THE ROUGH EDGES OF THE SINGLE MARKET
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Much has been written, and will continue to be written, in this journal and elsewhere on the successes of the EC single market programme.

It was with justifiable scepticism that insurers listened to Sir Leon Brittan in November 1989 when he declared that:

> "I want to press on as fast as I possibly can with the creation of a true single market in this traditionally fragmented sector . ... Companies should operate on a single insurance licence...Companies will be free to set up branches in other Member States [and] ... sell the full range of their products... on the basis of a single authorisation and supervision from the country where their head office is located."

Few would have believed that a Third Non-Life Directive and a Third Life Directive would have been adopted by the Commission by as early as 18th June and 10th November 1992 respectively. The Directives are required to be implemented by national laws by 31st December 1993 and (more realistically) to be brought into force by 1st July 1994.

The principal liberalising terms of the Directives are devastatingly simple. They provide that for an insurance company incorporated anywhere within the European Community a licence to carry on insurance business issued by its home member state will permit it to carry on insurance business in every Member State of the Community.

Despite the remaining practical barriers, the Directives have justifiably been hailed as having cleared the way, so far as this can legally be achieved, for a "single market" in all classes of insurance business within the European Community.

However, the speed and apparent purity of the single market programme have left in their wake inevitable problems to be dealt with by practitioners and regulators at a rather more leisurely pace. As Oliver Wendell Holmes once commented, "the life of the law has not been logic, it has been experience". Nowhere is this more true than in the field of insurance regulation. The philosophical integrity of the single market programme has only a limited relationship with reality. Certain requirements of the European legislation are difficult, if not impossible, to

reconcile with the way in which the market operates in practice. Other requirements have been uncomfortably superimposed on existing legislative requirements, in a manner that will have to be sorted out by new legislation in the medium to long term.

The Legislative background

Prior to the adoption of the First EC Non-Life Insurance Directive in 1973, the regulation of both life assurance and general insurance in the Member States of the EC had developed, if at all, on a piecemeal basis, reflecting local conditions. Local markets differed – and still differ – in size and complexity. Member States always have taken, and still do take, widely differing views on the purpose and relative importance of different means of insurance regulation.

There are, in broad terms, eight recognised methods of regulating insurance companies: regulation of ownership; review of managers and controllers; prohibition of insuring with unlicensed insurers based overseas ("non-admitted insurance"); solvency requirements; control of investments; control of premium rates; control of policy conditions; and regulation of marketing practices. Regulation is usually explained in terms of consumer protection, but historically has frequently had more to do with national politics and economics.

Certain Member States have traditionally imposed the minimum possible restriction on insurers, whether domestic or foreign. Those notably include the Netherlands and the UK. By contrast the Irish direct insurance market was effectively wholly closed to foreign or foreign-owned insurance companies from 1936 to 1976, at which time it was opened up only in favour of companies incorporated in other EC Member States. Some countries have resorted to state domination or ownership of insurance. The Portuguese insurance market was almost completely nationalised in 1975 after the previous year's revolution, and in terms of premium income is still about 60% state-owned. In France, post-war nationalisations mean that about 50% of the market even now is in the hands of seven state-owned companies.

In the four EC insurance markets of most immediate interest to outsiders after the UK (France, Germany, Italy and Spain) there has always been intense protection in terms of prohibition of "non-admitted" insurance, and four separate regimes for control of policy terms and premium rates.

Insurance was barely controlled by any UK governmental authority before the mid-1960s. Financial reporting requirements existed, but companies generally had "freedom with publicity" – in most respects, insurers were little more subject to governmental control than a grocer's shop. Subsequent regulation owes its existence to two phenomena only: financial scandals and European Directives.

When the regulation of insurance was first introduced in the United Kingdom in 1967 it was a minimalist move in response to the scandalous insolvency of Fire, Auto & Marine, and it reflected the practice of insurance in the United Kingdom at that time. The classes of insurance business recognised by the Companies Act 1967 were "industrial assurance business, liability insurance business, marine, aviation and transport insurance business, motor vehicle insurance business, ordinary long-term insurance business, pecuniary loss insurance business, personal accident insurance business and property insurance business." These categorizations were unchanged by the 1973 legislation and served the market adequately until the First Non-Life Directive was implemented. In particular, composite insurance companies were not prohibited, and the oldest insurance companies tended to carry on their business in this manner.

The structure imposed by the EC was more logical, but less flexible. There was a strict separation of long term and general business, and the creation of a definition of long term insurance business that is now enshrined in Schedule 1 to the Insurance Companies Act 1982. As well as including mainstream life assurance business, Schedule 1 includes a rag bag of other operations traditionally carried on by life assurance companies in individual Member States. At the request of the United Kingdom and Ireland, permanent health insurance was classified as long term business. Tontines, recognised in certain member states, are squeezed into the "long term" categorization, as well as capital redemption contracts. General insurance business was in turn divided (originally) into seventeen categorizations. The licensing of new composite insurers, carrying on both life and non-life business, was prohibited.

The reality of the market

This "sensible" classification was imposed on a market which was in reality not so tidily organised. This fact achieved judicial recognition from Kerr L J in *Phoenix Insurance* -v- *Halvanon* [1988] 1QB 216, 255 when he pointed out that "the new classification bears a considerable resemblance to the scheme of the Act of 1974 but unfortunately differs in a number of crucial respects which accord badly with

insurance law and practice in this country and – as many in the market would no doubt say – even with common sense".

Perhaps the most obvious area of discomfort is the split between "general" and "long term" business. The broad concept was that the two types of business involve different means of reserving such that they should not be carried on within one company. Regrettably, however, there are clear areas of overlap – not least in the field of health insurance.

The life and health market

Things might have been different had the private medical insurance market been more sophisticated in the early 1970s. As it is, the sort of conventional medical insurance carried out by companies such as BUPA and PPP was classified in 1973 for eternity as general business. Its near cousin, permanent health insurance, was classified as long term business, presumably on the basis that the reserving technique involved in this sort of insurance were notably different from those involved in the general market. The argument is superficially attractive, but it does not bear too much scrutiny either in theory or in practice.

The theory may at least as easily be applied in the 1990s to long tail commercial business. Those involved in the reassessment of reserves in the LMX market are increasingly turning to actuaries in the same manner as life assurance companies.

The Americans have a useful categorization of an "accident and health" insurance company, which offers the entire range of insurance products designed to cater for medical insurance and allied needs. It makes commercial sense for these products to be bundled into a single company. Subject to certain provisions of the Third Life Directive described below, such opportunities are not open to non-composite European insurers.

Or are they not? The UK was perhaps unwise to admit that it recognised any such concept as "permanent health insurance". The result was that, in the First Life Directive, PHI was described simply as "the type of insurance existing in Ireland and the United Kingdom known as permanent health insurance not subject to cancellation."

No more detailed description was provided. This left it entirely open for certain countries, including Belgium, to disclaim wholly the concept of permanent health

insurance. Whereas in the United Kingdom PHI and private medical insurance are now inevitably carried out in separate companies, the Belgians are happy to allow these operations to be carried out in a single entity on the basis that they simply don't categorize permanent health insurance business as being anything other than a form of medical insurance business.

The position in the United Kingdom has been rendered even worse, however, by the very detailed definition of "permanent health insurance" which was inserted into the legislation, now contained in Schedules 1 and 2 to the 1992 Act. For want of anything better, the wording originally contained in the Companies Act 1967 is repeated virtually word for word as follows:

> "Effecting and carrying out contracts of insurance providing specified benefits against risks of person becoming incapacitated in consequences of sustaining injury as a result of an accident or of an accident of a specified class or of sickness or infirmity, being contracts that:
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> (a) are expressed to be in effect for a period of not less that five years, or until the normal retirement age for the persons concerned, or without limit of time, and
>
> (b) either are not expressed to be terminable by the insurer, or are expressed to be so terminable only in special circumstances mentioned in the contract."

The definition is not a happy one. It implies that if a contract can last more than five years the contract will be one of permanent health insurance. The requirement is not that the benefits need be payable for more than five years but that the contract will be "in effect" for at least five years. As a result, an automatically renewable private medical insurance policy is likely to be a permanent health insurance policy, even if benefits under the policy are payable for no more than three months. Equally, a three month contract may be a PHI policy so long as the benefits are ultimately payable for more than 5 years.

On this basis, certain friendly societies who regard themselves as simply carrying on small scale sickness benefit business, but whose members were entitled to membership for life, found themselves squeezed into a permanent health insurance classification. Much was made in the press a couple of years ago of the "discovery" that permanent health insurance companies could write private

medical insurance business so long as the policies written were perpetually renewable (or at least not cancellable by the insurer within five years).

It is difficult to see the European classifications being changed in a hurry, but the United Kingdom's chosen definition of "permanent health insurance" is an unhappy one. It dates from a time when composites were the "norm", so that the wording of the definition was not so important. It would be useful if legislative time could be found at some stage to remedy a definition that has clearly not stood the test of the years.

The First Directive provided for an EC Commission report on the operation of composites to be prepared after ten years. In the event the report, completed in 1991, recommended that the ban on the creation of new composites should be lifted and that composites should be permitted to create branches and provide cross-border services in the Community.

However, those States opposing composites did so vehemently, and the recommendation was abandoned. Instead, the Third Life Directive provides a limited relaxation of the existing rule by permitting life assurance companies to obtain general business accident and sickness licenses; and by providing that insurance companies whose licenses are limited to accident and sickness business may obtain a license to carry on long term insurance business.

The ability of a life assurance company to carry out accident and sickness business may be a good thing, and may gradually encourage the growth of specialised accident and sickness companies, but is it really a bad thing for these companies to be able to offer, for example, third party liability coverage, as certain of the private medical insurance companies currently do?

Other life assurance problems

Life companies were not as a whole treated well by the strictness of the 1979 Directive. Prior to that, UK life assurance companies in particular had been used to provide a variety of non-insurance services. One thing that life assurance companies have in common is that they have huge gross assets compared with those of almost any other entity – significantly larger on the whole than those of a general insurance company. Their activities are viewed as "low risk" and they are, as a result, regarded as "solid" companies in the traditional sense for the miscellaneous tasks where a "solid" company is required. As a result, it was

formerly not uncommon for life assurance companies to act as corporate trustees. Similarly, their services were much in demand for the giving of guarantees, and they carried out other services such as pension fund management and the acceptance of funds on a capital redemption reserve basis.

Of these various activities, only pension fund management and the issue of capital redemption contracts were specifically sanctioned by the First Life Directive. By contrast, the Directive specifically gave rise to Section 16 of the 1982 Act, which provides that: "An insurance company . . . shall not carry on any activities, in the United Kingdom or elsewhere, otherwise than in connection with or for the purposes of its insurance business".

As a result, the carrying on by a life assurance company of some of these traditional activities is prima facie illegal.

Insurance companies and their advisor have taken a more or less robust approach to Section 16, depending on their point of view. The ABI discussed the ambit of Section 16 with the Department of Trade and Industry in 1987 and 1988, which resulted in a letter of guidance to members of the Association which reported that the DTI had correctly "pointed out that legally a company was not committing a criminal offence by carrying on activities contrary to section 16, but that contracts entered into as a result of these activities might be illegal, void and therefore unenforceable." As an example of prohibited activities, it was noted that "where trustee business, not connected with insurance business, had been an activity of the insurance company, provided steps had been taken to transfer to a separate trustee company all business that practically could be moved and otherwise no new business was being undertaken and no charges being made for the provision of investment management services, the DTI would not object to a small amount of residual business remaining with the insurance company."

The argument that activities in breach of section 16 are potentially "illegal, void and therefore unenforceable" is consistent with the series of cases in the mid-1980s discussing the position when an unauthorised insurers purports to issue an insurance policy in breach of the 1982 Act. The clear conclusion from the cases was that such insurance policies were wholly void (see in particular *Phoenix Insurance* -v- *Halvanon,* supra). The position in relation to unauthorised insurance policies has been reversed by Section 132 of the Financial Services Act 1986. However, similar reasoning potentially applies to contracts entered into in breach of section 16 such that neither party to such a contract could claim any rights under it.

Some life assurance companies still have long standing roles as corporate trustees. This situation now appears to be relatively rare.

However, the position of acting as guarantor is potentially more explosive. Even now, Lloyd's will accept a guarantee issued by a life assurance company instead of deposits from names. The standard arrangement is that a life assurance company will issue a guarantee to Lloyd's in exchange for a counter-indemnity from the individual concerned backed up by a life assurance policy taken out by the individual and "charged" back to the company. Is this arrangement really a mechanism for the sale of a life assurance policy that happens to involve the issue of a guarantee, or is it not rather the issue of a guarantee as a self-contained commercial transaction on condition that a life assurance policy is taken out as collateral?

(The position in relation to insurance-backed mortgage lending is quite different. In that case the mortgage loan is regarded as an investment by the life assurance company which is justifiable as part of its mainstream business.)

If the issue of a guarantee is in breach of section 16, it may appear to be rather a modest breach of the Insurance Companies Act 1982. The position is potentially worse because one of the classifications of general business is "suretyship" This class includes "contracts for fidelity bonds, performance bonds, administration bonds, bail bonds or custom bonds or similar contracts of guarantee". The classification is supported by section 95 (a) of the 1982 Act, which provides that for the purposes of the Act insurance includes "the effecting and carrying out, by a person not carrying on a banking business, of contracts for fidelity bonds, performance bonds, administration bonds, bail bonds or custom bonds or similar contracts of guarantee, being contracts effected by way of business (and not merely incidentally to some other business carried on by the person effecting them) in return for the payment of one or more premiums."

As a result, the issue by a life assurance company of a commercial guarantee (in other words a guarantee where the issue of the guarantee is itself the primary business activity) is not only in breach of section 16 but is potentially the issue of an insurance contract for which it has no authorisation. Under section 132 of the Financial Services Act, the "policyholder" may, with certain exceptions, at is own discretion seek to cancel such a "policy" and arrange for a return of the premium. An unlikely scenario, but it is embarrassing if our major life assurance companies are entering on a material scale into transactions which are even technically illegal.

Reinsurance

The reinsurance market is arguably even more hard done by. In the case of the life assurance market, specific rules were laid down which companies may find difficult to comply with. In the case of the reinsurance market, it was virtually ignored in the categorizations laid down by the Directives. As with direct writers, reinsurance companies are expected to obtain authorisations and carry on their business in accordance with the classifications now set out in Schedules 1 and 2 to the Insurance Companies Act 1982. In reality, UK reinsurance does not and cannot operate on such tidy lines.

In *DR Insurance Company* -v- *Seguros America Banamex* (1992), His Honour Judge Kershaw QC pointed out that "since 1924 and the decision of the House of Lords in *AG* -v- *Fors Akt National of Copenhagen* . . . reinsurance has been treated as with in the Insurance Companies Act." He quoted with approval the comments of Kerr LJ in the *Phoenix* case, quoted above, and agreed that "the classifications may be difficult to fit reinsurance in the United Kingdom."

In the case of quota share business covering UK insurers, it is not difficult to squeeze it into the classifications suggested by the Act. However, in the case of aggregate business it is virtually impossible to suggest that the reinsurance may be categorized along the lines suggested – in particular where the reinsured company is carrying on business overseas.

Inevitably, the market will gradually mould itself into the shape required by the legislation, but one might question whether this is really desirable. In certain cases, activities have been prohibited in respect of which there is no clear evidence that it is really undesirable for insurance companies to be carrying them out. Section 16 has itself prohibited numerous harmless activities which have traditionally been carried on by insurance companies. The prudent advice to an insurance company now has to be that even the provision of its staff to another group company, or the acting as agent on behalf of another insurance company for certain purposes, is prima facie in breach of section 16. However, who would truly argue that such activities are harmful in themselves?

As a postscript, life has been made more complicated in an equally illogical fashion because of separate rules that now must be applied within the EC on the one hand and to contracts with non-EC parties on the other.

Cancellation rights

Prior to the adoption of the Third Life Directive, the United Kingdom already had two separate regimes giving automatic cancellation rights to policyholders of long term life assurance policies – under the Insurance Companies Act 1982 and, for "investment" policies under the rules of LAUTRO.

The Third Life Directive now requires notification of a cancellation right to be made when a contract is concluded and permits Member States to provide a period of between 14 and 30 days for cancellation after receipt of the notice.

The provisions have already given rise to two sets of Cancellation Regulations in the United Kingdom. The Regulations recognised that different regimes will now apply to UK and EC insurers issuing policies to policyholders within the UK (which will be covered by the Directive); and to UK insurers issuing policies to non-UK policyholders and UK branches of non-EC insurers issuing policies in the UK or elsewhere (which will remain covered by the existing rules). Regrettably, the DTI has power to implement changes in UK law by statutory instrument only so far as is necessary to give effect to EC Directives. The result is that a UK policyholder entering into a contract with an EC insurer must now be notified of cancellation rights within 14 days of conclusion of the contract, and will have fourteen days from receipt of the notice to exercise those rights. By contrast, a policyholder of a non-EC insurer may receive his statutory notice even before the contract is entered into, and will have ten days to cancel from receipt of the notice or, if later, before he knows both that the contract has been entered into and that the first or only premium has been paid. The same rule applies to a UK policy issued to a non-UK policyholder, wherever resident. (A UK policyholder entering by post into a life assurance policy with a non-EC insurer, with no branch in the UK, has no UK cancellation rights at all!)

Portfolio transfers

Similar complexities arise in relation to portfolio transfers, although it may at least be argued that in this case there are corresponding benefits. Traditionally, if an insurance company wished to carry out a portfolio transfer of general business to another company in the UK under section 51 of the Insurance Companies Act 1992 this transfer could be carried out only subject to the consent of the Department of Trade and Industry. This applied whether the transferor or the

transferee was registered in the UK or elsewhere (although there may have been questions of local recognition of the transfer carried out in the overseas country).

It is now required that where one of the parties to a Section 51 transfer is a branch of a company registered in the EC the home regulators of that company are expected to be consulted on the matter. By contrast, a transfer to or from a branch of an American company needs no consultation whatever with the "home" regulators.

Conclusion

There is no particular moral to all this. It is difficult to reach any conclusion other than that on the one hand certain patterns have been imposed on the market which clearly do not reflect reality; and on the other side that certain inconsistencies have been injected into the market which are to be regretted. However, it is difficult to imagine in either case that time will be found for new legislation to sort these matters out in the near future. All that can be said with certainty is that practitioners have to be aware of the problems, and that they can no longer follow their noses and believe that having found the answer to one problem the answer to a similar problem is likely to be the same.

THE 1993 LONDON COLLOQUIUM "The Worldwide Problems of Living with a Single European Market"

Our biennial international colloquium took place, as usual, in the pleasant academic surroundings of University College, London. The theme had been chosen already two years ago, as it was felt then that mid-1993 would be a good time to take stock of the threats and opportunities of the new Single Market and so we were able to welcome notable speakers from both within Europe and from further afield.

BILA's President, Lord Justice Steyn, opened proceedings with a few words of welcome to London and then moved on to chair the first session. This was a look at exactly where we are now and the quartet of speakers from the UK, Jennifer Donohue of Barlow Lyde and Gilbert, Ruth Rooley, Director General, British Insurance and Investment Brokers Association, Alan Tyrrell Q.C. and Sir Anthony Meyer painted a picture of great progress having been made in the Community's