THE LEGAL IMPACT OF THE SINGLE CURRENCY ON THE INSURANCE SECTOR

by Dorothy Livingston and Robin Patterson

Introduction

As has been apparent from the considerable press coverage, substantial effort over the last few months has gone into devising a suitable legal framework for the introduction of the single currency. The matters which have been addressed to date are those which affect the whole of the financial sector; it can be hoped that once the overall "big picture" has been fixed, then more detailed examination of the more specific issues in each particular sector can begin. The result of the work to date, which has involved wide consultation with the legal and financial community in London and other European financial centres, has been the adoption by the European Commission of two draft Regulations establishing the legal framework of the euro. These were discussed (along with the much more politically contentious Stability Pact) and agreed by the European Council summit in Dublin on 14th December last, which invited the Council of Ministers formally to adopt the first of these Regulations without delay. This article, as it has been written before the formal adoption (and therefore publication) of the Regulations by the Council, is based on the wording of the Commission's draft documents as submitted to the Council. These documents may be subject to minor amendments as the legislative process is completed.

Much of this article will be concerned with the problems of ensuring continuity of contract as regards international financial contracts. All insurance companies will have to face these concerns, in relation to their funding operations and hedging activities. Many, if not most, of these aspects will affect the UK insurance market whether or not the UK participates in the single currency: whether we are in or out, the insurance sector will still have to deal with the consequences of the currencies of our major trading partners disappearing and being replaced by a single currency. In addition there are issues arising from the use by insurance companies of premium reserve currencies, and from the use by insurance companies of inter-currency payment systems. On these latter aspects there will clearly be practical differences depending on whether or not the UK participates in EMU. Further practical issues will arise, if the UK does participate, in relation to how insurance companies, in common with all providers of retail services, will deal with making and receiving payments in sterling and euros, particularly during the Transitional Period. Even if the UK does not participate in EMU, some insurance companies with substantial international clients may wish to convert their accounting systems to a dual currency system, depending on their competitive environment.

Continuity of Contract after EMU - The Issues

(i) **Non-revocability**

The aim of the Commission is that the introduction of the single currency should not be used by contractual parties who find themselves disadvantaged by the introduction of the single currency as an event entitling them unilaterally to terminate or vary their contractual obligations. This is the so-called principle of non-revocability. Two principles of private international law (recognised by most legal systems, including English law), the principle of "Lex Monetae" and the "nominalistic" principle, help to achieve this. The principle of Lex Monetae provides that the continuity of currency obligations are determined by the law of the country whose currency is involved. The nominalistic principle provides that a debt denominated in the currency of any country is treated as an obligation to pay the nominal amount of the debt in whatever is legal tender at the time of payment, according to the law of that country. The way in which the participating Member States will activate these two principles is through an EC Regulation which will convert their currencies into the euro at specified conversion rates.

(ii) **Frustration of Contract**

Problems arise in relation to the common law doctrine of frustration and the equivalent civil law concepts in other Member States. Frustration arises where a supervening event occurs which renders it physically or commercially impossible to fulfil the contract or transforms the obligation into a radically different obligation from that originally undertaken. It cannot, however, be invoked either to relieve a party of an imprudent commercial bargain, or where the parties have foreseen the relevant event and provided for it. Frustration arises automatically by operation of law and not by the exercise by one party of a right to terminate the contract. In addition, the effects of a contract being frustrated can be very substantial: under the Law Reform (Frustrated Contracts) Act 1943, ***all*** sums paid under a frustrated contract governed by English law are recoverable by the payer, unless the recipient is able to establish that the part of the contract already performed should be severed, notwithstanding the frustration of the contract as to further performance. The effects of such a retrospective unwinding of financial contracts, including insurance contracts, can be very substantial. Most contracts, even financial contracts, would not be frustrated by the introduction of a single currency, because performance of the contract would still be possible, even in a different currency, or because the introduction of the single currency had already been foreseeable at the time when the contract was entered into. However, there are certain categories of contracts, particularly swaps and derivatives contracts involving two affected currencies, where the contracts have been in place for a very long time and where the commercial rationale behind such contracts would be radically altered by the introduction of the single currency.

(iii) **Freedom of Contract**

The Commission's desire for continuity of contract does however clash with its wish also to uphold the overriding principle of freedom of contract - that the parties should be free to agree their own provisions for termination or variation of contracts on the introduction of a single currency. The main instance where this will be an issue is in relation to force majeure clauses, which are often deliberately widely and ambiguously drafted, with the result that that they may be triggered by the introduction of a single currency, without specifically referring to such eventuality.

(iv) **ECU-denominated obligations**

The ECU is to be replaced, at a conversion rate of one-for-one, by the euro. This could create problems in relation to the "private ECU" (i.e. the ECU as used as a quasi-currency by private parties), as the euro is likely to be perceived to be a stronger "currency" than the ECU (because it will be the currency of the stronger economies within the European Union) and so the nature of contracts which are converted into euro may be different from that if they had continued in ECU. There may therefore be an incentive for parties to claim that ECU-denominated obligations are frustrated by the introduction of the euro. There are also problems caused by the wide variety of legal definitions of the ECU used in financial contracts. Not all of these definitions mirror the official definition of ECU contained in the EC Treaty, although in most cases the parties will not have intended their definition to be substantially different from the official definition.

(v) **Recognition of the euro outside the EU**

In accordance with the principle of Lex Monetae, the euro will be recognised by other countries as the currency of the participating Member States. While this is an important first step, it still leaves the questions of frustration (or other similar legal concepts) and force majeure clauses and how these will be applied by foreign jurisdictions in relation to the introduction of the euro. Furthermore, it does not necessarily apply to the ECU, which is merely a measure of value and not a currency. Work is currently in progress in relation to the legal systems of the major trading partners of the European Union, in particular that of New York, whose law governs many financial contracts.

Continuity of Contract after EMU - The Commission's Proposals

The Commission has addressed the issues of legal certainty mentioned above in its proposal for the first Regulation. These issues will have to be faced by Member States whether or not they participate in EMU. The first Regulation will therefore apply in ***all*** Member States and, following the Dublin summit's recommendation that it be formally adopted without delay, it will come into force as soon as possible; probably early in 1997.

(i) **Continuity and Freedom of Contract**

Article 3 of the first draft Regulation, which contains the main provision on continuity on contracts, currently reads as follows:

> "The introduction of the euro shall not have the effect of altering any term of a legal instrument or of discharging or excusing performance under any legal instrument, nor give a party the right unilaterally to alter or terminate a legal instrument. This provision is subject to anything which parties may have agreed."

Two comments arise from the wording adopted by the Commission. First, it is only the introduction of the euro, in itself, which is included, and not the economic or commercial consequences arising from it. Such a wider formulation was suggested by bodies representing some market participants, but was rejected by the Commission, perhaps simply because it viewed the additional wording as unnecessary or perhaps (as has been suggested by some commentators) to leave some residual role for the doctrine of frustration and its continental equivalents. It may, it seems, require court decisions to determine whether this wording effectively excludes the doctrine of frustration for those contracts which are radically altered, in an economic or commercial sense, by the introduction of the euro. However particularly given the purposive or "teleological" rule which applies when courts are interpreting European legislation, it is widely thought that if such an eventuality arises, the courts will be keen to uphold continuity of contracts, rather than to find them to be frustrated on the basis of such a fine (and rather semantic) distinction in the wording of the Regulation.

The second comment is that the Article is stated to be "subject to anything which parties may have agreed". The wording in earlier working papers of the Commission had been more specific, and required a specific reference by the parties to the introduction of the euro and had been intended to restrict the ability of parties to invoke force majeure clauses. It is therefore significant that the Commission has dropped this wording, and the wording in the formally adopted draft Regulation comes down more heavily on the side of the ordinary rules of freedom of contract and leaves more room for the potential application of force majeure clauses.

(ii) **ECU-denominated Obligations**

In relation to the replacement of the ECU by the euro, Article 2 of the first draft Regulation provides that as from 1st January 1999 every reference in a legal instrument (which is a very widely defined term, including all types of laws, contracts and unilateral legal acts) to the ECU is replaced by reference to the euro at a rate of one euro to one ECU. Article 2 goes on to deal with the problem of the "private ECU" by providing that references to the ECU which are not defined in the terms of the Council Regulation which defines the "official ECU" shall be presumed to be references to the ECU as officially defined. The intention is that, in the majority of cases, ECU-denominated obligations shall be converted into euro-denominated obligations, notwithstanding minor defects in the definition of the term "ECU". It is, however, only a presumption, and once again freedom of contract is upheld: where parties have specifically and clearly defined the ECU differently, and with the clear intention that it will not be converted into the euro, the intentions of such parties will be carried out and the mechanisms they have put in place to deal with the disappearance of the ECU (for example payment in another currency) should be followed through. Most exisiting contracts will not be so clear, particularly those that predate the proposals for a single currency. Parties who want to move from the ECU to a currency which does not participate in EMU should review their contracts and seek to agree appropriate amendments.

Practical Issues

The second Regulation addresses the mechanics of the introduction of the euro and the transitional arrangements. Unlike the first Regulation it will apply only in those Member States who participate in monetary union, and will not come into force until 1st January 1999.

(i) **Transitional Arrangements**

This Regulation will list the countries who are to participate in EMU and will provide for the replacement of their national currencies by the euro. However, while the *currencies* will be replaced by the euro on 1st January 1999, references in legal instruments to the national currencies will not (unlike the ECU) be automatically replaced by references to the euro. This replacement will only occur at the end of the transitional period (31st December 2001 at the latest). During the three-year transitional period *national currency units* will continue to exist, but as denominations of the euro, and not as currencies in their own right. This is to enable, essentially for political reasons, a gradual changeover under the principle of "no compulsion no prohibition". It does, however, throw up its own problems which will, especially if the UK participates in EMU, have a major impact on the UK financial sector. Acts to be performed under legal instruments which specify the use of national currency units shall continue to be performed during the transitional period in national currency units although, of course, the parties may agree to convert payments into euro. Furthermore, the payment of a debt may be satisfied by payment of either national currency units or the euro unit. While there should be no economic difference between the two methods of payment (as the national currency unit will, by this stage, merely be rather awkward non-decimal fraction of a euro) there are clearly substantial practical implications for insurance companies and their banks and how they intend to handle such dual payments.

(ii) **Netting and Rounding**

Article 8(6) of the second draft Regulation provides that national legal provisions permitting or imposing netting, set-off or similar provisions shall apply between national currency units and the euro unit. In relation to rounding, Article 4 of the first Regulation specifies that the conversion rates will be expressed as one euro in terms of each national currency, to six significant figures. The conversion rates shall not be rounded or truncated when making conversions, and the use of inverse conversion rates (e.g. the value of one pound in terms of euros) will be prohibited. Conversion from one national currency unit to another will be done via the euro unit, with the amount being rounded to at least three decimal places in euro units before being converted into the second national currency unit. As these rounding conventions are being set in the first Regulation, they will be in place very soon, so as to enable companies to make the necessary adjustments to their systems.

(iii) **Reserve Currencies**

In the event of the UK joining the single currency, sterling will be replaced by the euro as one of the London insurance market's premium reserve currencies. This will result in substantial benefits in terms of the disappearance of the present currency risk between reserves held in sterling and liabilities in, say, Deutschmarks. In the event of the UK not joining, insurance companies will have to decide whether the euro should be a new reserve currency in addition to sterling. Clearly there may still be advantages in doing so, as insurance companies will then still be able to benefit from the elimination of currency risk between the participating Member States, even if the UK is not one of them.

(iv) **Capital Adequacy and Asset/Liability Matching**

This is in many ways the reverse of the reserve currency position outlined above, where, for regulatory purposes, assets are required to be held in a particular currency rather than a reserve currency. Both capital adequacy and liability/asset matching raise a similar point: how are assets in, say, Deutschmarks, treated for the purposes of matching liabilities in, say, French Francs, or assessing the capital adequacy of a French bank? The answer in both cases should be the same: during the transitional period, both Deutschmarks and French Francs are interchangeable and fungible denominations of the euro and all assets and liabilities should be treated as euro assets or euro liabilities, notwithstanding the fact that they may be expressed as Deutschmarks or French francs. The interesting question, and which commentators are understandably reluctant yet to face, is what happens if a country participates in EMU, but bails out during the transitional period, leaving its banks and institutional investors with grossly mis-matched assets/liabilities and capital adequacy.

(v) **Payment Systems**

A final practical issue is the potential effect on the insurance industry's own system of foreign currency exchange of the Commission's current working draft Directive on Settlement Finality and Collateral Security. This is not strictly speaking part of the measures introduced to give effect to the single currency, but it is another important change in the European financial system and is inevitably linked with the single currency project. The purpose of the Directive is to standardise across all the various payment systems in Europe the point at which a payment through a payment system becomes final and irrevocable, and also to limit the credit risk inherent in all payment systems by providing that the payment system itself will have a priority security over the assets in the system. As currently drafted (and the drafting is still at a very early stage) the scope of the Directive will be very wide and will cover virtually every payment system imaginable. It will almost certainly cover the insurance industry's own payment system. The latest draft extends the Directive to securities settlement systems, in which insurance companies also participate.

Conclusion

The current view in the London legal and financial community is that the major legal issues arising from the introduction of the euro have been adequately dealt with in the two draft Regulations which the Commission has adopted. It is hoped that the final form of the Regulations as enacted by the Council will be substantially in the form of that proposed by the Commission. These provisions, in particular those dealing with continuity of contract, are of critical importance to the insurance sector, as with all sectors in the financial services industry. The Commission's solution is sufficiently flexible to give certainty to the markets, but may contain a few loop-holes.

The other issues dealt with in this article and which are more specific to the insurance sector are essentially practical ones. Dealing with them will require careful consideration of the strategic issues involved. The best thing that the insurance sector can do now is start to think of every imaginable way in which operating in a new currency, or in the two currencies, will affect its business operations. The earlier that this "trouble-shooting" begins, the better.

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