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Regulating Insurance in the EC - A Model for Global Services Liberalisation?

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1. Introduction

This paper[1] examines the European Community's regulatory regime for insurance with a view to current efforts to achieve a greater degree of market liberalisation on the global level. It draws on Peter Holmes' and Alasdair Young's argument that the EU has pioneered trade liberalisation in a number of sectors, an experience which is a potential model for multilateral trade liberalisation.

The paper describes the evolution of the European method of insurance liberalisation by looking first at the pre-single market stage with its focus on market access and non-discrimination within national markets. Second, the method by which insurance liberalisation was achieved as part of the single market programme is analysed: mutual recognition of standards and minimum harmonisation of rules. Progress in market liberalisation relied heavily on the development of an Article 36 equivalent for financial services. The result is a European regime with a high degree of internal variation in regulatory goals, objectives and 'philosophies'.

The final section looks at how far this approach lends itself to emulation at the international level. It is the contention of the paper that the scope for transposition is minimal. The EU method of insurance liberalisation is less of a model for global service liberalisation and more a lesson in the limits to cross-border liberalisation.

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[1] I am grateful to Peter Holmes, Helen Wallace and Alasdair Young for their help and intellectual support in writing this paper.

2. Why regulate insurance? The example of risk

The issues highlighted here concern only the regulation of risks, and leave aside questions related to the 'level playing field': competition policy for the financial sector and the problem of different regulatory systems governing life insurance and pension funds (see White Paper on Pensions Reform, 1997).

(a.) systemic risk

The aim of government regulation of the financial situation of an insurance company is to protect the policyholder and, more generally, to ensure the stability of the financial system. The financial safety of companies such as banks or insurance firms is crucial to maintaining systemic stability of the economy at large. The bankruptcy of an insurance company can spread to other financial institutions causing financial collapse and loss in trust in the system. It is therefore important that the financial situation of insurance companies is carefully monitored to strike a balance between safeguarding the public interest on the one hand and business risks on the other. Prudential supervision - the control by the government of the solvency of an insurance company, its assets and its technical reserves etc. - has as its goal to ensure the financial soundness of the company so that it can meet its liabilities to policy-holders (Begg and Green, 1996).

(b.) asymmetries of information:

Insurance policy-holders lack the resources to assess the financial viability and solvency of an insurance company. This is particularly true for individual consumers in the small risks market. Asymmetries in information between the company and the consumer can justify the intervention of public authorities. Monitoring the financial situation of companies to ensure that these companies can meet their longer term liabilities towards the policy-holders is one way to increase transparency in the market. Another is to lay down binding rules on the availability of information to increase the power of consumers. This can be done, for example, by regulating the clauses of insurance contracts (McKenzie and Khalidi, 1996).

3. Pre-1986: harmonisation

In the 1974 *Van Binsbergen* judgement the ECJ established that national regulations, requesting that a service provider be established in the country where the service was being offered, inhibit the freedom to provide services in the EC and are thus in breach of Article 59. It took 25 years between the end of the transitional period and the full liberalisation of the insurance market on 1.7.1994 before the freedom to provide cross-border services became a formal reality.

Following the *Van Binsbergen* ruling, the Commission sought to create the conditions for trade liberalisation by attempting to harmonise rules governing insurance on a European level. The first steps towards greater harmonisation were taken in 1973[2] with the First Generation Non-Life Insurance Directive and in 1979[3] with the First Generation Life Insurance Directive 'on the co-ordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of direct insurance[4]'. They laid the emphasis on facilitating the right to exercise freedom of establishment in the market of the seven (Müller, 1995). The aim was to create conditions that would allow companies to set up branches and agencies of insurance undertakings in other member states. The directive set out procedures which made the start of direct insurance business in another member state subject to an official authorisation. It also defined the requirements for obtaining such authorisation (Rawlinson and Cornwell-Kelly, 1994). The country of establishment remained the central regulator, but the directive also included an element of duality combining host country control (country where branches or agencies had been set up) with home country control (the country where the firm had its head office).

The directives developed a formula as regards the calculation of the solvency margin. Control of the financial situation - solvency and financial security - of the insurance company was the competence of the authorities of the state where the company had received its authorisation. The directives' rules on prudential supervision were the first steps towards future harmonisation of essential rules. It established the principle that verification of solvency becomes the responsibility of the state where the insurance company had its head offices. Other aspects of prudential supervision, like the regulation of technical reserves and matching assets, were not harmonised. In

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[2] 73/239/EEC OJ L 228/3

[3] 79/267/EEC OJ L 63/1

[4] Re-insurance is by nature a global business and very different from life and non-life insurance. As a result it will not be discussed in this paper. It has been the subject of early Community legislation (64/225/EEC) but the regulation of this sector has never developed into a coherent system where common rules and principles apply to the entire re-insurance business in the EC.

addition the directives call on member states to take steps towards greater collaboration between regulatory authorities[5].

The first generation directives facilitated establishment, but they did nothing to remove barriers to the mobility of firms across markets. Common rules governing insurance proved difficult to formulate because of wide variations in member states' regulatory systems. With services remaining subject to national control, the added rules on establishment did not challenge member states' regulatory prerogatives. The insurance market remained fragmented despite the efforts of harmonisation by the Commission.

In the hope that the market for large commercial risks was easier to liberalise the Commission proposed a second non-life directive in 1975[6] (Pool, 1990). The proposal was strongly resisted by some member states. With varying systems of market control in place, high-standard member states such as Germany argued that European harmonisation would reduce the level of consumer protection in the enlarged market (Müller, 1995). However, as Sapir, Buiges and Jacquemin (1988) remind that, given the differences in regulatory intensity across member states there was widespread concern among national regulatory authorities that liberalisation of rules would create a situation of competition between national systems. Roth (1988) points to a conceptual influence on the Community's regulatory policy: freedom to provide services was interpreted as being accomplished with the exercise of the right to establishment.

Comprehensive harmonisation of rules required a negotiated compromise on the content and modalities of regulation. As there was little interest after the end of the transitional period in a common market for insurance and considerable concern among high standard countries over the deregulatory consequences of European rule-making there was little incentive to agree. It needs to be pointed out that domestic barriers to cross-border mobility of firms had less to do with overt discrimination against foreign providers than with differing national approaches to regulation (Hoekman and Sauvé, 1994). And, as Streeck (1995) points out, the system of European policy-making gave

[5] Reliance on co-operation between regulatory authorities has been a constant feature of the EC's approach to services liberalisation. However, it is only with full liberalisation of the market that co-operation has gained in practical significance, so much so that in the EC's final schedule of commitments in financial services to the WTO (1999/61/EC OJ L 20/38) it is mentioned: 'The European Communities and their Member States note the close cooperation among the insurance regulatory and supervisory authorities of the Member States and encourage their efforts to promote improved supervisory standards'.

Directive 91/675 OJ L 374/32 sets up an Insurance Committee consisting of representative from member states - chaired by the Commission - with the aim to help the Commission in its obligations as regards insurance. It replaces the Insurance Supervisory Conference, a purely intergovernmental body composed of representative from the national regulatory authorities, set up by the First Non-Life Directive [check]

[6] COM (75) 516 final OJ 1976 C 32/2 and COM (78) 63 final OJ 1978, C 36/14

disproportionate power to groups which had an interest in blocking moves towards European economic integration: industry, regulatory agencies and governments. Commission attempts to formulate common legislation met with resistance if not indifference.

The first insurance directives facilitated establishment and as such created conditions for increased competition within national markets. No steps, however, were taken to strengthen cross-border competition in the provision of services. The facilitation of intra-Community competition had to wait until the 1985 White Paper on the Single Market.

4. Intra-Community liberalisation and the 'insurance case'

Since European harmonisation of rules was resisted by member states freedom of establishment became the prime instrument of market opening. Under the formula developed in the First Generation Insurance Directives control of the market remained with national authorities, but all domestic rules were subject to the test of non-discrimination on grounds of nationality or with regard to the place of establishment of the provider. This strategy invited litigation before the ECJ - as finally happened with the key case *Commission v Germany* launched by the Commission under Article 169 in 1983. It became the turning point in the development of a European market.

In 1983 the Commission brought an action under Article 169 against Germany over its alleged failure to implement correctly the 1978 Coinsurance Directive[7]. Coinsurance concerns the insurance of large (i.e. industrial) risks divided among a number of insurers because of the nature or size of the risk. The Co-insurance Directive set out that the risk had to be situated in one of the member states of the Community and that among the group of insurers one must act as the lead insurer, authorised in one of the member states according to the rules specified in the First Non-Life Insurance Directive . The Directive, however, is silent on where the leading insurer must be authorised - in the country where the risk is situated or established in any member state of the Community. This issue became the major point of contention. Germany was arguing that for reasons of consumer protection the lead insurer must not only be authorised in Germany (which it had to be in any case if it wanted to carry out business in the German market) but that it must also have an establishment there.

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[7] 78/473/EEC OJ 1978 L 151/25

The German insurance supervisory law[8] did not recognise an insurer established and supervised in another Member State as fully qualified to carry out the task of lead insurer.

The action brought against Germany illustrates well the tension between trade liberalisation and the protection of the public interest. In comparison to the other defendants, the demands of the German insurance supervisory law were the most onerous. Since its beginnings in 1901 German insurance jurisprudence had evolved from a system that controlled entry into the market into one which oversaw every aspect of the insurance business (Finsinger, 1986a). With the experience of hyperinflation and the collapse of financial institutions in the 1920s concern over the social consequences of macroeconomic financial instability became deeply ingrained in Germany's post-war regulatory system of *Ordnungspolitik*. The protection of individual policyholders and with it the social dimension of the insurance sector was considered to justify wide-ranging public intervention in the market. As a result, in the mid-80s Germany's market together with Switzerland ranked as the most highly regulated market in all industrial developed countries (Finsinger, 1986b).

The Commission as the guardian of the Treaty was of the opinion that the German requirement as regards co-insurance constituted a breach of Treaty principles, in particular Article 59 and brought Germany before the Court. Taking into account the nature of the risks in co-insurance the Court ruled that German requirements for additional authorisation were not justified. The Court did admit, however, that, where the interests of mass policyholders are at stake, national regulatory requirements can impose restrictions on Treaty principles. In *Commission v Germany* the Court had taken that crucial step to move beyond discrimination. In ruling that the German insurance supervisory law infringes the European principle of freedom to provide services it created a deregulatory momentum in the fragmented market system of the Community. In terms of its impact the ruling intervened directly in the substance and scope of the German regulatory system with the aim to abolish regulatory obstacles faced by firms wishing to supply insurance services from another member state. A closer examination of the Court's line of argumentation and its relevance to the regulation of financial services within the EU follows below.

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[8] Versicherungsaufsichtsgesetz (VAG)

5. *Commission v Germany* (205/84) - the *Cassis de Dijon* for financial services?

The principles of mutual recognition espoused in the landmark *Cassis de Dijon*[9] case became the model on which the Commission built its single market programme. A good legally produced and marketed in one of the member states of the Community can be freely sold in another Member State under the same conditions as in the Member State of origin. As for goods, the removal of the remaining barriers to trade was relatively straightforward. But what about services? Applying the same model of market-opening to services as was done for goods would mean that a service legally produced and offered for sale in one of the member states of the Community could be sold in any other member state and that the authorities of the state of destination were prohibited from imposing additional requirements on the non-domestic service provider. To apply the 'goods' approach to services would imply that disparities in domestic regulation among member states be judged entirely under the principle of whether they inhibited cross-border trade in services.

In *Commission v Germany* the Court maintained that any national law that imposed fresh authorisation as a precondition for an insurer already established in another Member State to carry out business constituted negation of freedom to provide services.

> "Articles 59 and 60 EEC require the removal not only of all discrimination against a provider of a service on the grounds of his nationality but also all restrictions on his freedom to provide services [...]" (Commission v. Germany case 205/84, CMLR, 69, 1987, p.70)

The Court held that for large commercial risks prudential supervision is adequate to ensure the quality of the product. Following the *Cassis* approach the Court determined that member states' regulatory systems provided equivalent standards. Additional supervision in the host country was not necessary to ensure stability in the market. Referring to the gaps in the First Insurance Directive the Court argued that despite its provisions, the conditions for full liberalisation were not yet given; no agreement on technical reserves, localisation of assets and contractual conditions existed. Further harmonisation of rules was required before liberalisation could proceed.

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[9] case 120/78 [1979] ECR 649 [1979]

The Second Generation Non-life Directive[10] filled this legal vacuum. They took the first steps towards fully liberalising the market along the lines that the Court had set out. Liberalisation was to proceed gradually with the large industrial risks market deregulated before the same system would apply to the mass policy market. A threshold for large commercial risks was introduced above which the market was fully liberalised in 1990. By consolidating prudential control on a European basis, these directives opened the way for further deregulation in the mass consumer market. In 1990 the Third Generation Directives were agreed upon which paved the way for the final liberalisation of the sector. The markets became fully liberalised on 1.7.1994

The Second Generation Directives also clarified certain terms and laid down that any permanent presence of an undertaking in the territory of a member state shall be treated in the same way a an agency or a branch, even if it is only an office managed by an undertaking's own staff or an independent person with the authority to act (Rawlinson and Cornwell-Kelly, 1994). This definition was important to ensure that all different modes of supply were not restricted.

6. The general good - Article 36 for financial services?

In *Commission v Germany* the Court held that, given its commercial nature, co-insurance is not a candidate for consumer protection and Germany's claim for the need to have additional requirements was not valid. But, so the Court reasoned, there can be cases where the protection of the public interest warrants a restriction on the application of Treaty principles.

The Court recognised the special nature of insurance, in particular in the mass consumer market. Generally, insurance provides protection against personal risk. Its larger social significance is to meet the needs of individuals and their dependants to provide for the future should loss occur. The extent of reliance on insurance among the population characterises it as a "mass phenomenon" affecting "virtually the whole population" - a situation that makes protection imperative (CMLR, 69, p.102).

> "[T]he insurance sector is a particularly sensitive area from the point of view of the protection of the consumer both as a policy-holder and as an injured person. This is so in particular because of the specific nature of the service provided by the insurer, which is linked to future events, the occurrence of which, or at least the timing of which is uncertain at the time when the contract is

[10] 88/357/EEC OJ L 172/1

concluded. An insured person who does not obtain payment under a policy following an event giving rise to a claim may find himself in a very precarious position" (CMLR, 69, p.102)

Also, the Court identified the issue of asymmetry of information as constituting a particular problem for individual consumers in the mass insurance market. As individual consumers of financial products lack the resources to assess the solvency and general financial viability of an insurance company, improving information flows is an essential part of consumer protection and a precondition to confidence in the market (Wein, 1997).

> "Similarly, it is as a rule very difficult for a person seeking insurance to judge whether the likely future development of the insurer's financial position and the terms of the contract, usually imposed by the insurer, offer him sufficient guarantees that he will receive payment under the policy if a claimable event occurs" (CMLR, 1987, p102)

Following on from this the Court held that given the structural vulnerability of individual insurance policy-holders consumer protection measures are a necessary part of the market. And in the absence of harmonised European rules, the protection of individual consumers in the insurance market would fall to member states.

In *Commission v Germany* the Court has moved beyond right of establishment and non-discrimination to market integration by deregulation. In order to secure freedom of mobility for services in the EC/EEA territory[11] establishment as a precondition to business activity is not necessary. The ruling, however, strikes a balance between opening up markets and larger public concerns. As such the ruling does not sweep away all domestic forms of market regulation that inhibit cross-border services provision, but allows exemptions to Treaty rules if the protective measure can be justified according to the principle of the general good.

Through its case law the Court has developed the concept of the general good which seeks to mitigate the effects of Treaty principles on member states' regulatory systems. Usher (1994) argues that in *Commission v. Germany* the Court has developed a concept for financial services equivalent to Article 36 for goods. Similarly Weatherill and Beaumont (1994, p.589) argue: 'The decision in Commission v Germany also invites litigation, before both the European Court and national tribunals, as a means of establishing the enforceability of specific national rules'. The provisions of the general

[11] The insurance directives are applicable in the EEA area.

good can thus be compared to what Article 36 is for the free circulation of goods in the internal market: given the complexity of the insurance product the need for protection of the individual consumer can justify national protective measures in the absence of Community legislation[12].

High on the list of circumstances which justify exemptions to the market-making Treaty rules is consumer protection, but other matters can equally constitute reasons for the general good. In its Draft Interpretative Communication the Commission identifies a number of reasons, of which the following relate to insurance (Commission, 1997):

- the protection of the consumer;
- the preservation of the good reputation of the national financial sector;
- the prevention of fraud;
- the protection of workers including social protection; and
- the cohesion of the tax system.

From the Court's jurisprudence it follows that a national restrictive measure can be applied to the provision of services if the following criteria are met:

- the measure must be pursuant to the principle of the common good (consumer protection);
- the measures covers an area that has not already been harmonised at the European level;
- the measure must be non-discriminatory; and
- it must be objectively necessary and proportionate to the objective pursued (Tison, 1996, Weatherill & Beaumont, 1995).

It is important, however, to remember that part of the European approach to market creation is the recognition of the 'equivalence of safeguards' (Usher, 1994, p.74). The principles of mutual recognition of licences and qualifications requires member states' regulatory authorities to treat as equivalent the consumer protection measures of other member countries. Of crucial importance here is that the EU system provides access to a system of legal redress. Mutual recognition can only work on the basis of mutual trust. And trust is partly built through experience and co-operation, partly through a system of legal safeguards. And here not only the ECJ plays a role but also national legal systems.

The above analysis shows that the Court has been fundamental in gradually extending the Treaty provisions from right of establishment to supply of services

[12] However, thus far the Court has declined to define the exact meaning of the general good. The Commission has come forward with an Interpretative Communication of the Freedom to Provide Services and the General Good in Insurance Sector which has been criticised by industry for failing to clarify some of the legal uncertainty surrounding the concept of the general good.

across borders. Insurance regulation is by nature of a very complex nature, in particular in countries with extensive systems of protection. The rulings of the ECJ and the Single Market Programme had a substantial deregulatory impact on some member states. However, as Tison (1996) demonstrates, only a fraction of national rules governing insurance has been directly affected by changes at the European level. He distinguished between three areas of law:

(1.) Public law regulating market access: licensing requirements, the legal form of the company, own funds requirements, rules on solvency etc.

(2.) Public and private law regulating how products are offered on the market: rules on advertising, system of insurance intermediaries, professional code of intermediaries, competition law etc.

(3.) Private law regulating the substance of the services: contract rules, setting of premiums etc.

He points out that contrary to the process of market integration for goods (see the distinction between process- and product-related regulation in Peter Holmes and Alasdair Young paper), for services 'product-related rules' of the third type are *not* the subject of EU rules or jurisdiction (see table regulation of insurance in the EU at the end of the paper). It is public law defining the modalities of market access that had to be modified substantially in order to comply with single market legislation. National rules defining such varied aspects of insurance as rules on consumer information, calculation of prices, tax arrangements, company law, abusive market conduct remain national competencies. As long as these measures fulfil the test of non-discrimination and do not interfere with the application of commonly agreed prudential controls the EU systems allows for continued diversity in member states' regulatory systems.

In the area of market access and prudential supervision, no general good competencies can be claimed. As the UK pointed out during the Court proceeding in *Commission v Germany*, the public interest in the market for large commercial risks is best serve by ensuring the solvency and financial viability of the insurance company.

7. What characterises the EU model?

The 1985 White Paper on the Completion of the Single Market (Commission, 1985) had embedded the 'new approach' to liberalisation and developed it mainly for the goods markets. Efforts were then made to transpose this approach to the financial services sector: the principles were harmonisation of minimum rules, combined with mutual recognition of regulatory qualifications and licences. In the insurance business these rules included: calculation of technical provision and the solvency margin, the

conditions for taking up insurance business, and financial prudential supervision (Commission, 1997). The European approach to market liberalisation recognised that disparities in member states' regulatory systems may by themselves be synonymous with restrictions on free movement. The problem was to be overcome by creating a legal framework of mutual recognition that would ensure that an insurance service legally provided in one member state could be sold in any other member state without additional requirement. Of central importance in this system was consistent harmonisation of 'essential rules' rules to ensure the mutual trust of regulatory agencies. As Tsoukalis (1997) points out, transparent and commonly agreed minimum standards are the *sine qua non* in a market characterised by regulatory heterogeneity.

Under the European system the principle of home country control, sometimes called a 'single passport', allows companies which have received authorisation by the regulatory authorities of the country where they are established to provide services across the border into other European countries without authorisation of the host country. Responsibility for overall supervision remains with the country where the company has its head offices (home country). In the absence of common European legislation 'mandatory requirements' (Usher) need to be recognised as mutually equivalent. The main objective of the Second and Third Generation Directives was to consolidate a European minimum floor of common rules over and above which member countries could pursue different regulatory practices as long as those did not interfere with the free movement of services and people.

Another key aspect of the Community's approach to market liberalisation is the emphasis that has been put in the jurisdiction of the ECJ on provisions safeguarding the interests of the weakest parties in the transaction: for insurance the mass policy-holders. This means that, even in a system where insurance companies operate under a single licence, companies can be required to comply with host country conditions as part of the concept of the general good.

Overall, little attempt was made to replace national with European standards. Instead, the aim was to develop a system that would create the foundations of an open, non-discriminatory system. Member states are free to operate their own particular system of regulation above a common minimum floor of harmonised standards provided these rules do not conflict with Treaty principles on cross-border mobility.

The European Court of Justice has been a key actor in the evolution of the Community's regulatory model. In its decisions it tried to go beyond the prohibition of discrimination and has sought to widen the scope of the Treaty provisions to include all measures - discriminatory and non-discriminatory - that impede the free movement of persons, goods and services within the Community (Mancini, 1989; Tison, 1996)).

8. The EU regime and the GATS compared

Could the GATS take the EU route? Is the existing European system for insurance liberalisation a potential model for the multilateral system?

It is the argument of the remainder of this paper that the above account of insurance liberalisation in the EU is less of a model to be followed on the multilateral level than a lesson of what can and what cannot be achieved. The EU experience is of value to multilateral efforts as it shows what the constraints to comprehensive market liberalisation are.

8.1. A single market?

It would appear that the Community approach to insurance liberalisation - the combination of harmonisation of essential rules with home-country supervision - would significantly boost market unification. However, the last years have shown that the EU method has not been sufficient to ensure a fully operational single market in insurance. In that sense, the EU experience holds another lesson for multilateral services liberalisation: which modalities of liberalisation are effective in bringing about a functioning single market and which are not.

The speed of structural change in the intra-Community insurance market so far has been disappointing. The contestability of national insurance markets inside the EU remains limited. The most recent data show that relatively small and specialised countries are profiting from market liberalisation. 74,6% of all premium income in the Irish non-life business and 19.8% of the Irish life business originates from other EU member countries. For Luxembourg the figures are even higher: 94,3% for life and 20,9% for non-life (Eurostat, 1998). In the large, and profitable markets, foreign penetration is still below 20% (European Report, No. 2207).

The preferred method of penetration of markets is the acquisition of, or merger with, companies in foreign market. This allows ready access to distribution, advertisement and consumer networks - key factors in an industry that works according to the 'all business is local' principle in the retail insurance market. Although technological developments have greatly enhanced the tradability of insurance services, local presence in individual markets is still necessary in the retail sector. Corporate behaviour is starting to change however. There have been a number of spectacular cross-border acquisitions in the last years and the number of insurance companies in the EU decreased by 3.36% to 2 995 at the end of 1997 (Eurostat, 1998).

The European approach to market harmonisation does not entail the harmonisation of the characteristics of the individual markets of member states. This is criticised by some observers, who argue that the EU regime allows for too much flexibility with regard to the scope of national rules. Admittedly, the residual powers of the host country regulators remain significant. Not only does the concept of the general good lead to legal uncertainty in the market, inhibiting cross-border activity (Mathews and Pickering, 1995) but continuing variations in member states' regulatory philosophies and practices have acted as a barrier to trade. In addition, cultural attitudes and linguistic difficulties continue to shape customer purchasing behaviour in favour of domestic products.

The main impediments to market integration in the retail sector are:

- tax arrangements;
- lack of harmonisation of distributions systems (intermediaries); and
- lack of consumer confidence in cross-border selling of insurance services.

The Commission argues that it is now up to the insurance industry itself to make full use of the European regulatory system. 'The onus is on market operators to adopt to a changing business environment' (speech by single market commissioner Mario Monti on 18 May 1999). Others argue that it is not the lack of enthusiasm on the part of industry that frustrates the integration of insurance markets but the unwillingness of domestic decision-makers to go further than what is absolutely required. Holzheu and Wolters (1994) point to the regulation of health and life insurance policies in Germany to argue that such a broad range of restrictive national measures continue to be applicable that one cannot speak of a single European market at all. Zimmerman (1994) shows how little German regulatory practice has changed compared to regulatory activity prior to liberalisation.

Product-related regulation for mass insurance policies:	
Insurance contracts:	Premiums:
mandatory submission of contract conditions prohibited, but prototype contract conditions exist for each type of insurance and compliance is obligatory	The prior setting of prices is prohibited, but calculation of premiums standardised according to types or risk

Zimmerman, 1994

The Economic and Social Committee claims that, from a consumer point of view, the Community approach to market making in the insurance sector has failed to deliver consumer confidence in the market. It singles out the lack of common minimum requirements for basic contract conditions and the lack of European regulation of pre-

contract consumer information as constituting obstacles to enhanced cross-border shopping of insurance services (ESC, 1998). Although attempts had been made by the Commission to approximate national contract law governing insurance[13], no harmonisation of basic rules relating to insurance contracts has a yet been reached. The Directive on Unfair Terms in Insurance Contracts[14] is not sufficient to provide a European floor on common rules that would standardise contracts and offer consumers a comprehensive level of protection across the Community.

The adoption of the single passport system was intended to be a mechanism that would work to remove barriers to freedom of movement for services with minimal political intervention. Some observers argue that, ironically, it is the *lack* of European harmonisation of rules beyond prudential supervision that frustrates the creation of a single market. It appears that for mutual recognition to work in the retail insurance market more harmonisation of rules would be necessary. On 5 May 1999 the European Parliament voted to agree to a Commission proposal harmonising consumer provisions covering long distance sale of financial services. The establishment of one coherent set of consumer rules for the entire EU area was actively supported by the industry (Financial Times, 6 May 1999). What the EU experience shows is that liberalisation on the basis of mutual recognition can only proceed with some form of agreement on minimal rules. Consensus on the scope and substance of such 'minimal rules', however, cannot always be easily reached.

8.2. Insurance Liberalisation and the GATS

The lack of a fully functioning retail insurance market in the EU shows that for the *Cassis* approach to liberalisation to work, harmonisation of key rules is required. Clearly, inside the Community the extent and scope of these minimal standards is itself disputed. However, what becomes apparent from the EU system is that, if agreement on minimum standards cannot be achieved, full market opening will not take place. Given the social importance of prudential control of the insurance business, national regulators would not be prepared to trust foreign prudential standards as equivalent to their own. Harmonisation of prudential rules *as well as* a functioning system of legal redress are preconditions to market opening in the insurance sector. Both are not given in the multilateral context.

[13] COM (79) final, OJ C 79/190, amended by COM (80) 854 final, OJ C 355
[14] OJ L 93/95

What is the GATS' approach to insurance liberalisation? Below a brief overview of the main instruments of liberalisation in the GATS and the EU market.

Barriers to trade in insurance - to what extent are market restrictions eased?

instruments of liberalisation	WTO/GATS	EU
non-discrimination among foreign suppliers	most favoured nation principle	prohibition of discrimination on grounds of nationality four 'freedoms'
non-discrimination among suppliers	national treatment	right of establishment right to provide services mutual recognition of standards
freedom to choose any mode of supply	definition of trade in services in Art. 1 mode of supply of services defined in Members' schedules	complete freedom
recognition arrangements	no mutual recognition of licences and/ or authorisations of insurance companies	mutual recognition of national licenses & authorisations
harmonisation of prudential rules	no harmonisation of prudential rules annex on financial services: 'a Member *may* recognise prudential measures ...'	comprehensive harmonisation of prudential rules
other safeguards provisions	individually submitted Members' schedules general exceptions (Art. 14) emergency safeguards (Art. 10) balance of payments problems (Art.12)	'general good' system of 'regulatory pluralism' inside the EU
dispute settlement	Council for Trade in Services commitment to future negotiations of individual schedules	ECJ (Commission)

draws partly on Hoekman and Sauvé (1994)

The table shows that the market liberalisation provisions of the GATS compared to those of the EU are relatively weak. Safeguard provisions exist in both systems, but the GATS employs an even narrower approach than the EU. In the GATS, services liberalisation is taking place only in sectors identified in Members' schedules. 'Sector are negotiated in rather than out' (Snape, 1998, p.280) Also, exceptions and emergency clauses (Article X, Article XII and Article XIV) can allow temporary withdrawal of commitments.

Admittedly, the European system contains considerable safeguard provision too. The concept of the general good, for example, can justify discrimination of foreign providers in insurance retail markets. Also, the degree of internal variation in regulatory practices inside the EU acts as a barrier to trade. But the fundamental differences between the GATS and the EU lies in their approaches to services liberalisation. The GATS focuses on the promotion of national treatment and the most-

favoured-nation principle as trade liberalisation measures. What the GATS approach overlooks is that, when it comes to the highly complex product of insurance, non-discrimination is not enough to secure open markets. The removal of trade barriers (market access) and domestic regulation (national treatment) cannot work if safety concerns are not taken into account. International liberalisation of insurance services requires some form or other of common regulation or agreement on the equivalence of national regulatory systems.

The necessity to have common rules in tandem with market opening measures becomes apparent when one looks at the Community experience prior to the Single Market. Back then, Community activity was directed towards elimination of national rules that discriminated against foreign providers. The First Generation Insurance Directives facilitated the right of establishment to secure equal market access among foreign providers and national treatment among all suppliers. Integration of markets according to the principle of freedom to provide services was, however, not achieved. Market structures began to change only when the Second and Third Generation Insurance Directives were implemented as part of the Single Market Programme. Crucially, the *Cassis* approach of mutual recognition had a significant impact on reducing obstacles to service provision only because it was supported by basic agreed standards. In other words, because of the nature of the risks in the insurance business consensus on essential rules is a precondition to market liberalisation. Liberalisation on a purely most-favoured-nation basis would not work. Agreement is needed to create conditions of trust for national regulatory authorities to treat as equivalent other members' rules on solvency and own funds.

The GATS does not contain such provisions. Neither has it been clarified in the GATS what constitutes prudential control. Point 2. of the Annex on Financial Services says that:

> ' [...] a Member shall not be prevented from taking measures for prudential reasons [...].

As there has been concern that prudential supervision might be interpreted generously by some Members, the paragraph goes on to set down that:

> 'Where such measures do not conform with the provision of the Agreement, they shall not be used as a means of avoiding the Member's commitments or obligations under the Agreement'.

This paragraph illustrates that the GATS does not replace host-county supervision. Under the current GATS system the regulatory authority of the destination state can impose on the foreign supplier additional requirements on grounds of protection of the larger public interest - consumer protection, stability of the financial system, fraud control etc. The approach of the GATS aims at non-discrimination and market access as a means to trade liberalisation. Control over which provider and which service enters the market means that the GATS system does not go 'beyond borders'.

The fundamental difference between the GATS and the EU system is that the EU has made that step from focusing on non-discrimination and market access to trade liberalisation on the basis of mutual recognition and minimum harmonisation. The ECJ cases and the Single Market Initiative have been the turning point where the Community system moved 'beyond borders issues' and in terms of regulatory openness the EU model seems to point in the right way. The weakness of the GATS, however, is that its approach allows for various extensive safeguard provisions and de facto barriers to trade.

The GATS, however, contains scope for closer co-operation among a smaller group of member. Point 3. of the Annex on Financial Services states:

> 'A Member may recognise prudential measures of any other country in determining how the Member's measures relating to financial services shall be applied. Such recognition, which may be achieved through harmonisation or otherwise, may be based upon an agreement or arrangement with the country concerned or may be accorded autonomously'

As mentioned above, a most-favoured-nation approach to trade liberalisation in insurance is not viable. The European experience has shown that market liberalisation based on mutual recognition and home-country control is acceptable only if there are mechanisms and rules that ensure the mutual trust of national regulatory agencies. Given the potentially harmful repercussions of unsound prudential control, agreement on basic rules would always be necessary. Selective mutual recognition, however, is an option. There is scope in the GATS for bilateral agreement to open up insurance markets on the basis of mutual recognition combined with agreement of minimum rules[15]. Bottom-up co-operation between regulatory authorities could be exercised in

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[15] Insurance supervision is the responsability of individual states in the USA. A separate authorisation is required for each state where a foreign insurance companies wants to carry out business. Separate state legislation in the USA could create problems in such bilateral agreements.

order to create a framework for trade liberalisation that goes beyond the GATS but not as far as the EU

8. Conclusions

With the arrival of the Euro the Commission is under pressure to complete the regulatory framework for the wholesale and the retail insurance market in the EU (see Action Plan for Single Financial Market, May 1999). However, it remains doubtful whether economic integration in the insurance market will be achieved in the near future, this is particularly true for the retail sector. Because of the nature of risks in the insurance business, liberalisation can proceed only when there is agreement on some form of common regulation. Mutual trust among regulatory agencies on the appropriateness of prudential control can only be assured with consensus on common rules and access to a system of legal redress. There is, at the moment, no consensus inside the Community as regards the degree of harmonisation above the common floor of prudential supervision. However, as the continuing fragmentation of European insurance markets illustrates, even when there is minimal approximation of rules, integration is not certain. The EC experience is therefore more of a lesson on the limits to multilateral services liberalisation than a model to be emulated.

Regulating insurance in the EU:

aspects of insurance regulation	EU competence	national competence
(a.) *market access*		
prudential rules (solvency requirements, own funds etc.)	harmonised	specific national provisions for 'sensitive' areas such as health or life insurance remain in place
(b.) *how products are offered:*		
consumer protection	Article 129a (+ building consumer confidence in the single market)	national consumer law
company law	-	national competence
accountancy standards	partial harmonisation of accountancy standards (1991 Directive)	residual national competence
winding-up of insurance companies	(in preparation since 1989)	national competence
intermediaries	Intermediaries Directive (1979) supposedly of interim nature only; very restrictive scope	access to the market (qualification requirements) and the regulation of the exercise of the profession remain national competencies
tax arrangements	-	exclusive national competence
(c.) *content of the service:*		
contract conditions	failed directive	national competence
calculation of premiums	-	national competence

draws on Müller (1996)

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