Recent developments in the Swedish insurance market

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The Swedish Insurance Market has been under a constant transformation during the last decade. This is somewhat in contrast with the period from the end of the Second World War until the mid eighties, when a strict regulation lead to a low degree of product innovation and a low degree of market entry. The rapid transformation of the market during recent years has to a large extent been triggered by changes in regulation.

I would like to give you a view of structural developments in the market, high-light some recent trends in the insurance market and finally discuss some issues for prudential regulation and supervision. Let me, in order to put the development in the insurance market in a relevant perspective, start by giving you a general economic background.

Sweden experienced a dramatic period in the beginning of the 1990's. After two decades of high inflation, deficits in the current account and a very low savings ratio, the situation changed dramatically during the first years of this decade. Inflation went down to a level of 2-3 per cent annual increase. The savings ratio increased from negative to a level of around +8 per cent, as the household sector went through a period of massive portfolio adjustment due to changed economic incentives. The current account now shows a substantial surplus.

As you are well aware of this change was not easy. The defence of the fixed exchange rate in 1992 lead to high interest rates, and in the beginning of the 1990's we experienced a financial crisis of a formidable size. The banking sector was severely hit by the slump in the real estate market, were prices fell by around 50 per cent on commercial real estate. This lead to a massive revaluation of asset values in banks, but also in the insurance sector. Some of the big banks had to be supported by government action due to their importance in the payment system. In the insurance sector we saw e.g. the failure of the credit insurance company Svenska Kredit.

That is now all history. The financial sector has regained its stability, but in order to understand the Swedish market it is important to

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know that these experiences of the past will have long term effects on future developments in the market. Especially the experience gained as regards valuation of real estate will stay for a long time.

Another important feature affecting the Swedish financial market is the development of government finances. After showing a surplus in 1989 the Swedish government budget deteriorated to a bottom level of a deficit, amounting to around 14 per cent of GDP in fiscal 1993/94. This was partly due to cyclical effects, but also to a structural deficit in government finances. Presently the budget deficit is declining, and projections point to a deficit of around 5 per cent of GDP in 1996. Today the Swedish discussion focus on whether Sweden will meet the EU convergence criteria for the EMU in due time.

The deterioration of government finances lead to a substantial growth in government debt. This is of course a very clear warning signal, that has far reaching effects for developments, not only on the financial market as a whole, but also for the insurance sector.

For the insurance market there are two main effects. First, we will see effects on the supply side. Services formerly produced in the public sector will, due to the financial constraints, in the future to a larger extent have to be offered by insurance companies. Secondly, we will see effects on the demand side. Due to the permanently higher level of savings, we will see an increased demand for traditional insurance products. It must in this context be noted, that seen in a European perspective, the present level of savings is not high.

During the past years, volatility in the Swedish market has been very high. That is true not only for prices of financial assets but also for real estate prices and the exchange rate. As we all are aware, volatility always has a cost in the sense that it raises the insurance premiums in the markets. This cost has been high.

Structural developments affecting the insurance market

Let me now turn to some structural developments affecting the insurance market. Structural change is not only important generally. It is also an important factor behind recent developments in the Swedish insurance market. Let me try to high-light some issues.

The European integration

The creation of the European single market will looking back, no doubt, be seen as a major achievement in economic development in Europe. Sweden first joined this process by the EEA agreement, and after a referendum in 1994 Sweden became member of the union.

The entry of Sweden, Finland and Austria in the EU has increased the total population in the union from 348 million to 370 million, increased the total land area by one third and increased GDP per capita by one percentage point. As regards financial market issues, Sweden will contribute to the development in Europe by its spirit of free trade.

For the Swedish insurance sector the European integration has been of outmost importance in the process of structural modernization and adjustment that has taken place during the last decade. This process went through a major phase when the third generation directives were implemented the 1. July 1995. The opening up of the insurance market and harmonization of standards will improve market functions. The implementation of uniform risk diversification rules is, from a Swedish perspective, another major contribution to our financial market.

It would of course be misleading to look upon the European integration as something already done. The European integration is instead of course something living and a process in constant adaptation. The present discussion on further improvements in prudential regulation and supervision in Europe proves that. Let me come back to this more specifically later.

The Swedish pension reform

Sweden in the 1950's created a national pension system. This was a pay-as-you-go-system. During the 1960's and 1970's economic growth was high and this system accumulated a substantial surplus that was invested by the National Pension Fund. This fund became one of the major investors in the Swedish financial market.

During the l980's and beginning of the l990's, due to the slow down in economic growth and demographic developments, it became clear that this system had to be reformed. After a lot of discussion finally a decision was taken, to adjust the system by creating clearer links between individual income and future pensions and by introducing elements of individual funding in the system. The exact design of the system is still to be decided.

Change in social security

The trend in government finances has been clear during more than a decade. Due to the accumulation of debt, the growth of governments interest burden leads to a crowding out of government transfers in traditional areas. One such area is the social security system.

During the 1990's we have seen reduced compensation in a lot of social security systems e.g. as regards unemployment benefits and health insurance. These changes have taken different forms in different parts of the system. We have seen a reduction in compensation rates, greater financial responsibilities for employers and the introduction of qualifying periods for benefits.

The effect of these changes has first of all been a reduction of government expenditure. However, the incentives these changes produce is perhaps more interesting from an insurance market perspective. We have also seen changed behaviour leading to a greater demand for complementary insurance products and insurance companies developing such products.

Taxation

Taxation is always a subject that provokes sentiments. Sweden is no exception to this rule. This has also been demonstrated recently, when taxation of insurance has been on the agenda.

By tradition, premiums in pension insurance have had full deductability in taxation. In April 1995 a decision was taken to alter this and to reduce the maximum deductability to 50 percent on pension insurance premiums. This was a significant change, but it seems to early to see the full effects of this decision. So far the effects seem to be of minor magnitude.

Also other changes in taxation have occurred recently. The increase in capital tax and the adjustment of the tax on insurance premiums has affected the insurance market.

Seen from a European perspective, taxation of insurance products is an important subject. The free mobility of capital has changed conditions for taxation, and technology will add to a further enhanced mobility. It will take a long time before we see a uniform level of capital taxation, but incentives seems work in this direction. If such a development should realize, it would play down the importance of off-shore centres, which from a prudential perspective would be beneficial.

Recent trends in the Swedish Insurance Market

Given these structural changes that have occurred, it is interesting to turn to some recent trends in the Swedish insurance market. These trends are not only an effect of consumer demand and changes in economics of production in the insurance business. They can also to a certain extent be seen as a consequence of structural changes.

Distribution of services

In Sweden we have seen a true revolution in the distribution of insurance services during the 1980's and 1990's. Traditionally insurance was sold by insurance agents, but in the 1980's banks became a new distribution channel that soon became important. In 1990 insurance brokers were recognized by legislation, and soon the number of insurance brokers increased substantially. Today more than 800 active insurance brokers are registered at Finansinspektionen. All in all, however, the relative number of brokers are low, at least relative to UK standards, and we expect a further increase in the number of brokers.

These new forms of distribution of services have been to the advantage of the customer, both due to the improved access to services that it has rendered, but also due to the economics of new forms of distribution. It would be false not to recognize that further developments in distribution of services will take place. The years ahead, we will most probably see that new technology will further create new possibilities for the distribution of services.

From a regulatory perspective, these new forms of distribution calls for adaption in prudential regulation and supervision. In practice we have encountered difficulties as well as regards the possibility to supervise the enormously increased number of insurance brokers as rigidities in legislation and regulation. Solutions to these difficulties must be found, so that supervision better can be able to contribute to efficiency and stability in the insurance sector.

Products

The last couple of years we have seen unit-linked products conquering new and big market shares at the expense of traditional insurance products. However, the last year the increase of unit-link products has made a stop and traditional insurance products have picked up. In this more balanced situation, it is clear that unit-linked products have come to stay and be an important part of the insurance market. As regards new services as e.g. health insurance, it is evident that this market will grow. Until now they have entered the market as complementary products, that top up social security compensation schemes. An interesting phenomena in this new interest for insurance products was an additional pension scheme, that car worker unions concluded with employers during the wage negotiations. It is, however, to early to see the full extent of the introduction of new products and new customers.

A strong trend as regards product developments has been the reduced content of risk element in insurance products. Let me give you an example. When unit-linked products were introduced, regulation stipulated that there had to be a minimum of 5 per cent risk element in the product. Due to market pressure this was changed to a minimum of one per cent. Clearly market forces reduce the barriers between traditional insurance and other parts of the financial sector.

Competition

The degree of competition has increased considerably on the Swedish insurance market during the last years. There are several reasons for this. First, the insurance industry has been going through a period of restructuring. As mentioned, the industry has adopted to changes in the distribution channels have increased. Furthermore, new domestic insurance companies have entered the market. Let me as an indication of this mention, that during the last year eleven new domestic insurance companies were granted the permission to operate.

Competition cross-border from companies

established in other parts of the European union has so far been moderate. Although around 100 notifications have been made from companies wanting to conduct cross-border operations, we have not on any major scale in reality seen any major penetration of the Swedish market. From a Swedish perspective Swedish companies have asked for solvency certificates in order to open up branches or conduct cross-border operations. During the last year 26 such certificates have been issued.

The conclusion as regards cross-border activities is that they are picking up, but that it is presently too early to see the full extent of it.

Issues for prudential regulation and supervision

With the developments I have touched upon in mind, I would like to draw your attention to some issues for prudential regulation and supervision that are on our agenda. I am sure that many of these issues are well known for you, since they are of direct relevance for your work. At the same time I would like to take the opportunity to elaborate on some of them, in order to promote a further discussion on those issues.

The implementation of EU directives

Sweden has implemented the third generation insurance directives and will by the first of January 1996 have implemented the accounting directives for financial companies. The Swedish implementation of directives is carried out on two levels. On the first level, parliament decides upon the laws that implement the directives. On the second level, Finansinspektionen issues decrees, that on a more detailed level regulates the specifics of the directives. This is a practical division of labour between parliament and our institution, that gives room for a swift adaptation and correction of details i regulation. The implementation of directives in Sweden has so far been done by implementing laws and decrees by Finansinspektionen at the same time.

It is important that the directives are fully implemented, so that differences in the mode of implementation do not lead to distortions in the market or to barriers to entry. From the Swedish authorities point of view the intention for the participation in the European integration and the implementation of directives is to fully contribute to the internal market.

I am convinced that the new conditions for the insurance market created by the directives will improve the functioning of markets. At the same time it calls for an increased collaboration between authorities. We have only seen the beginning of this and we all know how long time it takes for companies or institutions from different countries to operate together. The operations of the European passport and the system of home country control will take a long time until it has found its final form. How supervisors work in this conjunction should be a matter for future dialogue.

Supervision of risk management and internal control systems

For supervisors and auditors, the perspectives on life sometimes seem to converge. I think we all sometimes share the view that mankind never learns and constantly repeats obvious mistakes. Let me give an example of this.

There was a young man in Singapore who dealt in futures contracts. He was successful and got the responsibility of not only trading but also back- office and control. He lost money on a sudden unexpected fall in prices and increased his betting in order to regain what he had lost. The internal control did not work. He lost his job. The owners lost their company and all the money.

The crash in Barings Bank high-lights the need for an efficient internal control in banks, as well as in insurance companies. Owners, management, auditors and supervisors have all good reasons to work in order to promote this. If we fail, it is the repute of all of us that is at stake.

What can we do? Well, I think the problem of deficiencies in internal control must be counteracted on several levels. Let me start with prudential regulation and supervision focusing on the work undertaken in Sweden.

Finansinspektion has developed special guidelines for internal control and risk management. They can be divided in two parts. The first part dealing with the responsibilities and the operations of the board. The second part dealing with specific risk areas as credits, market risks, etc.

However, we think that this is not enough. We also need to make on-site inspections in order to follow up the operations of internal control. The experiences from the financial crisis indicated that it was not enough to solely rely on auditors. Against this background we have tried to develop the capability and methodology of on-site inspections. This week we will issue a report on the result of an examination of the operations of 21 Swedish companies accounting for one third of the balances on the Swedish financial market. It is our intention to continue to monitor this issues.

It is my view, that the constant focus on internal control by supervisors is necessary. But this is not enough. In this work it is important that supervisors underline the importance of the work in the board rooms. The responsibilities of the board of directors, as regards risk management and internal control, needs to be specified in national legislation.

Owners play an important role in this context, and I think that they must sharpen their demands on their board members and on management regarding risk management and internal control. The board must bear the full responsibility in this area, and make sure that management does not expand into too risky operations. They can do this by demanding information about exposures, identifying risks, putting limits on these risks and by creating sufficient monitoring systems.

The auditors are of course extremely important in these issues. This is true both for internal as for external audit. One basic view, that I think is extremely important, is that the auditors do have access to the board room. In too many cases, we have seen the views from e.g. the internal audit being filtered by management before they finally reach the board. If the board bare the full responsibility for risk management and internal control they need to meet the auditors on a regular basis.

Disclosure and accounting issues

A topic, that has come higher on the agenda the last couple of years, is disclosure and accounting. The reason for this is the need in the market place to judge counterparties, as financial business has grown more and more complex.

For market practitioners, this is straightforward. They want to know as much as possible about counter parties. However, the interest to convey information about their own operations is not of the same magnitude. That is human but not sustainable.

For customers, improved information about market values, inherent risks and corporate policies is important, so that they can come to well informed decisions about their investments or choice of service operators. A good disclosure, including information on market values on financial instruments, is a necessary condition for market efficiency.

For supervisors, disclosure has lead to a lot of activities and sometimes to different conclusions. The most extreme case being New Zealand, where public supervision was brought to an end with the argument that a sufficient level of disclosure in cooperation with auditors could do the job. In Europe, this response seems a bit extreme.

In different regulatory fora in Europe, as well as in global fora, as IOSCO, the Basle Committee on Banking Supervision and in the IAIS, the issue of disclosure is being discussed and explored. To a large extent this discussion focuses on derivative activities. However, according to my view, disclosure must be developed not only for those products, but rather by taking into account all activities of financial institutions.

We can expect further developments concerning public disclosure the coming years. This is a good thing, since disclosure and accounting issues form an intrinsic part of prudential supervision and regulation. According to my experience as a supervisor, most supervisory problems that I have encountered has demanded an opinion from the supervisor as regards the value of equity and how this should be disclosed.

Clearly supervisors need to do more in this area. Some weeks ago, Finansinspektionen sent out for comments a proposal regarding disclosure and accounting rules. This proposal implements the accounting directives, but it also takes a number of steps forward as regards disclosure. A number of recommendations by the IASC (IAS 32) is put into the proposal, taking public disclosure on financial instruments a great step forward. The final decision regarding these guidelines will be taken in December this year.

Financial conglomerates

An issue, that supervisors must handle the years to come, is supervision of financial conglomerates. The so called tri-partite group has finalized a report on this issue at the same time as work is being done on this issue within the European union.

Problems of supervising a financial conglomerate are not new. What is new is the increase of financial conglomerates, and the increased need to find efficient supervisory tools for this. Therefore this is a very relevant issue that calls for a solution. Still a lot more job has to be carried out among regulators before we will see any result. This should preferably be done on a global basis. However, given the problems that might emerge, according to my view, Europe needs to have the capability to develop appropriate European regulations if a global solution could not be found.

In the insurance field, the development of directives for supervision of insurance undertakings in a group, is one part of the puzzle where real progress has been done. It is comforting that results have been achieved in this area.

Looking ahead

If we look ahead there is no reason to think that the Swedish Insurance Market ever will come back to the situation that prevailed for several decades after the Second World War. Few people mourn that. For all of us there are challenges ahead, and I am convinced that the European integration will be of major importance for the years to come, and that customers will benefit. But we should not have the false impression that this will be achieved without pain.