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Insurance, Investment and the Single European Market

Abstract: This paper considers the development of the insurance and investment markets in the EC from an historical and legal point of view. The likely changes as a result of the Single European Act are also considered together with possible ways of ensuring that the spirit of the Act is met. Finally, the paper considers the role of the actuary in the single european market.

Introduction:

The subject of this paper is the evolution of the single capital market and the single market in insurance and investment in the EC.

This paper is divided into several short sections as follows:

1 The justification for the single capital market and insurance market
2 The legal justification for the single capital and insurance market
3 The requirements for a single capital market and a single insurance market
4 The evolution of the single capital market since 1958
5 A comparison between the current market structure and the single market ideal
6 Ways of achieving the single market
7 Implications of achieving the single European market ideal for the actuarial profession

Part 1: The Justification for a Single Capital and Insurance Market:

The economic benefits from a single capital market are well known: borrowers can obtain capital from the cheapest source; savers can obtain higher rates of return from capital; as a result of these factors, capital will tend to flow towards its most efficient home, assuming that interest rates broadly speaking reflect rates of return from capital; in addition to these benefits, investors will be able to benefit

through diversifying investment portfolios. However, paradoxically, it is worth noting that if the single market leads to a convergence of Europe's economies and financial markets it may well become more difficult to take advantage of diversification because investment markets may become more cohesive.

A genuine single market in insurance and investment will allow individuals and companies to purchase insurance from the most efficient provider and should lead to increased efficiency and innovation due to the effects of competition. In addition, a single market should give rise to greater economies of scale in the provision of insurance, although the extent of these is possibly oversold.

Part 2: *The Legal Justification of a Single Capital Market and Single Market in Insurance:*

It would appear that the twin objectives of obtaining free capital movements and a unified insurance market in the EC are shared by the relevant law making authorities in the EC. In Article 67 of the Treaty of Rome, signed over thirty years ago, it states that "Member States shall, to the extent necessary for the proper functioning of the common market, progressively abolish as between themselves restrictions on the movement of capital." Whilst the intention behind this Treaty Article is quite clear, in legal terms it is somewhat vague. The phrase "to the extent necessary for the proper functioning of the common market" can be interpreted in many different ways.

Article 71 of the Treaty of Rome states that "Member States shall endeavour to avoid introducing any new restrictions which affect the movement of capital". Again, this is not the most specific of statements. Article 71 also seems to suggest that member states should be allowed to determine the degree to which there should be free movement of capital according to the economic and balance of payments situation as they see it.

Directives adopted in 1961 and 1962 were much more specific and defined various categories of capital movement which were subject to different degrees of liberalisation. European Court of Justice rulings and a further Directive in 1986 clarified the situation further: this latter directive extended compulsory liberalisation of capital movements to long term commercial credits and non-stock exchange securities. Spain and Portugal were allowed an extended period of time to comply with this directive and Greece and the Republic of Ireland were allowed to maintain restrictions by virtue of a safeguard clause in Article 108 of the Treaty of Rome.

The Single European Market Act makes the situation very clear indeed. Article 8a of the Act states "The internal market shall comprise an area without frontiers in which the free movement of goods, persons, services and capital is ensured in accordance with the provisions of this Treaty."

The distinction between capital movements and the provision of financial services is a very difficult one to draw, as shall be explained in Part 3. The freedom to provide services however is a basic right of all European Community citizens and limitations on that right, by member states is only lawful when such limitations are based on the general interest and are non-discriminatory.

Article 106 of the Treaty of Rome states that "Each Member State undertakes to authorise, in the currency of the member state in which the creditor or the benficiary resides, any payments connected with the exchange of goods, services or capital, and also any transfers of capital and wages, to the extent that the movement of goods, services, capital and persons is freed as between Member States in application of this Treaty."

It should be clear that Article 8a of the Single European Act also refers to the free movement of services.

The provision of services across borders can, of course, take place without any corresponding movement of capital (it may, for example only involve payments to factors of production); similarly, the movement of captial can take place without the provision of any services. Very often, however, as is made clear in the next section, the provision of a service will imply the movement of capital and it is difficult to separate the two twin issues of the single capital market and the single market in financial services. It is clear from the Treaty of Rome, Article 106, however, that the legal position regarding the free movement of financial services is subject to the slightly weaker legal status of the free movement of capital.

It would appear, therefore, that whilst the Treaty of Rome was relatively clear with regard to the provision Member States must make to liberalise capital movements and trade in financial services, there was also a clear loophole which Member States could use; the Single European Act contains no such ambiguity however.

Part 3: The Requirements for a Single Capital Market and Single Market in Insurance:

The single market in insurance and the single capital market are often discussed as if they were two separate and unrelated elements of the single market programme. As has been made clear by Servais (1989), this is not the case. The most important players in the market for long term capital, in any country which has a relatively free market in insurance and pension provision, are insurance companies and pension funds; the unified capital market is therefore inextricably linked with the single market in

insurance.

Consider, for example, a situation whereby the West German insurance market were regulated in such a way that U.K. insurance companies, or unit trust companies, could not sell unit trusts (the European equivalent of U.S. mutual funds) in West Germany, which invest in U.K. assets; whilst the removal of capital controls may allow a West German unit trust company to invest in U.K. assets, if the market for unit trusts were fairly vestigal in West Germany, restrictions on the sale of that type of policy by a U.K. company would provide an effective bar on capital movements.

Restrictions on the sale of certain types of policy (or rules which make their development very difficult), regardless of whether its origin were domestic or foreign, would certainly provide a very effective check on capital movements.

Thus, if we are to have a true single capital market, we require a true single market in insurance which would involve developing an insurance market relatively free of regulation.

There are many other types of regulation of insurance companies that can also provide an effective control on capital movements: for example, if terminal bonuses are not permitted on policies, this makes investment in any asset, the income stream from which is uncertain, more difficult (and therefore makes foreign currency investment relatively unattractive); the imposition of certain accounting techniques, such as the valuation of assets at the lower of book and market value, which prevent insurance companies from bringing capital gains into asset valuations until they are realised, must also reduce the incentive to invest in assets which have an uncertain income stream.

These two factors particularly reduce the incentive to invest in equity type of investments yet it may well be equity investments which are most likely to be considered when examining the possibilities for overseas investment. Equity investments, from wherever they emanate, are inherently real investments and can easily be justified on grounds of diversifying an equity portfolio; an international fixed interest investment, on the other hand, is denominated in a foreign currency and unless high prospective returns are anticipated, would normally only be considered if it were required to match overseas liabilities.

Imposing guaranteed surrender values also discourages an insurance company from investing in assets with an uncertain income stream; often investment restrictions which require an insurance company to invest in bonds issued by the domestic government are justified because guaranteed surrender values had previously been imposed by the government.

Other obvious controls on insurance companies and pension funds which restrict the creation of a single capital market are explicit controls on overseas investment. These may take the form of explicit exchange controls or may merely be controls on insurance company and pension fund investment.

Thus, if there is neither a single market in insurance and pension fund provision with a relatively low level of regulation or one which allows the mutual recognition of the regulation of other countries, the single capital market will be that much more difficult to achieve in anything other than name.

The argument can also be pursued contrawise: if there are significant controls on capital markets, such as exchange controls, the conditions necessary for the existence of a single market in insurance and pension provision will not have been met. The existence of controls on the exchange of currency, in the country receiving premiums, may prevent the provider of the contract matching its liabilties by currency if the liabilities are denominated in the home currency of the contract purchaser.

Exchange controls in the country of residence of the purchaser may prevent an individual from purchasing a contract the benefits from which were denominated in the currency of another country, even if an insurance company had actually established a branch in the country of residence of the purchaser. Thus the existence of exchange controls would provide a block on the freedom to market and sell insurance and pension policies in different member states of the EC.

The argument pursued above is not necessarily suggesting that the single capital market or a liberally regulated insurance industry is necessarily a good or a bad thing; it is merely being suggested that one cannot consider the single capital market and the single market in the provision of financial services in isolation from each other. A large part of the market for financial services is the market for insurance and pension provision.

Part 4 The Evolution of the Single Capital Market since 1958:

This paper is not intended to provide a history of contols on capital movments; a detailed history of that subject is contained within Booth (1989) and the references contained therein. In general, it has to be said that EC countries have not responded particularly quickly to the Treaty of Rome article regarding capital movements and even less quickly with regard to the liberalisation of the market for financial sevices. This is probably best illustrated by a few examples below.

In the 1960's and to a lesser extent (due to the existence of floating exchange rates) in the 1970's,

controls on capital movements were dictated by balance of payments considerations. A trend towards liberalisation began in the 1980's and from 1985 onwards, this tended to move in conjunction with financial liberalisation.

EC countries will be dealt with below roughly in the order in which they signed the Treaty of Rome:

The West German government, which had no adverse balance of payments problems, during the 1960's, did not impose restirctions on the outflow of capital although, from time to time, restrictions on the inflow of capital existed. Significant restrictions on the marketing of insurance products and insurance company and pension fund investment still exist however and, as has been explained, these must provide an important block on the achievement of both the single capital market and the single market in financial services.

The situation in the Netherlands is relatively free with regard to the movement of capital and the freedom to market insurance policies. At times there has been a requirement to conduct capital account transactions through a separate exchange market: it is probably the case, however, that these have rarely been effective in impeding capital movements.

France and Italy took around 32 years to comply with Article 67 of the Treaty of Rome; however the Italian government could probably maintain that balance of payments problems did not permit liberalisation earlier. There are still considerable restrictions on the freedom to market financial services and on portfolio investment of indigenous companies marketing financial services in the domestic market.

The U.K. government took 5 years to remove controls on capital movements after having signed the Treaty of Rome. In addition, it can be said that the U.K. government does not maintain controls on financial services in a way which would impede the movement of capital or impede the creation of a single market in insurance or pension provision.

Belgium and Luxembourg have maintained a dual exchange market throughout most of the period since the Treaty of Rome was signed. The very small spread between the official and financial rates of exchange for most of the time during which the dual exchange market has been in operation does suggest however that the linkage between the two exchange markets has been such that capital flows have not been effectively impeded.

It can be seen, just from these few examples, that the EC ideal of a unified capital market and a

market in which financial services can be freely traded was not achieved quickly after the Treaty of Rome was signed. The situation broadly evolved so that explicit exchange controls were removed, after a long time lag, whereas the freedom of insurance companies to market financial services within the EC and to invest in other EC countries did not materialise. As has been stated, however, the issue of a unified capital market and a unified market in financial services provision cannot easily be separated.

As has been mentioned, there was considerable liberalisation in the 1980's, with 1985 being a year when a number of changes took place [see IMF (1986)]. Direct and portfolio investment restrictions were relaxed in that year in Denmark, France, Italy and Spain.

It is of interest to move and look at the situation as we approach the implementation of the single European market, bearing in mind Article 8a of the Single European Act.

Part 5: The Current Market Structure:

Controls on exchange and other capital controls have now been abolished, in all except a small number of cases (normally in countries which have currencies which are not widely traded). However, there are such wide differences between the regulatory structure imposed on the provision of financial services in the EC that it would be very difficult to argue that a single market exists for financial services; this must inhibit the creation of a single capital market. Once again, a number of examples will serve to illustrate the point.

Broadly speaking, the regulatory systems in the Netherlands, the U.K. and Ireland could be described as liberal and they probably do not impose a constraint on the creation of the single capital market or the single market in insurance and pension provision. In the U.K., insurance companies from other EC countries can establish themselves subject to exactly the same regulation as that which would be imposed on a U.K. company; however, the head office may be regulated more strictly by the government of the country from which the insurance company emanates.

In most continental countries the situation is considerably different. In West Germany, for example, all products which are sold must first be approved by a regulatory authority and approval can take many years; product innovation is therefore very difficult. EC countries outside of West Germany must also obtain approval from the West German authorities in order to sell products in West Germany.

In addition to restrictions on product development there are also investment controls which prevent more than 30% of assets being invested in equities, in respect of most liabilities. Assets must be valued

at book value which may well discourage foreign equity investment within the EC.

In France there is relative freedom of product design, however overseas investment, particularly in equities, is discouraged because capital gains can only be distributed when realised. Foreign investment is not allowed except to match foreign liabilities and at least 50% of unit linked assets must be invested in French securities.

In Greece not more than 20% of an insurance company's share capital can be invested in equities; with regard to all equity investment, only Athens quoted companies can be held.

In Belgium technical reserves must be matched by assets held in Belgium.

In many countries, premium rates are determined by regulation and guaranteed surrender values are compulsory.

Part 6: The Single Market in Insurance: Which Way Forward?

Thus it can be seen that the existence of a plethora of restrictions on insurance companies, which have no uniform pattern across Europe, means that we are probably a long way from establishing a single market in insurance and pension provision. As has been explained in Part 3, these restrictions and regulations also imply that the single capital market is also probably a long way from being completed.

There are effectively two directions in which the European Community can move from its current situation. Firstly, each EC country could bring in exactly the same regulations so that a company established anywhere in the EC could operate and sell policies throughout the EC, with consumers all knowing that they were buying products regulated by the same set of rules.

Such harmonisation of regulation could be either at a low level of regulation, which would truly create the single market in insurance and investment, or at a high level of regulation. If regulation were harmonised so that an illiberal regime was created, it is difficult to see how the single market would be created in anything other than name.

The second approach to regulation would be to proceed down the route of mutual recognition: the path which has effectively been followed in the U.S. with regard to the recognition of the regulation of other states. By this method of regulation, each country would have its own regulatory system whilst allowing insurance companies operating under the regulatory systems of other countries to operate in

the domestic market. There would probably have to be some minimum level of harmonised regulation (such as solvency margins).

If mutual recognition were pursued, a U.K. insurance company (for example) regulated under U.K. rules, could set up a branch in France selling U.K. designed policies to French residents. This could be pursued on a blanket basis in all areas of insurance or, alternatively, only in certain areas (such as insurance bought by corporations or where the insured, rather than the insurer, makes the initial contact). It is the latter path which looks the more likely route in the short term.

Mutual recognition does have important advantages over harmonisation. Firstly, it is difficult for one country alone to block the progress towards the single market by imposing heavy regulation. If the French, for example, were to impose burdonsome regulation on their own insurance industry by regulating its own insurers, it could not thwart the creation of the single market alone because foreign insurers, under more liberal regulation, could fill the gap in the domestic market.

This aspect will also allow consumers of insurance products to choose between different regulatory systems thus creating competition between the different systems (with governments presumably wishing to move towards that system which was most popular with consumers in order to benefit the domestic industry).

As well as creating competition between systems there will also be an evolutionary aspect; if the different governments wish to put their own domestic insurers at an advantage in the single market, they will have an incentive to create the most desirable regulatory framework for consumers. Thus regulators, who often design regulation which becomes outmoded very quickly, will try to ensure that the insurers under their jurisdiction are regulated by the most appropriate degree of regulation, so that their insurers can compete in the single market.

Thus, paradoxically, it may well be the system of mutual recognition, rather than the route of harmonising regulation which takes the EC closest to the single market ideal. The Second Life Assurance Directive is likely to take us down that route, although it is likely to be in a limited number of fields.

Part 7 The Implications of the Single Market for the Actuarial Profession:

The system of regulation which is adopted will have an important effect on the actuarial profession in the EC. This subject will be covered briefly in this paper and the reader is referred to Haberman (1989)

for a fuller discussion.

If a more liberal system of regulation prevails, whether by harmonisation at a liberal level of regulation or through the method of mutual recognition of regulation, the actuarial profession should strengthen in the EC. If the policyholder is to be protected, a liberal system of regulation puts a greater responsibilty on the actuary in the areas of setting premium rates, policy development, reserving, investment etc. It would be necessary therefore, to maintain high educational standards in the actuarial profession, with educational standards and professional codes of conduct, perhaps, being strengthened in some territories.

If a liberal regulatory regime persists around most of the EC but educational standards are not strengthened in some territories, it may be necessary to use a system of practising certificates so that an actuary, who is theoretically qualified, can only practise in a particular area upon an additional demonstration of competence.

Even if the regulatory system does not evolve into a liberal system in each country, there will probably be changes in the method by which actuaries are educated in the single market environment. Under such a paradigm, it will probably not be necessary for educational standards to be strengthened in those countries which maintain a more restrictive regulatory system (as less responsibilty will be placed with the profession); however, the provisions of the Higher Education Directive will require mutual recognition of educational qualifications and experience requirements. Therefore actuaries who are qualified in one area of the EC may be regarded as qualified in another area of the EC, although they will be bound by codes of conduct prevailing in the host country. The system of practising certificates would ensure that they could not practise under the liberal regulatory regime without first having demonstrated the competence to do so.

If the system of regulation in the EC is harmonised, with a rather illiberal system being brought in, the actuarial profession in those countries where it is currently strong (such as in the U.K.) could weaken, as less responsibilty will be placed upon the actuary. Whilst fears of the actuary becoming little more than a glorified mathematician are possibly exaggerated, some weakening of the actuaries' status is inevitable as it will be necessary for the actuary to display judgement in fewer areas of competence.

Conclusion:

The free market in insurance and investment, in the EC, has taken some time to evolve. Progress is now being made towards the single market and there are various methods of approach towards this

aim which may be taken. The outcome of the single market programme will have an important effect on the actuarial profession both in the U.K. and on the continent, particularly when one also considers the implications of the Higher Education Directive.

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