

Towards a Good Governance in Financial and Insurance Services: Transparency in the Life Insurance Industry in Italy

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Transparency plays a central role in all aspects involving good governance and business ethics: this is even more true in an industry such as life insurance, for which trust and long-term relationship are key cornerstones. Transparency of life and pension products is currently a burning issue in Italy for several reasons, among which the fact that life insurance is gaining ground as one of the most popular saving vehicles and that a new pension reform was recently approved by the Parliament, paving the way to a more important role of insurers in the provision of supplementary pensions. Current criticism towards the industry focuses on regulatory differences between insurance and finance, particularly in the area of distribution and disclosure. Actually, such differences are not substantial and, thanks to regulatory initiatives – including self-regulation, are quickly disappearing.

The Geneva Papers (2005) 30, 443–450. doi:10.1057/palgrave.gpp.2510039

Keywords: life insurance; pensions; financial services; regulation; disclosure; distribution

Transparency, good governance and corporate social responsibility

Good governance and corporate social responsibility are among the most widely debated issues in the business community. Both concepts might be expressed concretely with the statement that the goal of a corporation is to optimize the so-called triple bottom line: economic, environmental and social. While for the first two items there is little to be added to clarify the concept it might be useful to dig into the third. Social bottom line means how shareholders take into account other stakeholders' interests. For a corporation, normally, other stakeholders are clients, government, employees, and other companies with which there are some business relationships. In this context, it is clear that transparency plays a central role in all aspects that involve good governance and business ethics and this is particularly true in an industry such as life insurance for which trust and long-term relationship are key cornerstones.

Product transparency in the spotlight

Currently in Italy a key issue is transparency in the life insurance sector with specific focus on product transparency. This issue is a crucial one for the following reasons:

- financial institutions are under media attack for recent financial scandals in which banks have been accused of being responsible of misselling, of having sold risky assets to retail customers, and of sometimes having also conflicts of interests;
- a new law to safeguard household financial savings is under discussion in Parliament and a possible reform concerning financial supervisory authorities is also under scrutiny;
- life insurance products are gaining ground as one of the most popular saving vehicles, particularly thanks to traditional policies that offer minimum return guarantees;
- a new pension reform has been approved by the Parliament, in which insurance companies are expected to play an even more important role in the provision of supplementary pensions.

About the first point mentioned above, it must be said that Italian insurance companies have not been involved in any financial scandals thanks to the fact that they have been prudent in their asset allocation and that they operate exclusively as asset managers of diversified financial portfolios.

Towards a new model for financial supervision?

As to the second point – the reform of financial supervision – the focus is, again, mainly on banks rather than insurance companies, but there might be important implications as well for the insurance sector. There is currently a wide debate in Italy about the ideal shape of financial supervision, and a preference seems to emerge, among both academics and politicians, for the so-called “functional” supervision: this could lead to a “three-peaks” model, consisting of an authority responsible for system stability, another one for competition and antitrust, and the last one for transparency and information. At the moment, in Italy, a hybrid model is in place, which combines features of both a functional approach and an “institutional” or vertical approach.

Growth of life insurance in Italy in the last decade

About the third point we believe it useful to state, at the beginning, that the current success of life insurance in Italy is not driven by regulatory arbitrage, as it is sometimes suggested: a sort of Say’s law according to which it is the supply that creates its own demand. If we look at the numbers we can see that the increase in life premiums over the last 10 years has been impressive (Figure 1); that this growth has brought Italy closer, in terms of premiums ratio to GDP, to other European countries (Figure 2); and that Italy is still well behind most other EU countries in terms of life technical provisions – corresponding to asset under-management (Figure 3).

It is quite likely that supply has played a role in this process: product innovation, new distribution channels and competition have all been intense in the period. But it is also evident that the recent ramp-up of life insurance in Italy has been strongly supported by demand, by real pension needs of Italian households that the industry has been able to meet. And that there is scope for further development, independently of the regulatory environment.

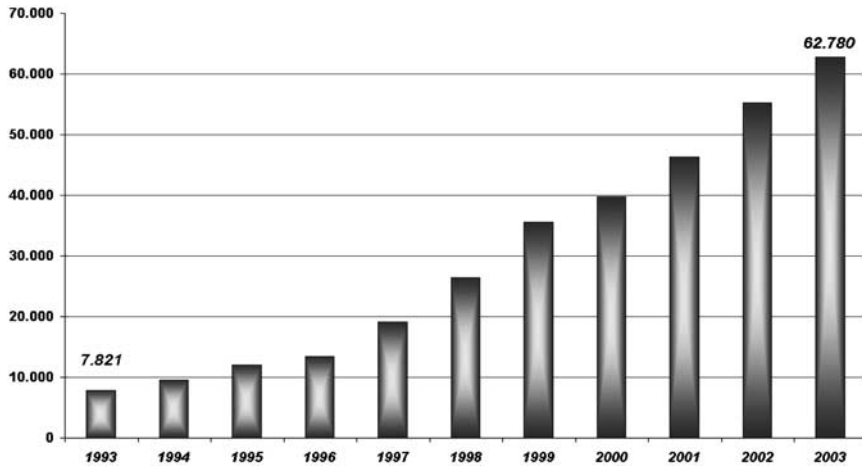


Figure 1. Life premiums in Italy 1993–2003 (euro million). Source: ANIA.

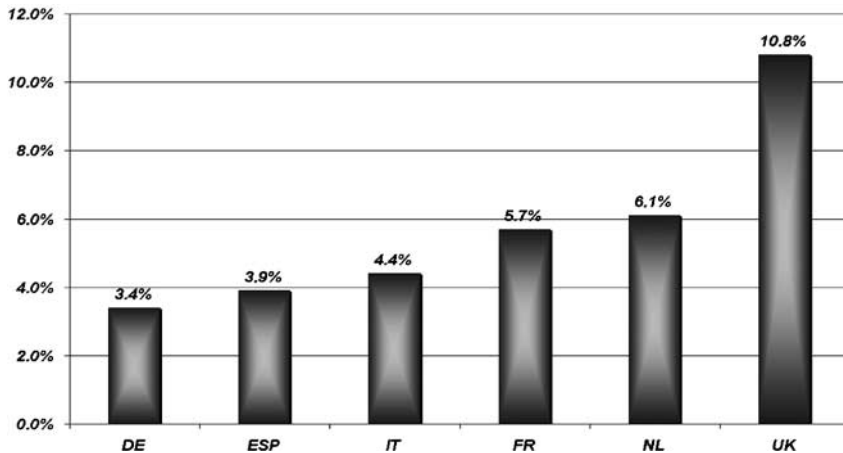


Figure 2. Life premiums as per cent of GDP in major European countries (2002). Source: CEA.

Reforming the pension system and promoting supplementary pensions

Coming to the fourth point, a new law reforming pensions has been recently approved by the Italian Parliament. It may seem that reforming the Italian pension system is a never ending process. To speak frankly, much has been done in the last ten years but much still remains to be done in order to assure the financial sustainability of the public pension system in the long term. The recent reform, however, takes a step towards the right direction, at least because it aims at promoting the development of

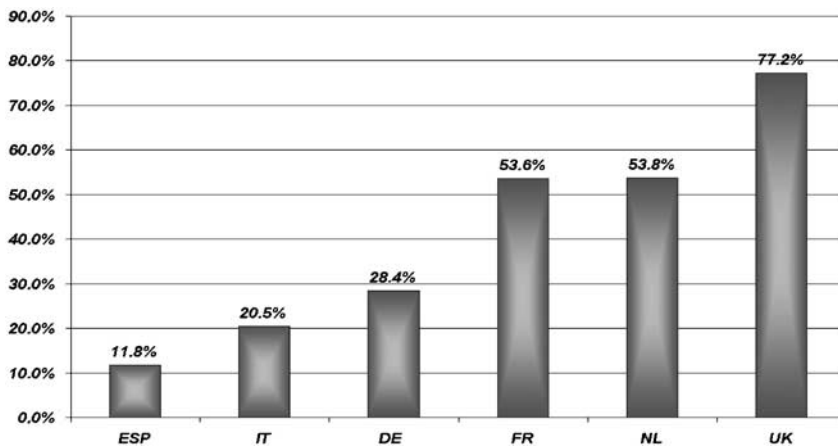


Figure 3. Life provisions as per cent of GDP in major European countries (2002). Source: CEA.

supplementary pension plans. Among the measures introduced by the reform, the following seem particularly important:

- the opportunity for the employees to invest in the so-called TFR (reserves that companies must set aside against future severance payments) in whichever pension plan they choose;
- the creation of a level playing field for all the different types of pension plans: occupational pension funds, financial pension plans offered by intermediaries either on a collective or individual basis and insurance policies. This is crucial in order to guarantee freedom of choice and competition in the pension industry;
- a new, more favourable, fiscal regime for contributions to the pension plans.

The principle of a level playing field in this area is fully supported by the insurance industry; it is therefore essential, for policymakers and for the market, that all pension vehicles be requested to comply with the same level of transparency.

Areas for criticism

For all the reasons mentioned so far stakeholders have recently put much attention on the life insurance market. Indeed the Italian insurance supervisory authority has issued more regulation in the last three years than in the previous ten years. Notwithstanding this, there is still criticism of the sector, not justified in our view, particularly in the following areas:

- distribution: weak professional standards of insurance intermediaries, especially when compared to the standards applied to financial advisors;

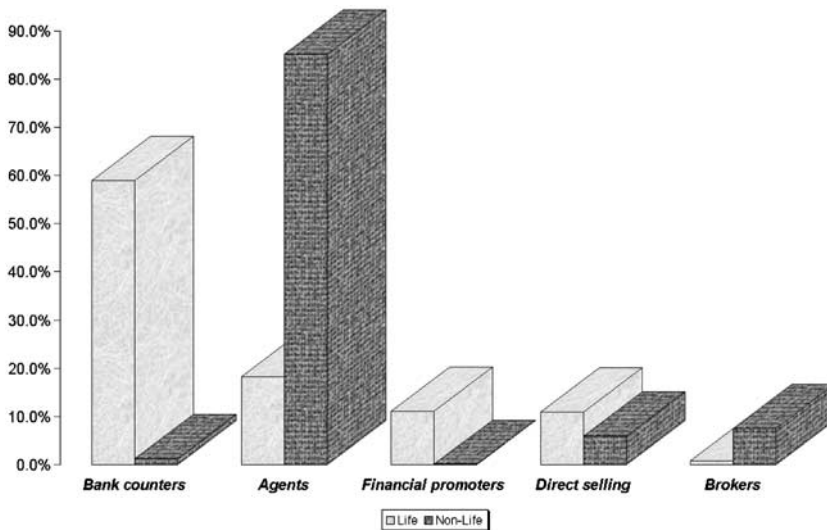


Figure 4. Distribution channels in the Italian life and non-life insurance industry (per cent of premiums, 2003). Source: ANIA.

- low transparency standards, in particular in the area of traditional product asset management;
- high costs expressed as premium loadings.

An evolving distribution system

This is an area where debate in Italy has always been lively. For a long time two main actors have played a prominent role in the market: agents and brokers. At the beginning of the nineties, banks entered directly into the market and gained a large market share in life insurance. Direct selling through mail, telephone and Internet were then introduced both by existing insurers and newcomers. The final outcome is a quite diversified distribution system, with banks leading the way in life and agents (and, to a lesser extent, brokers) still playing a crucial role in non-life insurance (Figure 4).

Professional standards in insurance distribution

Criticism in this area stems from the fact that, in the past, only agents and brokers had to comply with professional standards and had to register in a list kept by ISVAP, the insurance supervisory authority, while there was no particular standard for those working for a registered agent or broker or for a bank operator selling insurance policies in the bank premises. However, it must be recognized that agents, brokers and banks were held responsible for the behaviour of their staff and that agents and brokers, members of a professional body, could lose their qualification if they did not comply with their professional ethical standard. In any case, things are rapidly

changing, due to initiatives of ISVAP and to the forthcoming implementation of the EU directive on insurance mediation. All insurance intermediaries (not only agents and brokers) will have to:

- receive sufficient technical training from the insurance company;
- be included in a list of appointed insurance intermediaries kept by the supervisory authority; this inclusion is subordinated to the proof that certain professional requirements are met;
- abide by professional standards set by law, such as offering the best product for the policyholder needs, avoid conflict of interests, giving all relevant information to permit a rational choice to the client.

We believe therefore that distribution standards in the life insurance sector are coming very close to those of other financial products and that criticism is not fact-based anymore.

Disclosure for traditional with-profit products: outstanding issues

Coming to the issue of transparency, critics focus on traditional with-profit participation products. Such policies basically present smoothed returns, a guaranteed minimum return that is often consolidated on a yearly basis and a profit participation calculated on realized gains and financial yields of a well-defined fund (Figure 5).

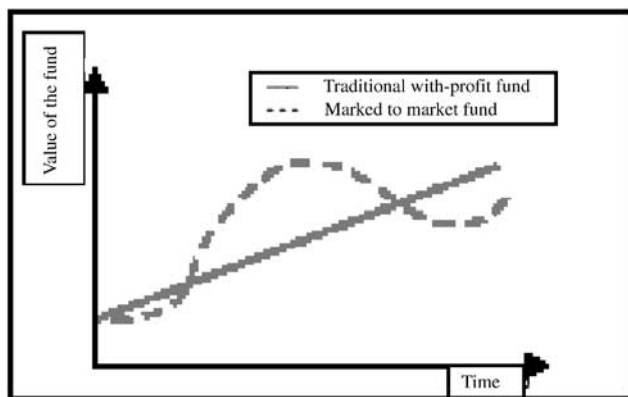


Figure 5. Traditional with-profit vs. marked to market funds.

Companies are liable with their own capital for the contractually guaranteed minimum return: in other words, if the fund does not produce enough return to meet this obligation the company must integrate the fund itself. The technicality used to manage this kind of products is based on accounting rules used to determine returns distributable to policyholders: assets are not valued on a marked-to-market basis but on a book basis, which means that capital gains are attributable to policyholders only when they are realized. Companies, as additional safeguard to policyholders, must:

- keep a solvency margin according to European regulation;

- build an additional reserve if assets' expected returns are not sufficient to meet minimum liability obligations;
- register the assets included in the funds: such assets cannot be confused with other assets of the company and independent accountants certify their returns.

Market vs. book value

Critics also focus on the missing disclosure of the market value of the individual funds (while the market value of the entire company assets is disclosed). While in principle this kind of disclosure is fair, we must notice that there are some risks in doing this such as:

- funds shopping: in fact, large clients would tend to enter into funds where unrealized capital gains are higher, potentially diluting yields to existing policyholders;
- conflicts between different cohorts of policyholders, since this product mechanism tends to create a redistribution of returns between different generations of policyholders by subtracting some return to some and adding it to someone else;
- short-termism. The issue of short-termism is a particularly sensitive one, since it leads to the core of the insurance activities. The life insurer takes up long-term obligations towards the customers and has to match them with long-term investments. This long-term attitude represents a typical feature of the insurance industry and, as such, it should not be influenced by the type of accounting environment.

However, disclosure of market values might be introduced, provided that ways can be found to mitigate the impact of the critical issues mentioned above.

Cost disclosure

Let me come, in the end, to the issue of cost transparency. Here criticism frequently refers to the high level of life products loadings in comparison to the costs of other financial products, such as mutual funds. In this area we sometimes see a psychological effect, in particular if we consider long-term recurring premium policies. The fact that insurers tend to express loadings also on premiums might have as an effect to overstate the real cost in comparison to mutual funds that express cost often only as management fee as a percentage of assets under management. Life insurers, however, support higher levels of disclosure also through self-regulation: a proposal for a new, simplified set of basic information for personal pension plans, for instance, has recently been submitted by the industry to the competent authorities.

Conclusion

Life insurance in Italy has been a fast-growing industry in the last decade. Reasons for success lie not only on the supply side but also on the demand side: it is a clear sign of insurers' capacity to meet the insurance needs of Italian households, not a side effect of some sort of regulatory arbitrage.

Current criticism towards the industry focuses on regulatory differences between insurance and finance, particularly in the area of distribution and disclosure. Actually, such differences are not substantial and, thanks to regulatory initiatives – including self-regulation – they are quickly disappearing.

The Italian insurance industry is firmly striding along the path towards higher standards of disclosure, because it is convinced that this is the way to reinforce trust in the market and thus support the important social and economic role that the industry is expected to play in the future.

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