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Discussion of "Regulation and Efficiency in European Insurance Markets"
by Ray Rees and Ekkehard Kessner

Discussion

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Rees and Kessner have done an excellent job of describing the German and British insurance markets, and contrasting the effects of their different regulatory systems, but the authors are much more optimistic than I am about the competitiveness and efficiency of a deregulated insurance market.

Consumers find it very hard to obtain and process information in this market; I do not agree with the authors' contention that shopping for insurance products is just like shopping for automobiles or other consumer durables. Many consumers find it very difficult to understand statistics or make financial calculations that are more complex than simple price comparisons, and they have much less opportunity to learn from experience about insurance policies than about most consumer durables. Consumers' difficulties in learning are often aggravated by a lack of interest (at best) or a phobia (at worst) of even thinking about the personal-mortality issues involved in life insurance, and by contrast with automobiles, hi-fis or washing machines, the characteristics of life insurance policies are not the standard, or even always acceptable, subjects of

conversation in the pub or at tea parties. (Customer relationships and switching costs also reduce competition in some insurance markets: see, e.g., Klemperer, 1995.)

The authors claim that German regulation allows many inefficient firms to survive alongside efficient firms, but that this is not the case in the less regulated UK, and their main evidence is an efficiency-frontier estimation of relative cost inefficiencies in the two markets. However, several things concern me about their interpretation of this evidence.

First, looking at a single data point for the period 1992–4 for each firm may not be enough. Apart from measurement errors and random fluctuations in costs, a firm that, for example, ran an aggressive advertising campaign, set up new offices, or hired and trained sales staff in this period, might not see the fruits of its investment in the form of increased business until a subsequent period. This seems particularly important for a method that depends on constructing an efficient frontier, so may be very sensitive to a single point. Since the estimates of the efficient frontiers are likely to be so sensitive to outliers, comparing average efficiencies based on them may be a poor test of the authors' claim. A better test may be to look at the dispersions of estimated efficiencies of firms in the two economies.

In fact the standard deviation of estimated efficiencies of German firms is 0.19 of their maximum efficiency (0.40 of their mean), whereas the standard deviation of estimated efficiencies of British firms is 0.24 of their maximum (0.43 of their mean). To me this suggests less effective competition in the British market! Certainly, I don't think these data prove the case that the German market is less efficient. More informal evidence – for example, the great 'mis-selling' scandal in the UK pensions market (a market that shares many similar features with life insurance) – also suggests caution about full deregulation. More generally, I think more could be learnt from experiences in related markets, particularly pensions and perhaps also banking; and I would have liked to see more discussion of these.

So while I support much deregulation, including in this market, I see some merit in regulating contract conditions. Standardizing terms and conditions improves transparency and reduces buyers' search costs, increasing the competitiveness of the market and reducing the risk of another mis-selling scandal. A relatively small number of policies should enable the markets to be fairly complete (just as having only a few mutual funds is sufficient to allow investors to get wherever they want in the stock market by using linear combinations of them) while providing much greater transparency. Transparency might particularly be improved by separating out the insurance and savings components of 'life insurance'.

Also, while I support the provision of additional information to allow consumers better to assess the solvency of individual insurance companies, I am less confident than the authors about the extent to which this can substitute for solvency regulation, given plausible levels of consumer rationality. Whether the regulation has to come from the government, or can come from a private organization – for example, companies could be required to maintain a particular credit rating from a private service – is less clear.

Finally, I would welcome stronger systems for dealing with consumer complaints. I might consider standards about the speed with which companies settle claims, etc. and I would make more data about these things public.

Writing from Germany, Rees and Kessner seem very confident that the grass is greener on the British side of the regulatory fence. Sitting in the UK, I feel less certain of that.