TALK BY MR. M.H.M. REID, UNDER SECRETARY DEPARTMENT OF TRADE 2 NOVEMBER 1979

When I was asked to address the association, your officers were kind enough to give me a wide discretion as to the subject. "Something to do with supervision" they said. I recently heard Mr. Skerman, the distinguished actuary of the Prudential Assurance Company speak on that broad subject, and I do not want to be accused of plagiarism. In any event, the framework of supervision has been settled since 1973 and there is nothing particularly new about it. As a further consideration my predecessor at the Department of Trade spoke to you on that theme three or four years ago. I do not want to expose myself to comparison. I propose accordingly to concentrate on the impact that membership of the EEC is having on supervision and to look quickly at the problems of policy and legal technique that it presents to us. I propose also to confine what I have to say to insurance companies. There is an impact on Lloyd's and perhaps also on brokers, but we shall get very tired and cross if some limit is not set to all this.

We start with our own supervisory legislation: the Insurance Companies Act, consolidated in 1974. In it, I distinguish four main processes. (1) The authorisation of companies. For authorisation companies are required to have the integrity, competence and financial resources necessary for the business. Second: scrutiny. This is the continuing process of checking the solvency of companies. It entails verifying that the reserves are adequate for the company's claims experience; that its assets are reasonably (even perhaps conservatively) valued; that the life funds are used strictly for the purpose intended, and that all the reserves are realisable at the time when they are likely to be needed. The counterpart function for the companies is a duty to disclose their affairs in some detail and in a form prescribed by Regulations. The third aspect is intervention. If the signs are that a company is running into difficulty or being mismanaged there is a range of measures to be taken to protect policyholders' interests. Almost by definition, there is no corresponding obligation on companies in this aspect. Finally there is winding up. I do not propose to say much more about this. I hesitate to say that it is a rare event and hence one that need not concern us, for that would be tempting providence. I prefer to say that so little progress has been made in the EEC on winding up that I cannot develop my theme in respect of it.

What I should like to do is to outline what effect membership of the EEC these processes in our legislation so far and then consider where it is likely to take us in future. Though I speak as a layman I want to try to bring out some purely legal problems that we may have to face.

The Treaty of Rome provides generally for freedom of establishment, freedom of services and more generally, a common - i.e. single, undivided market. On the other hand, the Treaty does not prohibit regulation or supervision of insurance by member governments. Indeed, Articles 58 and 60 by implication authorise it. There is in principle some contradiction between the proposition that there shall be a single market throughout the Community for goods and services: and the proposition that nine separate governments may regulate industries within their territories according to their own rules. Those rules, of course, affect the ability of companies to compete with each other. This contradiction is most evident in the case of industries where the regulation is close and detailed. There are few industries where the process is more elaborate than in insurance. Hence there are in practice still nine separate markets though the right of companies to be established in any of them is recognised and observed.

We have to face the fact that the supervisory systems of the member countries of the EEC are not at all alike. Put another way, insurance poses the same problems to governments throughout the Nine, but for reasons of history or national character the answers vary. Put more cynically, the incidence of scandals in the insurance industries of the Nine in the last hundred years has been different.

The authors of the Treaty saw the contradiction and their solution to it was the technique of the Directive. A harmonisation of practice was to be achieved on a basis acceptable to all. It may attenuate freedom of establishment or of services; and it may require self-restraint from governments. But it does tend to create a common market. Four important ones need to be mentioned. The non-life establishment directive; the life establishment directive; coinsurance; and the proposed services or second non-life directive. The first three have been adopted; the last has not. It took the Community sixteen years to agree on the first in 1973. Coinsurance followed in 1978 and Life early in 1979.

They are addressed to Governments and require them within a limited time to modify their legislation or practice to give effect to the Directive's requirements. How it is done is a matter for Governments and Parliaments, but national legislation inconsistent with directives can be challenged before the European Court and probably elsewhere.

The United Kingdom has given effect to the Non Life Establishment Directive by means of Regulations under the European Communities Act. The Regulations enable statutes to be modified without the full normal process of law-making. But they can modify statutes only strictly within the terms of the Directive which lays the obligation on the Government. There can be no corner cutting, or rounding off to make the resulting law consistent or logical. The non-life establishment directive for example does not apply to reinsurance, though the Insurance Companies Act, broadly speaking, does. Hence the modifications made to the Act pursuant to the Directive do not apply to re-insurers. This adds to the complexity of law and of administration. In addition to the categories and divisions established by statute there are cross categories and subdivisions created by the Directive. We have had to make four Regulations to give effect to the Directive.

i) The Insurance Companies (Classes of General Business) Regulations 1977 (SI 1977/1552);

ii) The Insurance Companies (Solvency: General Business) Regulations 1977 (SI 1977/1553);

iii) The Insurance Companies (Authorisation and Accounts: General Business) Regulations 1978 (SI 1978/720); and

iv) The Lloyd's (General Business) Regulations 1979 (SI 1979/956)

None of them presented us with great difficulty or involved great change. The right to be established in the London market was not greatly restricted, but the Act lost its pristine symmetry. I hesitate to say simplicity. In essence our system of authorisation was not changed. We had solvency requirements, we had classes of business and we required information about applicant companies as the basis of authorisation. The EEC requirements simply drew the dividing lines in different places. They did not draw different kinds of lines.

The Life Directive will introduce many more complexities. The provisions relating actually to establishment are not too burdensome. But there are two or three threads of philosophy running through the Directive that are alien to our thinking and legislation. We have come to the conclusion that Orders under the European Communities Act cannot graft upon our English law these concepts from Europe and there will have to be a new Bill in a year or so with these concepts in it. We can then take the opportunity to tidy up the mess in which our Act now is as a result of the first Directive. The Directive casts doubt - to put it no higher - on the virtues of composite companies,ie those doing both life and general business. There is a prohibition on the establishment of new composites, though new composite branches can be created in some circumstances. And there are new rules about the separate management of the life and non-life sides. Ostensibly the reason for this philosophy is that the savings of the life policyholders should be specially protected against the possibility of underwriting errors on the non-life side. But some of us have the unworthy suspicion that there is also lurking about the fear that life profits might enable general business premiums to be shaved; and that, of course, would have a bearing on the competitive position in a common market. A compromise has been reached. The life and non-life sides must be managed separately and the profits of one side may not be used to subsidise the other; but shareholders' funds may be used for the purposes of either. Finally, after ten years, the European Commission must report to the Council on the way that composites have operated in the meanwhile.

The life fund has always had to be kept separate and present legislation provides for this unequivocally, if not always with total simplicity. The separate management requirement may require some further elaboration. If this had been the only point we could just about have proceeded by Regulations under the ECA. As it is not, we need a new Bill.

A more fundamental new point is that in future the life side of the business will require an explicit solvency margin. Hitherto it has been the business of the actuary to ensure that a proper margin of solvency was provided by his techniques for valuing the liabilities and, in some sense, the assets. The continentals, while accepting the validity of actuarial techniques, were not prepared to accept them as the sole safeguard, and in future an explicit margin will have to be provided. Unfortunately, when it came to the point of deciding exactly what should count towards it, there was no complete consensus and the detail - but highly significant detail - had to be delegated to a new working group. Its deliberations are only now in their first stages. The starting points are far apart and the prospective solutions are not likely to be simple. The new Act will have to provide a power to enforce whatever is ultimately agreed through subordinate legislation. Hitherto we have provided for solvency on the life side without statutory provision.

A delay in this instance in implementing the directive is not a serious disadvantage. Meanwhile, national rules prevail and there is no real impairment of the common market, because there is no cross frontier market in life assurance. Until the currencies of the Nine are finally and quite irrevocably locked together, no such market is likely to be developed.

The point I seek to make at present is that another set of Regulations will, in due course, have to be made to give effect to the harmonisation laid down by the EEC. I do not think that, in reality, it will lay any new burden on the life companies here other than that of making sure that their practice complies with new legislation. It will not mean that they have to generate much more profit or pay less to policyholders. They will however have to present their records and accounts differently.

My colleagues in the Government Actuary's Department say that the Life Directive cannot be put into effect without Regulations for the valuation of liabilities on the life side. Perhaps we should have had them already. But they present two difficulties. The first is that the valuation should properly be a matter of judgment by the actuary. If the rules are completely inflexible they will leave nothing to the actuary and are likely to produce wrong results. It is the job of the actuary to see that proper provision is made for events up to, say, half a century ahead. It is in the nature of things, difficult to lay down in statutory regulations how to do that. Parliament, it is said, can do anything but make a man a woman; and a woman a man. But reading the medium or long term future is a pretty stiff task for it too. The solution is, of course, that the regaulations will lay down a minimum standard of liability regulations and the actuary will apply his judgment above that.

But this solution gives rise to a second difficulty and one which perhaps will appeal particularly to this audience: namely the actual drafting of these regulations. You have to draft within the rules for delegated legislation. Specifically, the draftsman must draft in such a way that nothing is left to the Department's discretion. Parliament has been prepared to delegate to Ministers the power to make Orders, subject to its own scrutiny. But it is less ready to delegate to Ministers the power to make Orders which give those Ministers a further discretion. And when you are drafting statutory instruments which indicate principles or standards for the application of technical professional judgment, it is very difficult indeed to avoid drafting to give a so-called double delegation. We may succeed in overcoming these difficulties. If not, the regulations themselves may have to go into the new Bill, perhaps as a schedule; and a power to give ministerial discretion can more readily be set up there. But it will of course require an Act of Parliament with all that that implies in terms of inflexibility to change the rules.

The point I am seeking to make is that in this area we are already pushing at the frontier of what is technically and practically possible in the way of delegated legislation. To reduce the art of actuaries - not in my view the most transparent of professions - to statutory instruments is something of a tour de force. The system may not stand much more. Saki says somewhere that every profession has its secrets; it would not be a profession otherwise. When their secrets are on the statute book, actuaries may begin to worry about their status.

The trouble is that there is more, and probably worse, to come. The Coinsurance Directive, already adopted, says that there shall be harmonisation of matching rules and the Community is at present considering a Directive dealing with the provision of insurance on a services basis - as the jargon has it. It means the provision of insurance across frontiers - eg an Italian householder can cover the contents of his flat at Lloyd's or I can get cover for my car from a Luxembourg firm.

It is a concept that flows directly from the Treaty of Rome. There is to be freedom of services, just as there is to be freedom of establishment. The UK, as a member state, has much to gain thereby. Our insurance services are efficient and our rates are highly competitive. This may reflect a better claims experience in the UK, but I doubt if that is the main reason. Many of us believe that the fundamental point is the greater freedom of British companies compared with continentals to settle their policy terms, their investments and the way in which they hold their reserves.

But this brings us back sharply to the problem of separate regulatory systems within a theoretically "common" market. As a condition of freedom of services, our partners want harmonisation of supervision. We have got this - more or less - in respect of authorisation. The question is whether we are to have it in respect of scrutiny and perhaps intervention. My friends in the industry do not scruple to complain that it costs their policyholders money for them to comply with out Accounts and Forms Regulations. (In reply, I suggest that this is merely a kind of secondary insurance premium against having to pay a levy under the Policyholders' Protection Act!) But if we are to harmonise our scruitiny, our continental partners are suggesting that the reserving policies of companies throughout the Community will have to be harmonized. They believe in particular in special reserves to cope with cyclical risks, special reserves for atomic risks and some enthusiasts would like special reserves to deal with jumbo jets.

There is also a keen interest in the matching of assets in currencies appropriate to the risk. I apologise for the banality, but "the appropriate currency" is like elephants - easy to recognise but difficult to define. Note that I say "difficult to define": not impossible to define. If there is to be harmonisation on reserving techniques, and on matching, there is before us a heavy, even daunting legislative task; and before the industry the potential burden of providing funds separately labelled - and properly recorded - in returns. The continentals firmly believe that their detailed regulation is necessary for the protection of policyholders. But then they have legal systems that enable a Government Department or the insurance supervisor to issue instructions to companies in considerable detail without the need for embodying everything in British style legislation. They enjoy the right - I pick the phrase without intending to suggest that I envy them - to exercise supervision through a form of double delegation. Their subordinate legislation enables them to agree or not to agree to certain practices; to insist or not insist on a certain solution within their discretion. Of course that discretion is not unfettered. There are tribunals in which the decision of state officials can be called in question.

What concerns me is whether we can move much further in the direction of European style supervision within our style of legislation and with our courts. There is the prospect of subordinate legislation to provide for

(1) the solvency margin of life companies

(2) the valuation of liabilities on the life side

(3) reserving techniques in general;

(4) matching assets to liabilities in the appropriate currency

Is this going to be a tolerable burden for our draftsmen? ; for the industry? ; for the legal system? Will the English level system be able to stand up to - or should I say digest - the complexity of continental supervision procedures?

I wonder how much further we can go without the legal framework buckling under the strain and having to be replaced with a court that would enforce the proposition that the Department of Trade knows best - until or unless the contrary is proved.

Perhaps, of course, the lawyers present will welcome the challenge. If there is to be work for all let it not be too simple. It will sort the men from the boys. But I wonder what the non-professionals think - and the policyholders.

Fortunately as it happens I do know the right answer. I said that we were moving in the direction of a system in which the Department of Trade knows best! The right answer is to go back to the principle of freedom of services that the Treaty enshrines. This should be the overriding principle. There is nothing intrinsically unsound in saying that a Frenchman shall have access to insurance in London subject to the safeguards of British supervision only. If the rates are attractive on those terms - and if the supervisory system does not break down - the business should be allowed to develop where the commercial advantage takes it.

In other words I am suggesting that the proper form of harminisation of government practices should be at the lowest common factor among the Nine. If governments and the public whom they represent - want a more complicated system with greater safeguards there is no reason to object. There might be two types of service available and a choice for the European citizen between them. A choice between a highly regulated system at the competitive price for that, and a less regulated system at the competitive price for that. One might drive out the other.

As I see it this kind of approach is just as consistent with the Treaty as an attempt to achieve harmonisation at the level of the most complex system. We have made rather slow progress on the latter route. It may be worth trying the former.

I do not of course believe that the solution is as easy as this. Nothing is settled in the EEC on the basis 100 per cent for one; and nothing for all those others. Nor should it be.

I fear that the British industry must reconcile itself - and I know that it has - to an increasingly complicated legal framework. I have suggested some of the areas where it will have its impact. I hope that the final outcome will be less thickly set about with legislative provisions than seems possible. But I make no promises. If anyone knows of a way to cut through the complexities, I hope he will tell me.