The Internal Market for Insurance : A Reality? *

by Humbert Drabbe**

1. Liberalisation of the EC insurance market

Financial markets, but in particular insurance, are relatively strictly regulated markets. A common objective of Governments in regulating financial markets is to protect clients against failure of banks, insurance companies or investment houses, although other reasons such as systemic risks, for instance in the case of banks, are equally important. Clearly, in insurance the primary objective of public authorities in all Member States is to ensure that insurance companies meet their liabilities towards policyholders and third parties. A second objective is often to strengthen the position of the individual vis-à-vis the insurance industry. Sharing the same objectives, however, does not mean that these are attained by the same means and you will be aware that insurance legislation differs from country to country. It is this second objective which is at the root of the diversity of insurance regulation in the EC Member States.

Traditionally, most Member States in the EC have in the past opted for a so-called "material" approach, concentrating not only on the financial position of the insurer (primary objective), but very much also on a systematic, *prior control* of the insurance product itself i.e. both the policy conditions and the premium.

In other countries, such as the U.K. and the Netherlands, public intervention is more restricted and allows the entrepreneur more freedom to define the products he intends to market, both as regards conditions and premiums. Control of insurance products is *ex post facto* and on a non-systematic basis i.e. *after* the product has been marketed and on an *ad hoc* basis. But to protect the public additional regulations may have been introduced, such as the conduct of business rules in the Financial Services Act in the U.K., or rules in the Netherlands seeking to promote independent brokers acting on behalf of clients.

These approaches towards supervision essentially differ in the degree of security the authorities deem necessary for the protection of, in particular, individuals. Greater stability and transparency of markets is provided by a strict regulation of products and by

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their systematic, prior control. The price, however, one has to pay is less competition, because the insurer has less freedom to take his own decisions as regards product development and price setting. Thus, there is also less choice for the consumer. In developing their supervisory systems over time, each Member State has found its own balance between regulation and security for the consumer on the one hand and competition and a wider choice of products and premia on the other hand.

The third directives provide the main tools for creating the Internal Market for insurance. The Member States have followed the Commission proposals and thus opted for an essentially "normative" approach: systematic, prior control of policies and premiums have been abolished. For those countries which traditionally applied prior, systematic control, these decisions imply an important deregulation with as a consequence that a new balance between regulation and competition will be introduced into their markets.

This is probably the most fundamental effect of the third generation directives. It is not surprising therefore that this issue was at the heart of the negotiations over these directives. The Commission had always argued that the switch to ex-post, non-systematic control was necessary to open up the 12 largely segregated markets in the Community. And indeed, a Community-wide system of prior control is not feasible without a very detailed regulation of insurance products at EC level and a harmonized or centralized form of supervision. That is clearly not a realistic alternative, leaving aside still that consumers would probably not much benefit from such an approach.

The second major innovation is of course the introduction of *full home country control* and the *single licence*: a company, once duly authorized in a Member State, can set up establishments or provide cross-border services throughout the EC (as well as most EFTA countries in the near future). As regards its financial position it will only have to report to the authorities, from which it received its single licence. Administrative procedures to set up new establishments in other Member States or provide cross-border services will be much simpler and tied to defined time-limits. This will greatly facilitate the setting up and running of cross-frontier business.

The abolition of prior systematic control and the introduction of the single licence and full home country control has been achieved on the basis of a relatively limited harmonization of national regulatory systems. Taken together, this will increase competition both within existing markets and between markets of Member States.

This more competitive environment implies that particularly markets, which so far are characterized by strict product control, and their supervisors will need to adapt. *Markets* will be more dynamic, more innovative and companies themselves will now in first instance be fully responsible for the products they develop and sell and no longer be able to rely, as in the past, on the prior consent of the supervisory authorities before they market a policy. There will be a greater diversity in products offered, posing a challenge also to those intermediating in insurance products: competition will be fiercer for them as well and clients will require sound advice and servicing over a wider range of products.

In implementing the third generation directives those countries will, and are, considering what consequences this enhanced freedom for market participants has. Germany, for instance, as a country with a traditional tight supervision over insurance activities, is seeking to strengthen the role of the actuary within the insurance company, very much along

the lines of the system as applied in the U.K., where the company's actuary under circumstances has the duty to report to the supervisory authorities. Measures are also taken to ensure that insurance intermediaries will be adequately qualified, this time inspired by the Recommendation on insurance intermediaries issued by the Commission in 1991.

The interesting thing to note here is that where prior control of policy conditions and tariffs has fallen away as an instrument of supervision, other less bureaucratic and more market-conform measures are taken to achieve an adequate balance between control and freedom, which ultimately should be to the benefit of consumers.

The German example also shows a certain convergence taking place between traditionally quite different regulatory approaches without *specific* legislative measures from the Community requiring this.

More dynamic markets also pose a challenge to the supervisory authorities, which have to rely on different tools to do their job and in general oblige them to follow market developments much more closely than in the past. New products will appear, due to the larger scope for product innovation and because of new legislation, for instance in the field of civil responsibility for products, services, the environment etc. As regards the asset side of the balance sheet new investment products such as derivatives, require attention. The scope of their responsibilities will increase as they will have to "follow" companies in their cross-border activities, leading to an intensification of contacts with their colleagues of the Member States.

Financial conglomerates grouping together banks, insurance companies and investment houses, are an increasingly common phenomenon on the Internal Market. They raise new problems for the supervisors of the three sectors and thus create the need for cooperation between these as well.

All these examples are to illustrate that supervision is becoming a much more difficult task. This has been recognized at EC level and we have taken action by the creation of the Insurance Committee, providing a platform for an effective cooperation between supervisory authorities and serving as a high-level advisory body to the Commission. Also the long-existing Conference of EC Insurance Supervisors is actually reviewing its functioning in view of strengthening cooperation and exchange of experience between control authorities at the more operational level.

These are crucial measures to make the single insurance market work smoothly and effectively. But the new challenges for supervisors cannot be addressed solely by a strengthening of cooperation and exchange of information or experience at EC level.

They may also have to reassess their own internal, structural capacity to cope with the more dynamic environment.

For *consumers*, the internal market should lead to a wider choice of products, competitive pricing and better servicing. There may, however, be an apparent loss of transparency for individual consumers in countries where product control has always been very strict and thus a relatively limited number of products have been "on sale". Without under-estimating the importance of this issue, I think that one can be confident that markets themselves will react when there is a demand for more transparency. In countries which are known for the wide variety of products offered, this does not seem to pose more problems than in other countries although consumer organisations, the press, or independent brokers may traditionally play a relatively more prominent role on innovative markets, because there has been

a more explicit demand for independent advice. The distinction made in the 1991 insurance intermediaries recommendation between dependent and independent intermediaries, has to be seen against this background. The same goes for the provisions relating to standard clauses in contracts laid down in the so-called block exemption for the insurance industry under article 85 of the EC Treaty.

The Commission itself will closely follow market developments. We are about to launch a study on the effects of the second non-life directive, partly in response to a request laid down in that directive, but also to ensure an adequate feedback signalling any potential or real problems for consumers, industry or supervisors which need to be addressed. As the study will cover the first area where the principles underlying the single market approach have been applied, i.e. large risks, it may also provide us with some useful information on what to expect when the single market directives will have entered into force.

Second, together with *Eurostat*, the European Statistical Office, we are in the process of strengthening the existing statistical information regarding insurance. Until now, they are not really of much use to the Commission, the national authorities or the industry. The first aim is to make a much better use of *existing* sources, make these comparable at EC level and available within a reasonably delay. In a second phase we will investigate together with all users, how these could be further developed to their benefit.

So far my comments have been to illustrate that the single insurance market will become a reality. But there are also question marks and these I will address now.

2. Potential and real barriers for the single insurance market

Let us first look at this legal framework itself as laid down in the insurance directives. Then I will address an issue outside the direct scope of the insurance directives which poses a real difficulty for free provision of services, i.e. tax.

The practical objective of the 3rd generation directives is to ensure the free flow of insurance products on the EC market. That means that insurance undertakings must be free in principle to advertise and market any insurance product anywhere in the Community and any consumer to buy any product for sale in the EC. As explained, the introduction of the single licence and home country control and abolishment of prior approval of policy conditions and premiums are instrumental in achieving this objective. However, the directives foresee no harmonisation of contract law. National provisions of contract law determine very much the policy conditions and thus the shape of the product and the possibilities for product innovation. Since contract law differs widely between Member States, the absence of harmonisation at EC level may, it is often argued, seriously hinder cross-border trade: Each product would have to meet the specific legal requirements of each Member State, particularly since the 3rd directives effectively say that, as a rule, the law applicable to the contract is the law of the country of the policyholder.

Not harmonising contract law would thus seem an open invitation to Member States to maintain or introduce restrictions to protect against foreign competition.

Why then did the Commission opt for this approach and not for the more safe route of harmonisation of contract law, which would, in principle, have very much limited the possibility to maintain restrictions to the free trade of insurance products? First, our experiences with the 1979 proposal for the harmonisation of contract law in non-life insurance were not positive at all: Member States were evenly split over the question whether to harmonise or

not. Moreover, the six countries in favour of harmonisation could not agree on one single issue and the proposal therefore did not get any further. Later, discussions relating to article 15 of the 2nd life directive introducing a cooling-off period, showed again a great reticence of Member States towards a harmonisation of insurance contract law.

So the Commission looked for an alternative approach to deal with barriers created by the different provisions in national contract law. The solution was to be found in the case law of the Court of Justice, dealing with reasons which may justify, according to Community law, the maintenance of barriers to intra-Community trade in services.

The relevant law has been very clearly and comprehensively described by Advocate General van Gerven in a recent article.¹ As this publication reflects the underlying ideas of the Commission when drafting the relevant articles of the insurance directives (as well as other financial services directives), I would invite anyone who is interested in this matter to read it. In looking at what restrictions may be justified, I want to leave aside the questions to what extent *discriminatory* measures i.e. where national rules differentiate between services or service providers on the basis of their nationality, can be permitted. Let me just say that these are only allowed if covered by one of the grounds explicitly mentioned in article 56 of the EC Treaty, which refers to public policy, public security or public health. The Court has always been very reticent to acknowledge discriminatory national rules under this heading.

I want to focus on *non-discriminatory* measures which can also be a barrier to trade and which could be justified “in the interest of the general good”. The third generation directives acknowledge that, in the absence of harmonisation, the general good *can* be invoked by Member States to protect the interests of consumers. This principle is laid down in article 28 of the 3rd directives. As the case law of the Court of Justice is applicable anyway and cannot be set aside, for instance, by a provision in a directive, these articles are of a declaratory nature. They simply make clear that one has to consider the Court’s case law to see which restrictions may be maintained and which not.

The relevant case law, in particular for financial services, can for instance be found in the ‘86 co-insurance cases but in fact already goes back to the 74’ van Bingsbergen case. The reference to the “general good” in the financial services directives as a ground for justification is directly based on these cases and on the concept of “imperative reasons relating to the public interest” as it is also sometimes referred to in these judgments.

There was no misunderstanding about this when the Council adopted these directives. Presentations and publications by Members of the Court and its Advocates General – I have already mentioned one such publication – show that the Court itself clearly understands what the insurance directives seek to do.

So, accordance to the co-insurance cases as confirmed by the 3rd directives, Member States may indeed maintain restrictions to protect consumers. But, apart from being justified for general good, any such restrictions must meet two further criteria:

- that protection for consumers may not already be provided by the rules of the State of establishment of the service providers i.e. there should be no duplication rules or overlapping controls, and second,

¹ W. van Gerven, J. Wouters, *Free Movement of Financial Services and the European Contract Convention*, EC Financial Market Regulation and Company Law (London, Sweets and Maxwell, 1993).

- the same protection must not be available through less restrictive rules, i.e. it has to meet a proportionality test.

The Court has thus developed a regime that allows for restrictions by Member States on the fundamental freedom to provide services, but within certain limits justified for instance on grounds of consumer protection. These limits create a kind of “Community filter” through which such legal restrictions will have to pass.

I should like to make a couple of points in relation to this Community filter:

First, in view of the Court’s case law, the Community filter not only applies to legislation restricting free provision of services involving insurance products directly across borders, but also applies to products sold through an establishment or a head office. Provisions of contract law relate to policy conditions and thus the shape of the product. Any product meeting the criteria under the general good test, can be sold on a given market by all licensed to sell insurance, whether established or not.

Second, article 28 of the 3rd directives by referring to the case law on the general good effectively obliges Member States, when transposing these directives into national law, to review their existing provisions of contract law to see whether these indeed meet the criteria set by the Court’s case law. The same goes where new provisions will be introduced. This is an important point as Member States sometimes have extensive legislation relating to insurance contracts. Making provisions mandatory is in itself not sufficient to make them pass the filter.

Third, this Community filter raises an important practical question on what will happen if a company introduces a product which does not meet or seem to meet the legal requirements laid down by the State where the product is marketed. The directives abolish systematic notification and prior approval of policy conditions and premiums and this can no longer be used as a condition for an undertaking to carry on its business. This logically implies that the undertaking no longer has to prove beforehand that its products meet all legal requirements. The Member State where the product is marketed will itself have to prove that the restriction it maintains meets the test of the Community filter, since the restrictive provision may be invalid under EC law anyway.

So the combined effect of the case law and the insurance directives moves the burden of proof from the insurance company to the national authorities. This is clearly very important where insurance companies or consumers disagree with national provisions and feel these are too restrictive and cannot be justified under the Court’s case law.

The Community filter approach does not only apply to national legal provisions in the field of contract law. Article 41 of both 3rd directives explicitly brings rules governing the form and content of *advertising* within its scope. Advocate General van Gerven in his article gives examples of reasons justifying, in principle, restrictions to the free provision of services, including the fiscal coherence of a national tax system. He also states one can expect the Court to expand this list in future.

Not all the examples he gives are of direct relevance to insurance, but where for instance the Maastricht Treaty refers to “the attainment of a high level of health protection”, one cannot exclude that in future restrictions based on such an objective will influence the cross-border trading in health insurance products.

Indeed, the third non-life directive, by referring to the protection of the general good, already recognizes that restrictions may be justified in the case of health insurance, where

it replaces or forms an alternative to cover provided for by social security “insofar as it is necessary to ensure that policyholders have effective access to private health cover... regardless of their age or risk profile”.

To answer the question whether the single insurance market will become a reality, my answer is yes. The legal framework created by the insurance directives in itself provides market participants with the opportunities to realize this objective in practice. Where the absence of harmonisation of contract law would seem to leave, at first sight, an important barrier intact, the Community filter developed in the case law of the Court of Justice provides an adequate, balanced solution between free movement of insurance products and consumer protection.

As mentioned, however, the Court recognizes other “general good” grounds than consumer protection, which may justify restrictions to a free provision of services. I already referred to the coherence of tax systems accepted by the Court in the *Bachmann* case. Since the tax rules very much influence the marketability of insurance products, particularly life assurance products, a few comments seem warranted.

The different *tax treatment of insurance products* clearly raises major difficulties for a proper functioning of the single market. Where life assurance products need to “qualify” to ensure that policyholders benefit from a favourable tax treatment, the tax regime effectively determines policy conditions and the marketability of assurance products. These have to be geared to the different tax requirements of each Member State. Where Member States have defined the presence of an establishment of the insurance company as a qualifying condition for tax deductibility, this is an infringement of the fundamental Treaty principles of free movement of persons and free provision of services, as the Court stated in the *Bachmann* case.

In non-life insurance the principle of territoriality means that contracts covering risks in two or more countries, have to be cut in the same number of pieces to ensure that each Member State where a part of the risk is located, gets its share of premium tax. This clearly affects an efficient cross-border organization of insurance cover, in particular for large risks.

These tax barriers have come to the fore, now that the administrative barriers related to prudential supervision are disappearing. Harmonisation of tax bases and levels could in principle solve these problems, but even when Member States would be prepared to follow that route, it would be a very lengthy process. So to tackle these problems, we have to look for pragmatic solutions.

The *Bachmann* case concerns the deductibility of life assurance premia. Although the Court recognized that a refusal by the tax authorities to grant tax deductibility where the contract has been concluded with a non-established insurer *as such* infringes on the freedom of services and the free movement of persons, such an infringement may still be justified to safeguard the coherence of a national tax system. The Court seems to indicate here that where a country grants tax deductibility of premiums from income tax *with the purpose* to tax the proceeds later when the contract expires, the tax authorities of that country must be in a position to effectively collect the tax which becomes due when the contract expires. This is a very reasonable principle nobody can really disagree with; it would seem that the issue here is essentially one of compliance. Where harmonisation is not a realistic option, a pragmatic answer could possibly be provided by ensuring that the tax authorities concerned receive the information necessary to draw up the tax form and collect the tax due.

It is along these lines that the Commission has recently begun consulting the Member States tax authorities. It is too early to say whether this approach will provide an adequate solution in all circumstances. One country for instance does not tax the proceeds directly with the policyholder, but taxes the capital gains on the investments with the *company* itself during the term of the contract. So how can fiscal coherence be safeguarded when the policyholder has taken out a contract with a non-established insurer, while still allowing him to deduct his premiums from his income tax? To tax the capital gains with the non-established insurer is clearly not a feasible option.

But there is a readiness with tax authorities to see how their concerns can be reconciled with the requirements of the single insurance market. Our first impression is that a system of exchange of information between the tax authorities and the service provider goes a long way in solving these problems, although it may not be sufficient in the situation I just described. Further consultations are therefore necessary.

3. Future developments

To conclude I should like to look briefly ahead and comment on an issue, not only of direct importance for the insurance sector, but with a much wider impact i.e. the ageing of the population in Member States. As a consequence of the decline in fertility and the accompanying increase in life expectancy, the age composition of the Community will show a fundamental change. The so-called old-age dependence ratio, i.e. the number of persons above 60/65 as a percentage of the number of persons in the active age groups, will double from about 21% in 1990 to as much as 42% in 2040, according to a OECD projection. In absolute terms this would mean an increase of the number of persons of 60 years and older from about 70 million in 1990 to some 130 million in 2040. Clearly these are estimates but the trend is sufficiently clear. It is also clear that this development is going to put a very heavy strain on public finance, in particular insofar as systems for retirement benefits and health care are provided through social security and contributions are normally tax favoured. Studies point out that in 1993 total expenditure for retirement benefits on average in the EC countries is likely to amount to 10% GDP.

A doubling of the old age dependency ratio over the next fifty years would thus, other things being equal, lead to a rise in retirement expenditure to about 20% of GDP. This figure still does not take account of the increase in total health expenditure.

Already, Member States do feel the strain on social security systems and are seeking to alleviate the financial charge on them. Amongst other possible solutions, Member States are looking for an increased role for private insurance. In Italy, for instance, a review of the pension system is under way seeking to give a larger share for prefunded schemes to provide supplementary benefits, thus alleviating the pressure on the pay-as-you-go financed public schemes. In France, where prefunded schemes are rather exceptional, the problem is also under consideration. In Germany the debate concentrates on how a system for dependency or care insurance can best be set up.

As said, the scope of this issue goes far beyond the insurance sector and raises major economic, social and political questions.

But it will have a major impact on insurance activities as well. Where prefunded schemes or private insurance might be able to step in to help solve these challenges, it would seem absolutely essential in order to meet the future financing requirements that in

particular any undue restrictions for an efficient asset management are avoided so as to allow for a maximum return on investments. At the same time, however, prudential supervision safeguarding the security of investments should be ensured.

Linking these consideration up with ongoing discussions in Brussels, you will understand why the Commission thinks it is of utmost importance that its proposal concerning the management of pension fund assets will not contain any restrictions for portfolio managers – be it a pension fund itself or external asset managers – which cannot be justified by purely prudential concerns.

Too restrictive currency matching requirements, for instance, prevent an efficient portfolio management and may in relatively small capital markets even lead to an imprudent concentration of risks. Where pension products are provided by life assurance companies the same arguments, of course, apply.

But also service providers other than investment managers, offering the custodian services of safekeeping and administration should not be unduly hampered. This would also negatively influence an efficient management of the investments insofar as these activities are already adequately supervised by the home state of the service provider which could be the case for banks or investment houses which have the European passport for these activities.

Where in relation to *insurance*, Member States may consider a larger role for the industry in areas which traditionally fall within the scope of social security, the approach taken for health insurance in the non-life directive could serve as an example. The “general good” concept which has been incorporated in article 28 of the third directives makes it possible to take account, in a flexible and balanced way, of concerns Member States may have as regards adequate protection of individuals.