFSC is also used by several North American insurers to penetrate the European market acting from an Irish base.[27]

Even more important than an opaque taxation regime, also discriminatory tax advantages only granted to specific groups have been widespread in the past. While tax competition in general is mostly regarded as desirable, unfair and discriminatory taxation certainly hampers integration. Discriminatory taxation has been present concerning tax deduction of life insurance premiums when deduction is limited to contracts that are effected with an insurer being authorised in the country of the policyholder. Even in 1999 ten EU/EEA countries (Austria, Belgium, Denmark, Finland, Germany, Greece, Luxembourg, Netherlands, Norway, Portugal) granted fiscal advantages of that form.[28] The European Commission in 1997 commented on this problem: "Concerning life insurance products, differences between Member States' direct tax regimes have proved to be a substantial barrier to the development of cross-border activities. [...] The Commission is acting in this field in order to avoid that taxation remains an obstacle to the insurance Single Market."[29] It is instructive to observe that this internet notice has not been modified for four years. According to the Commission's notice the judgment of the Court of Justice has been in a way that permits this form of discriminatory tax deduction if it ensures consistency with the national tax regimes.

The survey confirms the presumption made above since with regard to life insurance business pan-European competition is regarded "tentatively lower". In this special case the market participant explained that assessment by the sluggish behaviour of clients keeping their close ties to their well-known intermediary. Certainly though, market transparency also suffers from the extremely diverse tax provisions, especially within the life insurance sector.

Regulation, supervision and consumer protection

Regulation and prudent supervision of insurance as an highly regulated business within the EU is subject to minimum harmonisation standards. National supervisory authorities therefore are capable of using their scope for discretion. The following aspects are the most relevant:

(a) solvency of the undertaking ("solvency margin"),

(b) establishment of technical provisions,

(c) assets coverage of the technical provisions (e.g. currency matching rules).[30]

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[26] See Watson Wyatt (2001), Insurance and financial services review, August, and OECD (2001), Insurance Statistics Yearbook.

[27] See IMF (2001), Report on the observance of standards and codes – Ireland: II. Insurance Supervision and http://www.ifsc.ie.

[28] See OECD (1999), p. 40, 132-134.

[29] See http://europa.eu.int/comm/internal_market/en/finances/insur/87.htm#11.

[30] See Vollbrecht, (2001).

Similar to the fiscal arbitrage described above it could be a useful strategy to circumvent tough national provisions. An example for this behaviour can be found in Ireland where Italian insurers open up subsidiaries to circumvent the more stringent solvency margin requirements for life insurers set by the Italian regulatory authorities. These companies to a significant extent re-sell life insurance contracts cross-border to Italy.[31] Compared to the problems arising by differing taxation treatment though, a country with a particular tight regulation hurts its own industry. This promotes a convergence in regulatory issues but has no discriminatory effect.

Extensive consumer protection with respect to the general good principle is a basic problem for the retail markets. First, since consumer protection (under the general good principle) is based on the domicile of the consumer the companies have to adapt to the rules of 15 different countries. This means an immense barrier to market entry for SME insurers. Second, national authorities may use their discretionary scope for protectionist regulation. One has to weigh the value of consumer protection against an inferior supply with insurance services. Because there already exists a high level of consumer protection more harmonisation in this field is not premature for the benefit of the consumer. If the level of consumer protection was lowered this could be absorbed by models containing less distortions, e.g. the establishment of powerful pan-European ombudsman rules. The difficulty of credibly obtaining out of court redress is a barrier to the development of cross-border services, particularly in the financial sector since access to redress is vital to consumer confidence. The Commission puts it as follows: "Ultimately the consumer will always have access to the courts. But for cost reasons this is often a last resort. A realistic alternative has been established (FIN-NET) which provides effective and rapid out of court redress on a cross-border basis."[32]

Further policy induced obstacles were also mentioned as relevant in the ZEW survey: the lack of harmonisation of contract law, the freedom of the EU Member States to type and number compulsory classes of insurance, the missing global set of accounting rules. Another important barrier has not been identified as relevant. The immense costs for the transfer of small amounts within the EU payment systems certainly prevent retail customers from cross-border deals.[33]

Most policy induced obstacles to a truly Internal Market for insurance in the EU have been identified by EU representatives, in general by adopting the objectives of the Financial Services Action Plan (FSAP) in 1999.[34] The FSAP addresses both wholesale and retail aspects. Also with respect to e-commerce most recently many relevant issues have been taken up by the „Report on e-commerce and financial services to the Financial Services Policy Group" (August 2001). According to statements in the questionnaire policy action has the

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[31] See Watson Wyatt (2000).

[32] See http://europa.eu.int/comm/internal_market/en/finances/general/ecom.htm.

[33] See Schüler (2002).

[34] See Annex for details concerning the Financial Services Action Plan with relevance to insurance.

chief task to solve the legal domicile principle in the field of e-commerce. Furthermore, the political agreement about the Directive for the distance selling of financial services as an essential complement to the e-commerce Directive that will become effective in January 2002 has been an important step.

To complete the list of obstacles one should bear in mind that the cross-border data base should be improved. This could be reached by enhancing the co-operation between public authorities in the field of collecting more standardised statistics or even by the centralisation towards a pan-European Financial Services Authority. If no progress occurs in this field every assessment of insurance market integration remains incomplete.

5. Concluding remarks

„E-commerce may revolutionise the provision of financial services, especially cross-border within the Internal Market.“ (European Commission, 2001) [35]

A large scale project like that of the single market in insurance needs plenty of time. Actors of Member States and the EU institutions have to identify and remove problems and to agree in practical terms on how to apply the new legislation. Although the data base is far from perfect the analysis allows some general conclusions.

Three generations of Insurance Directives have formally set up the freedoms of establishment and the free movement of services. Of course, countries sustained their national peculiarities in several spheres hence impeding the expansion of cross-border sales. The analysis of the degree of openness and patterns of market entry in European insurance leads to strong differences among countries and among classes of insurance that partly can be explained by the obstacles to a truly single market.

On the supply side, there are obstacles emanating from different national rules (taxation, regulation, contract law, consumer protection). Though only to a slight extent discriminatory, these obstacles are costly and directly hinder cross-border transactions. On the demand side, customers, especially private consumers, are not as price sensitive concerning the purchase of a life insurance contract compared to the purchase of a refrigerator, for example. To a significant extent this is natural in the light of the complexity of many financial products and their characteristic as a good necessitating a large degree of long term confidence in the suppliers financial strength. Together, supply and demand sided circumstances can to a certain extent be made responsible for the outlined patterns of European cross-border integration. The above analysis suggests that in spite of large cross-border linkages through a wave of mergers and acquisitions the current degree of openness is insufficient, especially for the insurance of private (mass) risks. Admittedly, it should not be expected that the latter business possibly will catch up with the degree of integration in the reinsurance and industrial insurance business.

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[35] See European Commission, http://europa.eu.int/comm/internal_market/ en/finances/consumer/ 01-1325.htm).

But at this point technological changes arising through the internet offer a big chance to offset certain obstacles since barriers to market entry are being reduced for smaller insurers, mainly by cost cutting in administration, distribution and claims management.[36] Today, cross-border activities in EU insurance are pursued by only a few international insurers or financial conglomerates. Only these have surmounted the critical mass to do pan-European business. The entry barriers are high for tax reasons besides information asymmetries, consumer protection rules (general good) and consumer preferences. It is costly to deal with a plenty of differing tax and regulation regimes and other national peculiarities. The new setting (e-insurance as an additional or exclusive distribution channel, the Euro as single unit of account) shows up to have the chance for potential competitors with a lower financial size to enter the market. On the demand side, by using the internet not only the costs of a transaction decrease, but also pan-European price transparency is completed as soon as the Euro acquires the unit of account and the means of payment functions by January 2002. Thus overall efficiency might be improved. Actual transactions via the internet, though, are minimal amounting to merely 0.02% of total European premiums (0.2% in the USA).[37] Nowadays, the e-channel joins the group of established distribution channels like direct sales, tied agents, brokers and bankassurers. The e-channel has to be seen with a great deal of attention since it is well suited to further the integration of the retail markets for insurance products. But it should not be expected that e-insurance proceeds quickly. The propensity to use the internet only slowly expands owing to demographic factors since elderly customers will change their established relationships in purchasing financial products to a far lesser extent than the internet generation.

[36] See Swiss Re (2000b).

[37] See Swiss Re (2000b), p. 12.

Annex

The tables in figure 4 provide extracts from the official EU documentation concerning progress on individual actions in the Financial Services Action Plan (FSAP). The tables show the current situation and provide the Commission's assessment of the degree to which Community institutions and Member States have achieved the objectives set out in the Action Plan until January 2002. Our own assessment has been added in the last column.

Figure 4: Selected issues of the Financial Services Action Plan: Focus insurance

Legend	x	Action has successfully completed
	+	Progress has been achieved in meeting the targets set in the Action Plan
	–	No progress (not acute in this excerpt)
	**	Own assessment: important for the integration of personal insurance

Strategic Objective 2: Open and secure retail markets

Action	Initial FSAP optimal timeframe	Present timeframe	(*)	
Political agreement on proposal for a Directive on the Distance Marketing of Financial Services	Adoption end 2000	Political agreement Oct 2000 Adoption Jun 2002	+	**
Interpretative Communication on the freedom to provide services and the general good in insurance	Issue summer 1999	Issued Feb 2000	x	
Proposal for amendment of Insurance Intermediaries Directive	Proposal mid 2000 Adoption 2002	Proposal Sep 2000 Adoption Dec 2002	+	**
Commission Communication on a single market for payments	Issue summer 1999	Issued Jan 2000	x	
Commission Action Plan to prevent fraud and counterfeiting in payments systems	Issue end 1999	Issued Feb 2001	x	
Commission Communication on an e-commerce policy for financial services	Issue mid 2000	Issued Jan 2001	x	

Strategic Objective 3: State of the art prudential rules and supervision

Action	Initial FSAP optimal timeframe	Present timeframe	(*)	
Adopt the proposed Directive on the Reorganisation and Winding-up of Insurance undertakings	Adoption 2001	Adopted Mar 2001	x	
Adopt the proposal for an Electronic Money Directive	Adoption 2000	Adopted Sep 2000	x	
Amend the solvency margin requirements in the Insurance Directive	Proposal mid 2000 Adoption 2003	Proposal Oct 2000 Adoption Jan 2002	+	
Amendment of the Insurance Directives and the ISD to permit information exchange with third countries	Proposal autumn 1999 Adoption 2001	Proposal Sep 2000 Adopted Nov 2000	x	
Adopting a Directive on Prudential Rules for Financial Conglomerates	Proposal end 2000 Adoption 2002	Proposal Apr 2001 Adoption Dec 2002	+	

Objective: Wider conditions for an optimal single financial market

Action	Initial FSAP optimal timeframe	Present timeframe	(*)	
Adopt a Directive for ensuring taxation of interest income from cross-border investment of savings	Political agreement by Nov 1999 Adoption 2000	New Proposal Jul 2001 Adoption Dec 2002	+	**
Implementation of the December 1997 Code of Conduct on business taxation	Ongoing examination in the Code of Conduct Group	Ongoing examination in the Code of Conduct Group	+	**
Review of taxation of financial service products	Discussion in Taxation Policy Group		x	**

Source: European Commission, extracted from the Commissions web-site (http://europa.eu.int/comm/internal_market/en/finances/actionplan/index.htm) on January, 20, 2002, own additions.

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