

Better Regulation for European Insurers to Fulfill Their Role in Society

What's needed on the regulatory front for European insurers to meet worldwide competition successfully

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Good afternoon Ladies and Gentlemen. I would like to congratulate the CEA for organizing such a distinguished gathering – it comes at a time of crucial change for our industry, and I am very glad to have the opportunity to join this debate. I very much welcome that CEA chose to dedicate this conference to the subject of “Better Regulation for European Insurers to Fulfill Their Role in Society”. This is a topic of utmost importance.

My theme for today – “What’s Needed on the Regulatory Front for European Insurers to Meet Worldwide Competition Successfully” – cuts right to the core of what one may call the “European malaise”: persistent sluggish economic growth and unemployment. If we want to meet worldwide competition successfully, if we want to achieve the goals of the Lisbon process, we must act promptly and decisively. Now it would be presumptuous if I were to propose a solution for all that is ailing the European economies. My goal is more modest and focused on what I understand best – our industry.

The insurance industry too has seen its fair share of challenges. Over the past four years, beginning with the terrorist attacks of September 11 and the near-meltdown of global equity markets, to the hurricanes in the United States and flooding across Europe, our industry has indeed faced unprecedented difficulties. As we are all aware, these pressures

tested not only the profitability of the sector, but also our ability to serve our customers. Undoubtedly, there are more challenges to come.

We all recognize that our industry is fundamental to the welfare of our societies. Without insurance, our capacity to mitigate risk would be limited and the ability to protect our customers' assets from catastrophic loss would be impaired. To put it in context, if the UK economy had grown at the rate it did before the development of financial institutions, it would be fifteen times smaller than it is today. Our ability to compete, to innovate and to deliver at competitive prices are crucial for all stakeholders – including the more than 400 million people living in the European Union. This is even more important in today's perpetually changing and demanding risk environment. I believe that regulation can make a major contribution towards meeting this goal.

There is a real opportunity here to create a competitive advantage not only for the European insurance industry but for the whole European economy. Ladies and gentlemen, the EU is in the fortunate situation that work on the future of insurance regulation has just begun. We are provided with an amazing opportunity to rebuild our regulatory structure almost from scratch. The EU is a dynamic market, and we have the chance to create dynamic regulation to match.

Strengthening the European insurance industry means to create a competitive advantage for the European insurance industry by wisely designing efficient regulation that is supportive of markets. We should aim to make it the best in the world. Well designed regulation that strengthens the European industry's backbone is central to our ability to outperform global competitors.

I think we all agree that market interventions must be designed to meet economically sound goals of regulation – to correct for market failure, ensure systemic stability and protect the consumer – and that regulation should complement markets by setting a framework within which efficient and sustainable markets can develop. Regulation should not attempt to substitute for markets or to shield our industry from competition.

Competition is healthy. I am convinced that competitive markets will always provide the best protection, because they are innovative and responsive to quickly changing conditions.

But matters are not that simple. There are also other breeds of regulation.

Indeed there is still regulation that protects industries from competition, imposes barriers to market entry – and exit for that matter. In light of the obvious resistances this creates, I welcome the European Commission’s commitment to do away with this type of regulation. In the US regulators approve the rates – a striking example of erring market intervention. In markets where we do not know this kind of tight rate supervision, competition can be much more intense, even resulting in lower prices for consumers. For example, over the five-year period to 2003, the cost of term assurance in the UK dropped 30%. The insurance cycle shows that the market is constantly looking for the lowest sustainable price. At times, it even errs on the side of offering products at an unrealistically low level. But even in this situation, the regulatory response should not be rate setting but ensuring that the industry is financially strong and capable to meet the promises made in the past.

There is another breed of regulation we should be wary about: When regulators act not in response to economic criteria – as the market inevitably does – but in response to political pressure. A corporate scandal shows up in the news, there is a public outcry, and regulators feel compelled to respond. This ad hoc, damage-control method of regulation is clearly not the way to design a regulatory structure that complements markets. We must avoid the risk of regulation that is purely reactive and made up on the spur of the moment.

Look at the US in the past five years: Enron, Worldcom, Tyco. These scandals were quickly followed by the rushed introduction of Sarbanes-Oxley and the new NYSE listings rules in 2002. Arguably, this is a classic example of regulation without concept of cost or benefit. But it appears that the pendulum may be swinging back. The Secretary of the US Treasury said recently, and I quote, “The American corporation has been and it continues to be an extraordinary engine for economic development, innovation, and change. Sarbanes-Oxley was a much needed and timely tool for keeping that engine on track and running properly. We need to make sure it is not inadvertently applied in a way that cripples that engine.”

I certainly agree with Secretary Snow's conclusion, and I would hope that his statement will catalyze the beginning of a discussion about the costs and benefits of market intervention in the US. To be sure, we need a strong regulator who carefully weighs the costs and benefits of regulation, just like the approach and philosophy that the Commission and the FSA are publicly committed to. Regulatory intervention must be based on clear evidence of market failure or systemic instability and a sound cost benefit analysis. It is an approach I thoroughly embrace.

We should heed that "punishment by regulation" is often surpassed by the verdict of functioning markets. Enron faced its demise at the hands of the market more quickly than any regulator could have ordained. This swift reaction demonstrates the impartial – and some may say ruthless – efficacy of markets.

There is also regulation through litigation. To strengthen the European industries' competitiveness we need legal certainty and we must be wary not to imitate the US tort system with all its deficiencies. We must recognize the risks to our industry that arise from today's compensation culture. We must deal with them by helping to design flexible regulation that can be adapted to unpredictable situations without continuing to promote a society lacking personal responsibility. A regulatory structure that was designed well in the first instance is more likely to prevent de facto regulation through legal precedent.

We should be conscious that, as markets continue to grow together, regulation increasingly spills over from one jurisdiction to another. Legislators and supervisors must follow market developments and cooperate better to avoid conflicts of regulations. Again, Sarbanes-Oxley is a telling example. I believe the European Commission is on the right track with the Financial Markets Regulatory Dialogue taken up with the US, regular dialogues with Japan and the intensifying contacts with China and India. This will help to counter the threat of regulatory spillovers.

Finally, there is regulation that overloads business with paperwork. For example, the Hampton Review recently undertaken in the UK to examine regulatory burdens noted that

there are too many overlapping forms and data requirements. Something as simple as changes to data collection methods could save the insurance industry a great deal of time and money, not to mention improving business-regulator relations and reducing regulatory fatigue. In 2002, the US Health and Human Services Department made one change to one data collection on health insurance regulation, and saved 37 million hours of paperwork. This type of regulation too, I believe, is being reconsidered within the European Commission. Let me underscore that the ultimate beneficiary of such endeavors will always be the consumer.

I am sure you would all agree that ill-designed regulation deters entrepreneurship and innovation and slows the rise of new businesses. It increases cost, induces misallocation of capital, fosters uncertainty, and leads to opportunity costs of diverted management time. Clearly, it has a negative impact on competitiveness and growth.

Avoiding these types of regulation can give us the competitive edge to boost the European economy. Ultimately, strong and sound regulation will be a competitive asset. It will enhance the capabilities of our industry in the global arena, and it will foster an environment conducive for insurers to support economic growth and prosperity.

It can give us a competitive advantage over countries where regulators fail to sufficiently recognize the importance of economically well-designed regulation. At this point I should like to express my respect and esteem for the European Commission. It has made it clear that competitiveness, growth and jobs are the top priorities.

But the regulatory burden continues to be large across Europe. A number of Member States have failed to minimize add-ons to the basic frameworks and rules laid down in the EU. Indeed, most of us are facing considerable inefficiencies in the way our European operations are regulated. Our companies, particularly those with an EU-wide presence, are confronted with high compliance and reporting costs. We are not regulated in the same way we are managed – with a view to our European and worldwide operations.

For example, some regulators in the EU – and in Switzerland too – are developing risk-sensitive capital requirements, but this is not the case in all EU countries. However, we are seeing some convergence towards a dynamic risk-based prudential framework for European companies. Working together with the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS), the European Commission will present a Framework Directive aiming at the convergence of quantitative and qualitative supervisory methods. This is a step in the right direction.

To this, I would like to add my plea for a principles-based regulation. It is, in my mind, the only way to ensure that regulation will be flexible enough and able to keep up with the dynamics of our markets.

The reason is simple. Even the best regulator will never have a rule for every situation. But a principles-based approach will provide the flexibility to deal with unanticipated situations. Of course, the principles need to be accompanied by guidelines on acceptable standards of conduct, which may evolve. But the beauty of a principles-based system is that it allows this evolution without the need for constant prescriptive legislation. It will also be flexible enough to help avoid politically motivated regulation because it can adapt to the most up-to-date business practices. A principles-based approach will also be equipped to cope with country-to-country differences and reduces the incentive for regulatory arbitrage.

However, there is one caveat to my call for principles-based regulation. In order for it to work, our industry and regulators must cooperate better. We are in an excellent position to establish a permanent dialogue with the EU to provide information and specialist knowledge – and to explain what our industry needs. We must take a proactive approach to interacting with regulators. Only by taking part in the process will we get regulation designed to strengthen the European insurance industry. I should like to pay a compliment to Charlie McCreevy who acknowledges this need and has committed to continue to ensure that wide consultation is an essential part of preparing new policies and legislation.

I would like to urge my colleagues that with regulatory changes taking place so quickly at the EU level, we as an industry cannot afford to wait for regulators to come to us. We now

have the opportunity to help determine the principles that will guide our businesses. We should promote dynamic regulation that responds to market forces, fosters innovation, and encourages self-regulation. We, as an industry, must take responsibility for freeing up competition by helping the regulators help us.

In the end though, meeting worldwide competition successfully takes a lot more than well-designed regulation. I would like to underscore the importance of corporate governance and executives' integrity as it became strikingly apparent in the customer – broker – insurer relationship. Even though full disclosure of commissions will help to release competitive forces and whatever regulation will ultimately mandate there will always be room left for fraudulent intent and we must continue to manage conflicts. As John Tiner recently pointed out, the management of such conflicts is not the responsibility of the regulator. In fact, formal regulation may lack the necessary bite to deter fraudulent behavior as the costs of detecting and providing evidence of such instances can be prohibitive. Insurers and brokers must demonstrate responsible behavior by implementing well designed self-regulation including behavioral norms, codes of conduct and corporate governance structures. Most importantly, this must be supported and borne by management – our executives' integrity is key.

Ethical behavior must indeed be an integral part of a company's culture. It is vital that the companies in all industries communicate the right signals. It does not suffice to be only meeting financial targets. Our actions must be based on long-term interests rather than on short-term, expedient solutions. This requires us to manage our businesses with integrity, and cultivating long-term relationships with our customers based on trust. The commitment to integrity must begin in the executive suite. We must instill fundamental principles that focus on the spirit, not just the letter of good corporate governance. This is a clear preference for principles over rules, and the principles on which we must focus are few: transparency, integrity and accountability.

Thank you.