European Monetary Union and its implications

By Mark Elborne and Karen Brymer

Introduction

European Monetary Union ("EMU") is not a new issue. As early as 1972 an EEC report suggested that a common currency should be created by 1980. This was projected in 1986 with the signing of the Single European Act. This Act envisaged the creation of a single market across the EEC. The Council of Ministers created a Committee headed by Jacques DeLors to identify the steps required to be taken to achieve monetary union. Their recommendations were embodied in the Maastricht Treaty which came into force in member states on 1st November 1993. In 1995, the single European currency was given the name the "Euro" which is scheduled to be introduced on the 1st January 1999 in 11 of the 15 member states (namely; Belgium, Germany, Spain, France, Ireland, Italy, Luxembourg, Holland, Austria, Portugal and Finland - covering a geographical area that has come to be known as the "Euro Zone").

The U.K. is not one of the member states participating in this first wave of EMU, having negotiated an "opt out" in the Maastricht Treaty. Denmark, Sweden and Greece are also not in the first wave of participating states. For the 11 participating states listed above, the timetable to monetary union has been established and is described below.

The introduction of EMU is likely to affect reinsurers internationally including the 11 participating states going forward in the first wave, non participating EU states such as the UK, as well as non EU countries such as US and Japan, many of whom conduct business in Europe or have subsidiaries in Europe and will wish to (and, indeed, will have to) deal in the Euro.

European Monetary Union - Timetable

When one considers that there are at least 20 billion bank notes in the EU, any instant transition to Euro notes and coins would quite clearly be impractical. Accordingly, a "transitional phase" will take place commencing January 1st 1999 and concluding December 31st 2001 during which the Euro will exist as an accounting unit only (i.e. not in cash form) with existing notes and coins of individual national currencies still being used. However, the individual national currencies will cease to exist as a matter of law and will continue instead as denominations of the Euro with each national currency unit having an irrevocable exchange rate (which will be set before the start of the transitional period) effectively locking the exchange rate for each currency to the Euro. Regulations have been produced in order to minimise confusion during this period (see below). From 1st January 2002 and for a period of 6 months, Euro notes and coins will be introduced circulating alongside national currency. After 30th June 2002, currencies of the participating states will cease to be legal tender.

Although Euro currency will not be in circulation until the end of the transitional period (i.e January 2002), businesses in the participating states will be able to make non-cash payments, keep accounts, negotiate contracts and price products in Euros. UK businesses will be able to do the same although if they agree to accept payment in the Euro, the amount could be affected by exchange rate fluctuations as against the pound.

Conversion of Denominated Currencies to the Euro

Conversion rates for participating currencies into Euros will be at a fixed official rate which will have six significant figures (i.e 4.56789 Euros or 45.2222 Euros). This means that figures which were round before conversion will not be so afterwards. A deductible, previously stated as a round Fr. 500,000 is likely to become less manageable when expressed as a Euro. There will be one hundred cents to the Euro and pricing payable in cash all for crediting/debiting bank accounts will be expressed to the nearest two decimal places i.e. 5.56 Euro. This will have greatest impact on those countries whose national currency do not have decimals such as Italy, Portugal and Spain.

If the third figure is a five then the amount will be rounded up. Rounding is required whenever there is a conversion of amounts to be paid or accounted for and this will include payment of premiums and claims. The exchange rates into and out of Euro denomination are unlikely to mirror each other exactly and the difference between the two rates may give rise to a loss. Although the loss incurred in relation to each conversion will be small reinsurers should note for accounting purposes that converting for example the total balance of premium paid at the end of the year, will give a different result to that had reached each payment been converted individually.

Payments of Amounts due Under Contract

Draft Regulation 109 (one of the 3 major pieces of legislation laying the ground work for monetary union, together with The 235 Regulation (see below) and the Maastricht Treaty), which will not be ratified by the UK, provides that during the transitional period, payments must be made in the currency units specified in a contract. For EMU participating states this means that neither party can compel the other to pay or accept Euro (unless presumably the currency of the contract is expressed to be the Euro) or this method of payment is agreed between the parties. The watchwords during this period is "no compulsion, no prohibition".

The exception is where a debtor under a contract makes a payment directly to a creditors bank account in a participating member state. In that situation, he is able to elect to pay either in Euros or in the denominated currency of that participating member state in which the creditors account is located, irrespective of what is said in the contract.

Thus where a German reinsurer provides reinsurance cover to a French reinsured and premium is expressed to be payable in Deutschmarks, the strict position will be that payment must be made in Deutschmarks. However, if the French reinsured intends to pay premium directly to the German reinsurer's bank account in Frankfurt, he can elect to pay either in Euros or Deutschmarks and his contractual obligations will still have been discharged.

What is the position where an English reinsurer is liable to pay a claim to a German reinsured and the contract specifies Deutschmark payments? Regulation 109 will not be ratified by the UK. Even if the contract is governed by English Law and the reinsurer is in England (i.e outside the Euro Zone), it is still likely that Regulation 109 and its provisions will apply.

The Lex Monetae principle involves the courts looking to the law of the country in which the debt is expressed to define the meaning of that currency even if the contract is governed by a different law.

Accordingly, the English reinsurer will (during the transitional period) strictly be obliged to pay claims in Deutschmarks but if paying monies directly into an account in Frankfurt, it may choose whether to pay in Euros or Deutschmarks. For reinsurers whose business is already highly international, dealing in the Euro in this way and generally is likely to have many broad commercial advantages.

Advantages of EMU

The single currency should bring with it many direct benefits for participating member states including the elimination of exchange risks as between participating states (although not as against Sterling or the US dollar). It will also result in price transparency enabling a comparison in real terms between insurance and reinsurance products, deductibles and rates which will in turn encourage pan European selling of insurance and reinsurance products and heightened competition. However, regulation and tax regimes will still be different across the Euro Zone which may hamper this process. It will also result in the cost reductions generally as businesses in participating states will not face currency conversion charges when conducting business with other participating states. Reinsurers could make savings through pan European processing centres handling payment of premium and claims in one single currency. This, coupled with the removal of exchange risks could give reinsurers in such countries a distinct commercial advantage. Companies will also be able to match assets with liabilities more easily. Further, the introduction of the new European Central bank is also hoped to create economic stability as it sets monetary policy across the Euro Zone and is expected to follow policies of low inflation.

For non participating states and other non EU countries, the impact of the Euro will still be significant and will directly affect importers and exporters from and to the Euro Zone, financial markets, banks and subsidiaries of large multi national companies. Indeed a number of European companies with operations in the UK have already announced an intention to move their accounts entirely to the Euro after 1st January 1999 (e.g. Siemens and Philips).

For UK reinsurers and insurers operating in the London market, the Euro may have a smaller impact than initially imagined. Just over 50% of London Market transactions are in dollars, 18% in sterling, 8% in Yen and 7% in other European Union currencies (Deutschmark-3% and French Francs - 2%). The ability to deal and trade in Euros however is not so much a matter of legal necessity but of commercial necessity. It will be important in terms of retaining and increasing market share that if a reinsured wishes to pay premium and receive claims in Euro, the reinsurer can oblige.

Many LIRMA members are in fact subsidiaries of European companies who have extensive interests in Europe and who will already be very much up to speed in terms of Euro compliance. In recognition of the importance of maintaining the pre eminence of the Lloyd's market, Lloyd's set up a working party to consider the introduction of the Euro, in June 1997. It is likely that the Euro will become one of Lloyd's settlement currencies (in addition to the current 9 including the Dollar, Sterling, the Yen, the Deutschmark, the Franc, the Australian dollar, the Lire, the Canadian dollar and the Guilder). Indeed, the LPC (London Processing Centre) was aiming for a 1st October completion date to allow its members wishing to transact business in Euros to do so through the 1999 renewal season.

Legal Issues

One legal issue for reinsurers is whether the continuity of reinsurance contracts could be threatened by the introduction of EMU. Where a reinsurance contract is governed by the law of any EU member state (which will include non Euro Zone EU member states such as the UK) the position should be quite clear. Article 3 of Regulation 235 states that *"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 such an instrument. This provision is subject to anything which the parties may have agreed".* Thus, where a reinsurance contract provides for claims to be paid in say francs and the franc ceases to exist, the reinsurer could not refuse to pay on the grounds that it is no longer possible to perform the contract (The 235 Regulation entered into force in all 15 EC member states on 20 June 1997).

The legal position in other legal jurisdictions may however be slightly different. Whilst some US jurisdictions (New York and Illinois) have drafted special legislation to ensure their laws are consistent, it would be prudent nevertheless, where reinsurers have contracts governed by the law of a non EU state, to seek local legal advice and if the position remains ambiguous, to seek to agree a continuity clause (provided the wording used is thoroughly clear).

Under English law, the doctrine of contract frustration provides that a contract may be automatically discharged if, during the currency of the contract and without fault of either party, some event occurs which renders further performance an impossibility, renders it illegal or brings about a radical change in the circumstances so that the contract becomes essentially different from that which was originally undertaken. It is unlikely that the introduction of the EMU will constitute such a "radical change" to constitute frustration of the contract. The principle of continuity applies and any payment formerly required in a national currency of a participating member state can legally be made in the alternative currency of the Euro. Lloyd's and ILU and LIRMA will be publishing a standard clause or set of Clauses for incorporation into contracts in existence post January 1999 to maintain continuity.

It is of course open to parties to reinsurance contracts taking effect after 1st January 1999 to provide that payments of premiums and settlements of claims can *only* be made in Euros. It is very likely that many foreign clients will prefer this.

Reinsurers should be aware of a particular drafting point that concerns excess points in excess of loss wordings. These are often expressed to be calculated at fixed exchange rates in round figures for ease of calculation. If one or more of the currencies stipulated include one or more in the first wave of EMU, this clause will need to be amended.

There are no significant legal obstacles to using the Euro in the UK for retailing or banking/ business purposes should business entities chose to do so and this applies to the Euro as a foreign currency and if the UK joins the single currency. The UK legal system will allow the Euro to be used in contracts for example as the US dollar or Deutschmark is used today.

Investments

The Association of British Insurers (ABI) have produced figures which suggest that around 70% of small insurance companies have either equities or bonds held in one of the currency due to form part of EMU. This figure jumps significantly in relation to large or medium size insurers (and presumably reinsurers) with portfolios in excess of £2bn pounds in the UK to as much as 95%. The 1st January 1999 will therefore have a direct impact on such companies in terms of asset value and it is vital that their systems are ready to receive, operate and work in Euro terms.

Euro Compliance

As well ensuring their systems are Year 2000 compliant, reinsurers will need to ensure that their systems are also Euro compliant to deal with the technological implication of monetary union. In the summer of 1997, Cap Gemini estimated the cost of preparing for EMU could be as much as £80m for an international insurer. Indeed, it is widely recognised that the main disadvantage of EMU is the Initial IT investment required.

Reinsurers will need to undertake a thorough review as to how the introduction of the Euro is likely to impact on their systems. For example, the field sizes of existing systems will need to be able to accommodate both the Euro symbol and the numerical Euro conversion rate figures (six figure sums). The currency code, the "EUR" has been registered for the Euro. Reinsurers will also need to ensure their system can convert Euro denominated currencies into the Euro and indeed other non-Euro denominated foreign currencies into the Euro. When conducting conversions, the system will need to be able to implement the specific rounding rules.

It will also be vital to ensure that reinsurers' business partners (including reinsureds and brokers) are Euro compliant to ensure claims/premium calculations are accurate etc.

Possible Loss Exposure Arising out of EMU

As with year 2000, it is inevitable that the introduction of EMU will, particularly in the early stages, bring about teething problems as businesses, banks and other financial institutions and indeed the systems employed by them, come to grips with the change to EMU. Liability policies are most likely to be triggered by Euro related claims e.g. One can imagine a situation where claims will be made by solicitors on their professional indemnity policies arising out of awards against them in negligence for failing to advise adequately or an EMU related issues just as IT consultants may claim on their liability policies in relation to claims made against them in connection with their installation/advice on Euro software systems.

This raises many of the same issues addressed in relation to year 2000 including, aggregation and settlements.

Conclusion

Whether operating within an EU state participating in the first wave of EMU or not, from 1st January 1999 reinsurers will undoubtedly be affected as the financial geography of Europe alters as never before. The simple fact is that in an increasingly global market, reinsurers will have to adapt to deal in the Euro and should be addressing the IT issues now in order to enable them to do so.

Mark Elborne and Karen Brymer
Elborne Mitchell