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European Community: U.S. Financial Services' Competitiveness under the Single Market Program

Statement of
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Before the
Subcommittee on Commerce, Consumer, and Monetary Affairs, Committee on Government Operations
House of Representatives

Mr. Chairman and Members of the Subcommittee:

It is a pleasure to be here today to discuss our assessment of how the European Community's Single Market Program might affect U.S. financial firms. Overall, we believe that the Single Market Program means that greater opportunities will exist for U.S. financial firms to expand their already considerable business in the European Community. Contrary to initial concerns, it appears as though U.S. financial firms will face relatively few Community-imposed restrictions that would prevent them from participating in these opportunities.

Concerning your specific interest in the E.C.'s potential effect on U.S. insurance firms, we found that in most European countries, the insurance industry continues to be one of the most strictly regulated segments of the economy. As a result, foreign insurers --both members and nonmembers of the Community -- generally play a minor role in national markets. Accordingly, insurance has been the most difficult financial sector to liberalize under the Single Market Program.

BACKGROUND

The European Community, composed of 12 nations, plans to create a single European market by 1992. The Community envisions a single, integrated market for the unrestricted movement of people, goods, services, and capital among its member states. Initiated in 1985, the Community aims to complete this Single Market Program by the end of 1992. While a majority of the initiatives necessary to create this single market have been enacted, many of the most troublesome issues remain unresolved. Our report,[1] released today, focuses on certain aspects of the European Community's Single Market Program, such as

- the potential opportunities and challenges for financial firms presented by changes in the Community and

- how U.S. government agencies are working to assure U.S. financial firms full and fair access to European markets.

An integrated Community rivals the United States and Japan as the world's largest market: it will have -- with 325 million people, a gross national product of $4 trillion, an amount matched annually in trading volume on bond and equity markets, and an insurance market that accounts for roughly a quarter of world premiums.

U.S. financial firms have a considerable stake in Community countries, chiefly conducting wholesale financial activities. Continued access to Community markets is, therefore, important to their global business strategies. U.S. banks are active in every

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[1] EUROPEAN COMMUNITY: U.S. Financial Services' Competitiveness Under the Single Market Program (GAO/NSIAD-90-99, May 21, 1990)

Community country, holding over $210 billion, or roughly 5 percent, of total Community bank assets among their hundreds of branches and subsidiaries. U.S. securities houses rank among the world's largest in their Euromarket activities. And, while only a few U.S. insurance companies operate in the Community today, the 1992 program has sparked renewed interest.

OPPORTUNITIES AND CHALLENGES FOR U.S. FIRMS

Looking first at the opportunities afforded by the 1992 program, firms incorporated in the Community, including subsidiaries of U.S.-owned financial firms, will be able to directly benefit from new powers and market access. Further, any financial firm with a presence in the Community, such as branches of U.S. financial firms, can profit from the increased demand for financial services as a result of economic expansion and restructuring under the Single Market Program.

Financial institutions incorporated in a Community country will obtain "single passports" to freely branch into any other Community country or freely offer services and products across borders. With this freedom, institutions will be able to consolidate operations and standardize products. Financial firms, in many instances, will also enjoy a broader range of powers. For example, the 1992 program endorses a universal banking model, whereby banks will be permitted to offer a wide array of financial services, including securities activities.

Despite these new opportunities, however, many U.S. financial firms do not plan to expand beyond their existing wholesale operations in Europe. Many factors drive this decision, such as limited capital for new investment, fears of increased competition, and other business considerations.

This choice is particularly true for U.S. commercial banks, for which new, more stringent capital adequacy requirements, and the lingering effects of bad loans made to developing nations, limit capital available for new ventures. In this latter respect, some banks believe that a better alternative for their limited capital available for new investment would be opportunities presented by the relaxation of interstate banking restrictions in the United States.

In addition, unlike other U.S. financial firms, U.S. banks must contend with certain U.S. laws and regulations that limit their overseas competitiveness. For example, U.S. law restricts the mixing of banking and securities activities in the United States, and regulations constrain U.S. banks' overseas securities activities. With the increasing importance of asset securitization and private placement as ways to finance development, U.S. banks are increasingly at a disadvantage compared to Community banks. Community banks are not similarly restricted under the Community's universal banking model.

U.S. GOVERNMENT'S ROLE

As a result of the evolving divergence between the U.S.' and the Community's approaches to bank powers, there is a greater urgency to resolve the issue of how broad U.S. bank powers should be. While we still believe that this decision is ultimately a judgmental one, Congress should consider the competitive prospects for U.S. banks in a post-1992 Europe when rendering its decision.

Turning to our assessment of the executive branch's efforts to aid U.S. financial firms, we found that generally the response was timely and coordinated. U.S. government agencies ensured that U.S. financial sector interests were treated fairly in the emerging European Community's single market. This treatment was most evident in a successful effort to overcome a restrictive reciprocity provision in an early version of Community banking legislation. U.S. firms were initially concerned that the Community might erect barriers to non-Community firms through a restrictive reciprocity provision.

Through a variety of means, U.S. government agencies banded together to lobby the Community early in its legislative "decision-making" process. Most concerns over U.S. financial firms' access to the Community were eliminated when the Community eventually adopted a less restrictive form of reciprocity in its final banking legislation. This provision will more than likely be replicated in the Community's securities and insurance legislation. While it is impossible to isolate the effect of U.S. government efforts from other factors, such as the change in Community leadership, member state objections, and private sector efforts, U.S. financial firms were generally pleased with the U.S. government's actions.

EFFECT ON U.S. INSURANCE INDUSTRY

Mr. Chairman, you have expressed particular interest in how well U.S. firms fare in the international insurance market and how well the U.S. government has assisted U.S. insurance firms overseas.

The world's private insurance market totals roughly $1 trillion annually in life and non-life policy premiums. The European Community is the second largest global market for private insurance after the United States, accounting for approximately 22 percent of the world market. The U.S. market generates approximately 43 percent of the world's premiums, while Japan generates another 20 percent.

According to an insurance industry study, growth in the European insurance market will likely continue to outpace that in the U.S.'

insurance market. Diminishing reliance on public social insurance systems in Europe is expected to increase the demand for private insurance there.

The Community's ultimate objective is to create a single market for insurance similar to that for banking and investment services, whereby insurance companies established in any Community country would be able to provide services freely throughout the European Community. Insurers would be subject to similar rules and regulations in each of the member states in which they opened an office. Policyholders would be able to cover their risk by choosing among insurers throughout the Community.

Progress toward this Community goal is lagging, however. The greatest success has been in the area of non-life insurance, especially for industrial and commercial policies. The First Non-Life Insurance Directive, implemented in 1973, permits Community non-life insurance companies to freely establish subsidiaries or branches in any other Community country. However, they are still subject to the official authorization and laws of that other Community country, known as the host country, and cannot offer cross-border services.

The Second Non-Life Insurance Directive, passed by the Community in 1988 and due to go into effect on June 30, 1990, is a significant step toward allowing non-life insurance companies the freedom to provide cross-border services. The directive allows Community insurance companies to offer their big commercial and industrial customers, known as large risks, their services freely throughout the Community, subject to the rules and regulations of their own home country. After June 1990, Community insurers will no longer need an established presence in a particular Community country to sell insurance to large risks there. Non-life insurance services provided to retail consumers was not similarly liberalized.

In the life insurance sector, a directive allowing freedom of establishment, paralleling the 1973 non-life directive, was adopted in 1979. While a proposal to also liberalize the offering of life insurance on a cross-border basis was introduced in 1988, the directive is still in the European Parliament, and there is no way of knowing when or if the directive will be finalized.

The European Commission recognizes that the steps I just mentioned, as well as the others currently in place, are not enough, alone, to fulfill its goal of creating a single insurance market. Therefore, the Commission is in the process of drafting directives, which, if passed, will allow Community insurers to operate on a single license. They will be free not only to set up branches in other member states, but also to sell a full range of products anywhere in the Community on the basis of a single authorization and subject to only one supervisory authority.

As I stated earlier, foreign insurance companies typically play a minor role in national markets. A 1989 European insurance industry study noted that the weighted average share of foreign insurers amounts to only 7.5 percent.

BARRIERS FACED BY U.S. INSURANCE FIRMS

The report noted that even in countries with relatively few legal restrictions on market access, such as Great Britain and the Netherlands, foreign insurers' market share is relatively small. Among the existing barriers to the free flow of insurance services we have noted are

-- "buy national" government procurement practices;

-- high concentration and cartel practices;

-- member state restrictions on the placement of contracts with insurers not established in that state;

-- differing tax regimes, which affect premiums, profits and reserve levels;

-- product restrictions;

-- differing treatment of reserves and investment supervision;

-- differing marketing rules; and

-- consumer national preferences and language barriers.

The EC Commission is hopeful that many of these barriers will disappear under the Single Market Program. However, it recognizes that insurance liberalization will continue to lag behind the other financial sectors.

Our work revealed that only a handful of U.S. insurers are active in the Community. These firms mostly provide property and casualty insurance for business and industrial customers. Generally, they have sought to portray themselves as European firms by incorporating in one member state from which they branch elsewhere in Europe.

The limited penetration of Community insurance markets by U.S. insurance companies can be partly attributed to the barriers already noted. However, the insurance companies themselves have not evinced a great deal of interest in the Community. A recent survey reported that 80 percent of U.S. insurance executives have little or no notion of the market potential of the Community. Other reasons given by insurance executives for the low U.S. penetration in Europe include (1) the domestic orientation and conservative nature of the industry in general, (2) the current saturation of the insurance market, especially in northern Europe, and (3) competing opportunities in the Far East.

With the growing prospect of a single market in the Community, there are indications of some increase in U.S. insurance industry interest. Several U.S. insurers, including both life and non-life insurers, are beginning to establish themselves in the Community. Based on our discussions with representatives of the U.S. insurance industry in the Community, at least eight U.S. companies are establishing distribution alliances with Community banks and insurance companies or opening new offices.

Most of the activity is expected to occur in the southern Community countries such as Spain, Italy, and Greece, whose economies have been less developed than those of other Community member states. As the economies of these countries grow, demand for insurance is expected to increase. For example, as consumer incomes rise, the perceived need for insurance coverage to protect survivors may increase. In addition, domestic regulation in these countries has been especially restrictive historically and foreign penetration low. Therefore, as more efficient foreign insurers are permitted to enter these countries, profit opportunities are anticipated.

LIMITED U.S. GOVERNMENT HELP FOR U.S. INSURANCE FIRMS

While the U.S. government generally has provided an effective response to Community financial services initiatives, the insurance sector has been somewhat of an exception. The Department of Commerce claims lead responsibility for protecting U.S. insurance interests before the Community, but its activities thus far have been primarily informational. While the Treasury Department has responsibility for financial issues associated with the 1992 program, it is clearly not as active in insurance as it has been with banking and securities issues.

Commerce's Foreign Commercial Service aids U.S. insurers in establishing their businesses and instructs them on local business practices but does not focus on regulatory treatment issues. Cognizant State Department and Treasury officials overseas have focused primarily on commercial and investment banking, at the expense of the insurance sector.

The relative neglect afforded the insurance sector by the U.S. government can be attributed to several factors: the small presence of U.S. insurance companies in the Community, the absence of a federal insurance regulator, and the less advanced status of the Community's insurance initiatives.

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Mr. Chairman, this concludes my prepared remarks. I would be happy to answer any questions that you or the members of the Subcommittee may have.