# INSURANCE REGULATION AND EC INTEGRATION ( I )

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## 1. INTRODUCTION

Insurance is designed to reduce the financial burden of losses arising from specific kinds of risk. It provides a function for allocating individual losses to other members of a group exposed to similar losses. Since insurance plays such an significant role in the financial sector of a society, it is essential that insurance business ought be carried out in a fair and stable manner so as to ensure the financial security of personal and commercial entities, the efficient disposition of economic resources and the protection of policyholders' interest. In addition, insurance has a social function and is highly related to the public interest; the government therefore does not only have to define its role with concern for the social importance of insurance industry but also has a responsibility to encourage and require insurance undertakings to respond to the current needs of society at large. Accordingly, the implementation of a prudent regulation in respect to insurance business is an important purpose of the government.

In Western Europe, the Treaty of Rome which came into force in 1958 introduced the concept of a single Community-wide market, where national frontiers would not restrict the movement of people, corporations, goods, services or capital and where the system of law ensured that the competition within the community was not distorted. There are three fundamental objectives in the Treaty: namely, the freedom of establishment, the freedom to provide services and the free movement of capital. If the aims of the Treaty are achieved, the citizens of Member States do not just benefit from the freedoms within the territory of the Community, but also from a large economic scale of the single market from the concentration of all Member States' economic resources.

In order to achieve these objectives, the harmonization amongst different Member States is essential. However, it is difficult, because most of the works will concern the

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coordimation of laws, regulations and administrative provisions of all Member States. With respect to the insurance sector, the Community's programmes for creating a single insurance market were implemented by way of "Directives". At first, unanimity within the Council with the proposed Directives was originally required. For many years, however, the progress towards the goal of integration was often slow. Gradually the Community realized that the goal of comprehensive harmonization amongst Member States was impractical because any one Member State, whatever its size, could use its veto to delay the process of integration. Therefore, the Single European Act 1986 adopted a new system of majority voting to accelerate the legislative procedure. Meanwhile, the Act also incorporated into Community law the deadline of 31 December 1992, by which the single market was to be achieved. Up to the present, it can be said that the goal of a single insurance market is almost completed.

Recently, the Treaty on European Union (the Maastricht Treaty) was signed in 1991. It furthermore pledged Member States to a full economic, monetary and political union with a view to the eventual creation of an European Union. If the aims of the Masstricht Treaty are achieved, the Community will have taken an historical step towards a federal system.

The purpose of this paper is to examine the efficiency of the integration programmes of the EC insurance market in terms of the general principles of financial market regulations as they are applied in the insurance sector. Accordingly, the general principles of insurance regulation and the integration programmes with regard to the EC insurance market will be the main subjects of this paper. In spite that they are divided into two separate parts, it does not mean they are two different or independent subjects but, conversely, the context of each one of them is closely related to the other.

In the first part of this paper, the general principles and approaches of insurance regulation will be dicussed. The purpose of this analysis is to provide a framework for identifying certain basic issues in respect to the regulation of insurance market. The experiences of some countries, particularly the UK and USA, will be compared and adopted to develop my arguments. There are four main issues to be discussed in this respect, including the recognised interests in an insurance market, the policy consideration in respect to the decisions-making of insurance regulation, the general structure of insurance regulation and the different sources of insurance regulation.

The purpose of the second part is to assess the integration of the EC insurance market in terms of the general principles of insurance regulation which has been identified in the first part. In fact, it can be found that some additional difficulties and obstacles arose in the process of integration due to the maintenance of some Member States. In connection with this issue, it is important to examine the relevant principles which had been designed to deal with these problems. Therefore, the context of this part will comprise the concept of the Single European Market, the fundamental principles for achieving a single insurance market, the development of EC insurance integration programmes and the relevant EC legislation in respect to insurance sector.

In the last part, the final conlusion and some comments will be made with regard to the efficiency and potential obstacles to the integration programmes of the EC insurance market.

# 2.GENERAL PRINCIPLES OF INSURANCE REGULATION

## 2.1 The Recognized Interests in the Insurance Market

Insurance is a financial arrangement in which one party agrees to compensate for the loss of the other if it results from the occurrence of a specified contingent event. In an insurance contract, one party (the insured) pays his contribution, i.e. the premium, to obtain his financial security and peace of mind, and the counter party (the insurer), after receiving the premium as the consideration insurance contract, promises to indemnify the insured for his loss caused by an insured peril. Obviously, it is easy to recognise in the first instance that there are at least two groups of persons in insurance market: i.e. insurance undertakings (the seller of insurance) and policyholders (the buyer). However, not all of any insurance transaction is conducted directly by these two parties. Some of them are made through insurance intermediaries. In fact, they play an important role in the insurance market, and, therfore, their interests should not be neglected.

In addition to the groups we mentioned above, it seems to be an omission if we ignore the interests of governments. This is because they usually need to make use of insurance as their instruments to accomplish specific policies. On the other hand, most importantly, the majority of insurance regulations and supervisions are conducted by them.

Knowing the different interests in insurance markets, it seems logical to take them into consideration before we start discussing other issues of insurance regulation. These different interests will be reviewed in the following paragraphs.

### 2.1.a Policyholder

Generally speaking, the primary goal of insurance regulation is to protect the interests of policyholders from the unfair impairments of the insurance undertakings. Most people would take it for granted that regulations would be implemented to benefit all policyholders. However, not all the insurance buyers have the same interests. The large industrial buyers who have equal bargaining powers are normally more conscious of their real interests and easily find the ways to express their opinions effectively. Private citizens, although they can gather around as a group of policyholders, are more reluctant to engage themselves for some insurance affairs. Just because of this silent character of the general policyholders, it is rare to find a pressure group organized among policyholders. Theoretically, the policyholders should have their own elected representatives who can speak up for them in the parliament. Furthermore, government or any other associations which are concerned in the affairs of consumer protection should have similar functions. In some cases, nevertheless, the interests of policyholders seemed to be ignored and, the worst of all, some government regulations disguised themselves with the mask of policyholders' protection. In the light of the above, it is very important to identify the real interests of policyholders when we consider the issue of policyholders protection.

### 2.1.b Insurance Undertakings

Apparently, the insurance undertakings which engage in carrying on insurance business have direct interests related to government regulations and on them the main part of

regulation instruments are implemented. The main reason of which insurance undertakings must be regulated and controlled is that the insurance business is highly concerned with public interest but in most cases insurance undertakings are usually in a better economic position than policyholders.

It is always argued that a perfectly competitive insurance market will tend to promote both distributive and productive efficiency and that any government intervention and regulation will distort the workings of the competitive process. In other words, it is said that a competitive market without government regulation can be economically neutral in the way in which it allocates funds to different groups. However, should we still emphasize the market working even though it is inconsistent with some social policies? Is there any naturally systemic inefficiency in the insurance market? Is it possible that an insurance market becomes perfectly competitive by its own working? This sort of issues will be dicussed in the following sections.

If we consider the point of opinion expressed, insurance undertakings are certainly much better organized as a pressure group than others in insurance markets. For example, during the process of the insurance intergration in the EU, the domestic insurers within the Member States made their own views known through their own associations, such as the Federation Francaise des Societes d'Assurances (FFSA) and the British Insurers' International Committee(BIIC). In a large multi-national insurance market it is necessary to present a clear unified national view to the Comite Europeen des Assurances (CEA).[1] Therefore, when we touch the issue of the interests of different groups, it seems not so important for a regulator to find out the real interests of insurance undertakings actively because, in general, their opinions will be clearly expressed in proper circumstances through their representatives.

### 2.1.c Insurance Intermediary

Not every insurance business is conducted directly by insurance undertakings and some of them are through insurance intermediaries. This is because they can provide some assisting functions to both parties in an insurance transaction, such as arranging the coverage for special demands, delivering premiums and proceeds, and assisting some claim settlements.

An insurance intermediary, in respect to his/her legal status, can be categorized into two groups: namely insurance agents and insurance brokers. An insurance agent is anyone who is authorized by an insurance undertakings to solicit, create, modify or terminate insurance transactions. Thus, they are agents of the insurance undertakings. In contrast, an insurance broker is an agent of prospective insurance buyers even though his commission will be paid by insurers after the transaction is conducted. In fact, the distinction in respect to legal status in an insurance business is not easy to draw a line in the real world.

In addition, if we compare the characteristics of their business, we can find most insurance agents are engaged in "personal line insurance" which relates to the private citizen, such as motor insurance and life insurance. Although insurance brokers can provide similar functions as insurance agents, in most cases they are involved in "industrial line business". Reinsurance and marine insurance may be two good examples for this context. The main reason is that insurance brokers are more sophisticated and experienced in dealing with large industrial or international risks. In UK, the brokers in the London Market,

including the Lloyd's of London, have their long-lasting involvement in the insurance market and other financial markets, especially in the business related to special or catastrophic risks.

2.1.d Government

Even though governments normally play a supervisory role in the field of insurance regulation, they can still make use of insurance directly to achieve various policy objectives. We can define this kind of insurance with a terminology called "Policy Insurance". For example, in order to protect the innocent victims in motor accidents and fulfill the goal of social justice, governments can demand the motor drivers in their territories to buy a compulsory motor liability insurance in a required amount or provide an equal security before they may drive on the road. Therefore, it is obvious that governments indeed have tremendous interests in the insurance market, notwithstanding that they still have a duty to regulate the market and consider different interests of other groups.[2]

## 2.2 The Policy Considerations Of Insurance Regulation

In general, there are two conventional hypotheses in the justification for governmental regulation: namely the Public Interest Hypothesis and the Capture Hypothesis.[3] The former implies that government will intervence in certain economic activities in response to the public's demands for the relief from inequitable or inefficient market practices. Under such an approach, regulation is viewed strictly as a remedial activity. It is undertaken primarily to eliminate or reduce the costs associated with some market failures. However, the concept of a public interests in flexible and difficult to define. It is dynamic and varies with the court's opinion, which changes from time to time to reflect current social and economic conditions, along with shifts in public opinion.[4] In the field of insurance, it seems more acceptable than in other industries that "insurance is a business affected by the public interest". This rule had already been adopted by the US court since 1914.[5]

On the other hand, the Capture Hypothesis asserts that regulation is demanded by different interest groups which attempt to argue their own private interests. As we discussed above, different players in an insurance market often organize their own associations as pressure groups to demand the government meet their interests in the process of decision-making for regulation affairs.

In the context of insurance regulation, what considerations ought to be examined in a regulatory regime for an insurance market? We may conclude, based upon the above approaches, some principles in the following discussion.

2.2.a Policyhloders' Protection

(a) Financial Solvency

The incentive of a policyholder for buying insurance is to ensure his/her financial security and keep his/her peace of mind. The most important factor policyholders is the financial adequacy of their insurers, i.e. the financial solvency. As we mentioned easlier, insurers will indemnify the loss or pay the proceeds if the covered peril occurs and causes a financial loss to policyholders. However, since policyholders generally pay their premium in advance, if an insurer becomes insolvent and unable to honor his promise, the policyhold-

ers do not just lose the purchase value of insurance product but also the resources to meet their financial demands, such as the indemnity for the loss of property damages, the income in the period of disablility, the payment for meeting the liability to a third party or the supports to the survivors who rely on the dead insured. Under such circumstances policyholders will suffer an undesirable financial strike against which they intend to use insurance as a preventing vehicle. Consequently, it probably caused their peaceful living encounter some unexpected changes in the finance sector. It is apparently against the fundamental principles of the insurance system.

Any insolvency problem is not necessarily due to fraud or dishonesty of insurers or their officials but probably results from their incompetent managements, bad business practices or a series of large losses and catastrophes beyond their controls. For the sake of public confidence, the government has a duty to make some adequate and prudent supervision on the financial sector of insurance industry in order to prevent them from insolvency. After all, this is the most essential protection for policyholders.

(b)Asymmetry of Information

In addition to insolvency, asymmetry of information between buyers and sellers is another common issue in insurance markets. In practice, the asymmetry of information is mutual to both parties. From an insurer's point of view, an insured typically knows much about the nature of his risks. Such information is not always objective and ascertainable for the insurer and the risk is generally under the direct control of the insured. It leads to two particular problems in the management of insurance business, namely "moral hazard" and "adverse selection". The former will induce an insured intentionally to destroy the subject-matter insured (i.e. the insured's property or life) or be less cautious against the risks than the status uninsured, so that it results in an increase of the chance of loss. The latter means only those who recognize themselves or their property in a high degree of risk will approach to an insurer for seeking their insurance protection, and the insurer has no chance to select the risks he wants. In other words, the selection of risks is done conversely by an insured, Nevertheless, even though these problems are easily found in the real world, they still could be diminished by the requirement of "the duty of disclosure" or "the doctrine of utmost good faith" to the prospective policyholders. It can also be overcome by the professional judgments of well-experienced underwriters.

On the other hand, from an insured's point of view, an insurance product is an invisible service which relates to a lot of complicated factors, such as the calculation of premium and the ambiguous legal wordings in an insurance policy. For the aspect of calculation of premium, the price of insurance product, it involves complex mathematics and statistics that only underwriters(for non-life business) and actuaries (for the long-term business) can deal with. Obviously, it is too difficult for policyholders to find the real price of their policies. In addition, the wording in an insurance policy is another inherent danger for policyholders. Since an insurance contract is a typical contract of adhesion, its contents are usually drawn by the insurers. Under such a circumstance, the prospective policyhloders have few opportunities to change the context of standard insurance policies. However, most of the wordings contained in insurance policies are difficult terminology and it means that most policyholders are reluctant to read their insurance policies. When the strict liter-

al meanings of policy terms are contradictory to the reasonable expectation of the policyholders, they will be forced to assume an extra risk out of the field they can reasonably expected. Accordingly, government has a duty to examine premium rates and policy wordings for the prospective policyholders to protect them against any unfair treatment from insurance undertakings by virtue of asymmetry of information.

2.2.b Promotion of Competition

Over the past twenty years, regulation in financial markets has a significant development and, in the meantime, there is increasing feeling that too much government regulation restricts the functions of the markets. The advocates of "deregulation" argue that "competition and innovation are being stifled" and "let the market do its job".[6] Undeniably, some government regulations reduce the impact of competition. For instance, the control of the contents of insurance contracts which tend towards standardization reduces the number of products on offer and discourages innovation; and the financial controls which are designed to ensure insurance undertakings being able to meet their commitments make it more difficult to enter the market and prevent some less successful insurers from paying the ultimate price for their inefficiency. However, in an insurance market, can "the invisible hand" achieve maximum social welfare by way of its appropriate allocation of resources? In the view of Finsinger, an economically neutral financial market without government regulation may not be consistent with a community's social priorities. He said:[7]

"Notwithstanding perfect competition and perfect knowledge, a social misallocation of resources can occur because the basis of competitive decision making is private costs and returns that may not fully reflect the relevant social costs and returns. Governments therefore have a responsibility to have regard for important objectives other than economic efficiency. Conflicts may arise between the maintenance of an efficient market operation and these other policy objectives, which is certainly the case in the market for insurance. Certain forms of government regulation may actually enhance efficiency but many do not. The existence of government regulation can largely be explained in term of these other policy objectives."

In the opinion of Finsinger, it seems possible that there exists a perfect competition market in respect to the economic sector and the purpose of regulation is just to make a concession to certain policy objectives for the whole interest of society. However, is it possible that an insurance market without any regulation can develop itself perfectly competitive wiht "an invisible hand"? It is submitted that the answer should be considered cautiously because there is some inherent market deficiency in an insurance market. There are at least two arguments can be discussed in this respect.

First, according to the fundamental principles of economic theory the equal price will be automatically determined in a market of perfect competition. However, the price of insurance, i.e. the premium, sometimes will be inadequate because of unhealthy competition in the real world. For example, according to an US investigation on non-life insurers in 1910, price competition led to a destructive rate war and some insurers' insolvency. The reason was that some marginal insurers attempted to gain fire insurance business by lowering the rates and the better managed insurers were forced to match these rate reductions, whether the new rate was adequate or not. It led to increasingly inadequate rates and even-

tually resulted in wide-spread insurers' insolvency when a major fire occurred.[8]

Secondly, if we retrospect the insurance history from a worldwide perspective, the international reinsurance markets had always been very liberal and highly competitive since there were few restrictions and no frontiers for reinsurance transactions. We can also find thers is a tendency to the formation of cartels in reinsurance markets, such as the Munich Re. and the Swiss Re., because of the inherent unfair competition factor. In the management of insurance enterprises, reinsurance is an essential tool for spreading risk, especially for non-life insurance business. When the underwriters are dealing with a large scale case, they cannot accept the business beyond their underwriting capacity unless they have reinsurance support from their reinsurers. Thus, some emerging countries which lack capital for establishing their underwriting capacity have to resort to the international reinsurance markets to meet their demands. In general, the reinsurers have to "follow the fortune" of the (ceding) insurers. It means that the premium rate which reinsurers take should follow the original rate that was decided by the (ceding) insurers. In some catastrophic cases, however, the underwriters in emerging markets normally have to inquire from their reinsurers for the price before they accept the business. In practice, "Reinsurance controls the underwriting of direct insurance" is a very common phenomenon in the insurance markets of emerging countries. Therefore, it has a potential possibility that the local insurers in emerging countries are easily forced to transform themselves into "fronting companies" of foreign reinsurance groups and, even worse, the whole market is controlled by these groups if the government has no regulations against this potential risk.

Theoretically, the perfect competition model of modern economic theory is based on a number of assumptions. "It assumes that there are in the market a large number of buyers and sellers, the latter all producing identical or homogeneous products; that consumers have perfect information, and always act in order to maximise utility;that resources flow freely from one area of economic activity to another, and that there are no impediments to the emergence of new competition ("barriers to entry"); and that business people always maximise profits." [9] As we discussed above, there are some inherent factors such as information asymmetry and unfair competition in an insurance market, it is necessary to take advantage of regulation to promote it close to a more competitive position even though there still are other policies which should be considered in respect of insurance regulation. The single insurance market in the European Union, which will be discussed in later sections, is a typical example for this aspect.

### 2.2.c Government's Policy Objectives

Governments also have interests in insurance markets because they can use insurance as a vehicle to influence the allocation of social resources and achieve some policy objectives. In addition to the objectives of the protection of policyholders and the promotion of competition, there are others in the economic and social sectors;

(a) Economic policy objective—it normally relates to government's monetary policy, public finance, debt management, taxation policy and other external policy. As in the example to which we have referred, the governments in some emerging countries have to develop some restrictions on reinsurance business in order to protect their domestic insurance industry against the unfair competition from international reinsurance cartels. The

socalled "national reinsurance system" could be the most popular way used by these countries. Furthermore, governments can also use the system to prevent their currency from flowing out of their countries. In Germany, the regulation of investment undertaken by insurance companies implicitly assists government's debt management.[10]

(b) Social Policy— The intervention and regulation of government in the operation of insurance markets is usually heightened by the common perception that insurance benefits society. This leads logically to certain insurance being made compulsory.[11] A good example familiar to everyone is compulsory motor liability insurance, which is designed to protect the innocent victims in motor accidents. In some forms of health insurance and insurance-based pension arrangements, it is asserted that insurance is not a merket-place activity like any other, but a sort of private extension of social security.[12] Under such circumstances, a social policy objective is a very important factor when governments make their decisions in respect of the affairs of insurance regulation.

## 2.3 The General Structure of Insurance Regulation

### 2.3.a Licensing Requirements

A license is a document stating that the insurer has complied with the regulatory conditions and is authorized to engage in the insurance business for which it has applied. There are many stringent requirements as to suitability and financial soundness which must be satisfied before the authorization is given by the regulators. These requirements are wide-ranging and vary from time to time, including insurer's name, the professional background of its directors and officers, type of organization, scope of business, minimum capital, and so on. They are designed to protect policyholders from the birth of inadequate conceived insurers, the misleading of insurers' names and the insurance undertakings organized by the people of questionable reputation.

In US, a license to write insurance may be issued to a domestic, foreign, or alien insurer. Each state can establish stricter licensing requirements for alien and foreign insurers than for domestic ones. This practice is justified because domestic insurers' assets are generally in the state and more easily subject to the commissioner's (the insurance regulators of each state)control through court procedure.[13]

In UK, under Insurance Company Act 1982 (ICA 1982), the permission of the Secretary of State is required to carry on insurance business of any class. There are certain prerequisites for authorization:

(a) The company must comply with the solvency regulations and possess sufficient financial resources to meet its needs.

(b) All controllers, directors, managers, and underwriting agents of the company must be "fit and proper persons".

(c) The company must submit a detailed plan, setting out the types of business it proposes to underwrite, premium rates, reinsurance arrangements, and so on.

Authorizations are granted for specified classes of business. The schedules to ICA 1982 divide insurance business into long-term business (essentially life assurance) and general business (everything else). Long-term business is further subdivided into seven classes, and general business into eighteen classes.[14]

Moreover, it is a criminal offence, under ICA 1982 Section 14, to carry on any insurance business in the UK without having the necessary authorization. In other words, any unauthorized insurance business conducted in UK will be an illegal contract. It arises from a controversial issue under the Common Law System—" whether the counter party who enters into an insurance contract with an unauthorized insurer can assert his rights under the contract against the unauthorized insurer?". There were a lot of conflicting case law and academic discussions on this issue. Nevertheless, it is too far away from the main subjects of this paper; there seems no necessity to discuss further for this respect.[15]

2.3.b Financial Requirements

It may be argued whether financial requirements are associated with the losses of efficiency in insurance operations. If these regulations are binding, then there must be costs resulting either from suboptimal investment strategies or from larger reserves held than those in an unregulated competitive market. However, in the view of Finsinger, these costs seem to be quite small. "First of all, the typical solvency rules generally leave ample choice for the portfolio of investments counting as reserves margin. Secondly, the solvency regulations do not seem to be binding with respect to quantity of reserves except for companies controlled by fraudulent or irresponsible risk-loving managers."[16] In spite of the reasons mentioned above, if we consider in respect of policyholders' protection, the financial requirements to insurance undertakings seem to be the most importane tools in insurance regulation. In this paper, three basic financial requirements will be discussed: namely "Capital Adequacy", "Investment Restriction" and "Solvency Margin."

(a) Capital Adequacy

"Capital" is not a unitary concept; it is susceptible to differing meanings to different persons under divergent circumstances. This disparity may impair or distort desired regulatory objects and bring into question certain regulatory predisposition toward the capital adequacy issue.[17] In respect of financial accounts, capital is the net worth of an private enterprise, calculated on the assumption that assets of the enterprise can be liquidated on a going-concern basis, and liabilities and obligation of the enterprise can be paid and satisfied in full. Capital, to the extent it can be translated into monetary value, becomes an integral part of the right-hand side (i.e., the liability and the equity side) of an enterprise's balance sheet.[18] The final net worth or capital calculation is the sum of the value of nonliability contributions made to the enterprise by its owners, plus retained or undistributed surplus.

Since there are different types of insurance undertakings, the capital type varies in different types of insurers. For a "stock-company insurer", its capital stock account represents the dollars value nominally assigned to shares issued to stockholders. For a "mutual-company insurer", a minimum paid-in fund is required, but as no capital stock, this fund is assigned entirely to paid-in surplus. This initial fund usually is supplied by lenders but is treated as a guarantee fund rather than a liability. Interest may be paid on this fund and the principal may e repaid from its earnings. For an individual insurer, such ás an underwriting member (not corporate members) in Lloyd's of London, there is no paid-in capital requirement at all. However, individual members of Lloyd' are liable for valid claims on

their underwriting to the full extent of their personal assets.[20]

Capital adequacy of insurance undertakings refers to the minimum level of capital for such an institution, viewed as necessary or desirable by the insurance regulator for the "safe and sound" operation of insurance undertakings. It is essential for establishing insurers' underwriting capacity. This is because the increase of the portential new business or some large-scale business could cause the exhaustion of surplus and the resultant impairment of its capital. Therefore, unless the insurer repairs the deficit in respect of its capital or surplus, it has to stop underwriting additional business because no more underwriting capacity is available.[21] On the other hand, sufficient capital or surplus is needed to guarantee an insurer's continued solvency for a period long enough to detect and corret his adverse underwriting and investment experience.

(b) Investment Restrictions

In order to protect policyholders' interest in respect of the solvency of insurance undertakings, prevent concentration of economic power and encourage the commitment of funds for socially desirable purposes, it generally contains some restrictions on the investment of insurers' assets in insurance regulation. These restrictions are concerned with both qualitative and quantitative controls and deal with the following items: the types of investment media, protfolio distribution among approved media, amount of security required for authorized media to qualify, percentage of a firm's outstanding common stock that may be held, percentage of admitted assets that may be invested in a single corporation, percentage of admitted assets in a single investment issue of a corporation, and the sources of investment funds.

Generally speaking, the insurance regulators should adopt a conservative attitude toward the investment restrictions to prevent insurers from falling into financial trouble as a result of the disarrangement of investments. Thus, the investment vehicles which insurers can use should be less speculative than other financial institutions. However, the London Insurance Market (including the leading insurance broker "Sedgwick" and the Association of British Insurers), undaunted by Baring derivative debacle,[22] looks to plunge into an even more esoteric form of futures and options trading through reinsurance. The reason for using the derivatives is that the biggest potential catastrophes could still wipe out insurers and reinsurers, even though they have a substantial dispensation against disasters.

At present, the reinsurers in the London Market can trade "Cat Index" future in the Chicago derivative market, and now the London market aims to produce British and European "Cat Indices" for trading closer to home. It is argued that the transactions of reinsurance, including the investment, should not be regulated by government because reinsurance has an international feature and is not directly involved in policyholders' interests. However, even though reinsurers have no direct relationships with policyholders, it is possible that a direct insurer becomes insolvent because of the financial problems of its reinsurers, so that it will impair policy holders' interests. According to these, it seems worth more consideration on these issues: whether reinsurers can be allowed to use highly speculative investment instruments, such like derivatives; or whether regulators should put some requirements on direct insures when they select their reinsurers to cede their business.

(c) Solvency Margin

Solvency margin requirements can also be regarded as "early warning systems". When the solvency of an insurance undertaking becomes critical, measures to avoid bankruptcy can be imposed on the insurer. Even though the insurer sometimes cannot redirect its course on its own, it generally commands a positive value. This is so because substantial costs of acquisition are embodied in its policyholders and there can always be found a healthy insurance undertaking willing or even keen on take-over. Thus, solvency rules increase the likelihood of take-over in the case of solvency problems.[23] In other words, the solvency margin requirements can demand the insurer to maintain a minimum financial standard which may induce other institutes to take over, even though the insurer is actually experiencing a financial distress.

The solvency margin requirements vary among different countries because the calculations of margin involve the accounting principles that regulators adopt, such as the accounting methods applied to the valuation of assets and the determination of liability of an insurance undertaking. Meanwhile, they also vary in respect of different insurance business. For instances, the insurance commissioners in US usually use "policyholders' surplus" to measure insurance undertakings' solvency margin. Statutory policyholders' surplus is the amount by which assets exceed liabilities, as measured by state regulators. Except for the regulatory restrictions applying to valuations, the concept of policyholders' surplus is the same as the concept of equity in ordinary business finance.[24] In UK, all authorized insurance companies must meet certain solvency margin standards which conform to the ( first generation) Insurance Directives issued by the European Community. Any company underwriting direct long-term insurance business must maintain a minimum solvency margin, according to an annual actuarial valuation of its assets and liabilities for different types of long-term business. On the other hand, a company underwriting general insurance or reinsurance business must maintain a minimum solvency margin at least equal to the minimum guarantee fund for the classes of the business it transacts. The solvency margin is calculated by two methods—the premium basis and the claims basis—and the prescribed margin of free reserves and shareholders' funds is the greater of the two sums thus calculated.

2.3.c Business Requirements

(a) Statutory Reports

In cooperation with regulators' investigation on the subject of solvency and management of authorized insurers, insurers must file statutory reports to the regulators in respect of the business they engage in. These reports are in accordance with the forms developed by the regulators and are detailed in related to their business.. For example, in UK, the ICA 1982 lays down certain requirements: such as (1) all compaies must deposit each year with the Department of Trade and Industry (DTI) detailed accounts together with other information concerning matters such as premium and claims analyses and reinsurance arrangements, in a form laid down in the Insurance Companies (Accounts and Statements) Regulation 1983. (2) the DTI must be notified of any changes of directors and managers. It must also be notified of proposed changes of some managing officers of UK executives and representatives of other states.[25]

(b) Product Controls

An insurance product is an invisible service which relates to a lot of complicated factors, especially for the legal wordings in insurance policies. It causes most of policyholders to be reluctant or unalbe to read their policies. In some cases, the wordings in insurance policies are so complicated that even lawyers can not understand what they mean, as shown by the number of cases that reach court for interpretation. It is understandable that lay persons may be unable to comprehend the real meaning of policy wording.[26] The standardization of insurance policy presents an opportunity for unscrupulous insurers to draft wordings which contain certain terms or conditions unfavorable to the policyholders. Even though the insurers do not intend to take unfair advantages from policy wordings, it is still possible to make them misleading and ambiguous. In order to protect both the public and reputable insurers against irresponsible insurers, insurance regulators in some countries are empowered with an authority to approve the policy forms and wordings prepared to be sold by insurers. In consequence, some standard policy froms will be developed by insurers' experience or in accordance to the regulators' instructions, especially in the case of personal line insurance. The main reason is that most of insurers nomally expect that their policies can be approved as soon as possible, even though such a system will hamper the innovation of new products.

(c) Business Methods Controls

Insurance regulation also seeks to protect the public from the incompetent and dishonest insurers or intermediaries, and so as to achieve the goal of fair trade. The regulators may stipulate the methods used by insurers or intermediaries to acquire their potential business. Such regulations are concerned with ethical or professional standards of the activities for insurers and intermediaries. It can roughly be categorized into two groups: the supervision of insurance intermediary and the controls toward marketing methods.

(1) The supervision of insurance intermediary: As observed earlier, not all insurance business are conducted directly by insurance undertakings. Some of them are through insurance intermediaries because they can provide some assisting functions to both parties in an insurance transaction. They thus play a very important part in insurance markets. Generally speaking, insurance intermediaries must be licensed by their domestic regulators and qualified in certain specific professional requirements. For example, in 1976 the UK government proposed the licensing of all insurance intermediaries, in the same way as in the US, under the Insurance Brokers (Registration) Act 1977. In addition, the Financial Services Act 1986 required any person or firm which advises on investment to be authorized, either as an independent intermediary or as a tied representative of a company, which is then responsible for the activities of that representatives.

(2) Controls toward marketing methods: Owing to severe competition in insurance marketing, some insurance undertakings or intermediaries will use unjust methods to induce prospective policyholders. These methods include misrepresentation, twisting, rebating and unfair discrimination in premium etc... In Uk, there are some restrictions on the selling of insurance. For instance, the Insurance companies (Advertisements) (Amendment) Regulations 1983 are designed to protect the public against possible misleading advertising by the life insurance companies located outside UK that have not received DTI authorization. The Regulations specify that advertisements inviting people to enter into a long-

term insurance contract with such a company must provide certain details, such as the name of company (including the fact of unauthorization), the intermediary marketing the products, the trustees and the relationship between all three parties.[27] In addition, there are other marketing regulations in the Financial Services Act 1986 and the Policyholders Protection Act 1975.

## 2.4 The Different Sources of Insurance Regulation

Broadly speaking, the forms of government regulation operate through three divisions: namely the legislative sector, the judicial sector and the administrative sector. Meanwhile, self-regulation, which can be construed as one part of administrative control, is a fourth regulatory regime. However, if we adopt a strict approach to the definition of "Regulation" , it seems only to be applied to the regulation of the administrative sector in government.

Different government authorities have their own duties in respect of insurance regulation affairs. The legislative sector should consider different interests in details and make the law fit for the real world. The administrative sector should prudently supervise the operations of insurance undertakings with the authority delegated by the legislative sector. The judicial sector, the last resort of policyholders, should protect the innocent party by way of construction of laws when the above sectors fail in their jobs. In the following paragraphs, these different regimes of government regulation toward insurance affairs will be discussed.

### 2.4.a Legislative Controls

In order to govern the operation of insurance undertakings, every country or state has its own insurance law and relative rules. These legislations are stipulated in respect of many matters, such as licensing requirements, business methods, financial requirements, liquidation and taxation. The real purpose of legislation control is to protect the interest and welfare of its citizens. In some countries adopting the Civic Law System, the insurance legislation can even gorerns some details of various insurance contracts.

The task of drafting legislation is not left solely to legislators. As we mentioned earlier, different groups in an insurance market will express their opinions through their representatives in parliament. It is inevitable that there may be some conflicts of interests while drafting the proposal statutes. Under such a circumstance, the final legislation is normally the result of compromises among different groups. However, the legislators who lack an objective position sometimes neglect the interest of the public because, in most cases, the consumers' voice is vague in the market. Therefore, it is essential for legislation to find the core interest of the proposed ldgislation before making the judgment. In addition, the growth of legislative activities can be anticipated because of the diversity and innovation of insurance markets, especially in respect of the EC insurance single market.

### 2.4.b Administrative Controls

The main task of insurance regulation is allocated to the administrative sectors in government because it requires some specialized knowledge difficult for common legislators. Thus, there is normally an insurance department in government which takes charge of the supervision of insurance undertakings in accordance with the authority deledgated

from the legislative sector. Decision or rule makings of the regulators are subject to judicial reviews if any affected partics wish to challenge them. In the process of decision or rule makings, there are three main objectives which regulators should aim to achieve: (a) a balance between flexibility and certainty, (b) a change in the perceptions of the regulation held by the regulated and the wider community, and (c) the exercise of control over the regulated and other regulators.[28] In other words, these regulatory decisions or rules concern with different considerations and grow from the necessity for both flexibility and technical understanding. Their context is naturally tremendous and complicated, sometimes changed frequently, because they have to cope with the diversity of the insurance market.

Generally speaking, the regulators dealing with the task of insurance regulation should be the officers in the insurance department. However, the financial and mental resources available to an insurance department limit the quantity and quality of regulatory authority. Furthermore, the necessity for political considerations to take precedence, in some cases, over rational approaches also hinders appropriate regulatory action. Therefore, it seems possible to achieve regulatory effectiveness in respect of some professional ambits if regulators delegate some parts of their authority to an independent third party. The appropriate instances are the designated agents like the Security Investment Board (SIB) and Self-Regulation Organizations (SRO) under the UK regulatory structure for investment business, even thourgh they are less related to insurance business.

In UK, the Financial Services Act 1986 vests regulatory power in the Secretary of State for DTI. Many but not all of these regulatory powers may be delegated to the "designated agency" (s.114). The SIB, a private company rather than a government agency, is identified as the first designated agency (s.114(2)). The FSA 1986 allows powers to be delegated to the SIB only where the Secretary of State is satisfied that a number of specified statutory conditions have been met.[29] Furthermore, the activities of the SIB are to be subject to the continued scrutiny of the DTI which possesses the ultimate weapon in the form of a statutory power (s.115) to resume those powers which have been transferred.[30] Then the SIB in turn is empowered to recognise other self-regulating bodies, each of which is intended to be responsible for particular aspects of investment business. In respect of long term insurance business, the "Life Assurance and Unit Trust Regulatory Organization" (LAUTRO) is intended to regulate businesses which are engaged in the production and selling of life insurance and pooled investments such as unit trusts.[31]

2.4.c Judicial Controls

The judicial sectors of government also play an important role in respect of insurance regulation. The courts interpret the statutes related to insurance affairs when its meaning is challenged, and also settle disputes in insurance contracts. Fundamentally, a court should not only rule based on the constitutionality of insurance legislation and take reference to the regulatory actions of the administrative regulators, but should also interpret the contract term in dispute according to two basic principles: "probe the true intent of both parties" and "the benefit of ambiguity is contributed to the insured". This is because an insurance contract is an adhesive one and most of its wordings are drafted by insurers. The party taking charges in drafting the wordings of insurance policies, the insurers, should assume all the responsibilities arising from his negligence (i.e. drafting the ambiguous

wordings). Furthermore, in some litigation cases of US, when the traditional interpretation methods became unavailable to protect innocent policyholders, the courts adopted so called "Doctrine of Reasonable Expectation" as a supplemental method of interpretation. Under this doctrine, as long as the wordings in plocy contradict the resonable expectation of policyholders, even though they are not ambiguous in literature, the term which contains these wording could still be presumed avoidable.

2.4.d Self-Regulation

A self-regulation regime has been developed as an alternative method, instead of inefficient public regulation. Under such structure, some cooperative organizations are set up among insurers to execute regulatory affairs. These associations exert some controls over the business through "code of ethics or parctices" and various agreements in order to restrict inappropriate and unprofessional conducts of insurance undertakings. In UK, for example, the "Association of British Insurers" (ABI) has similar self-regulation effects among their members. On the other hand, some self-regulatory organizations have the delegated authority from the regulators, such as LAUTRO we mentioned earlier.

Furthermore, in respect of insurance self-regulation, the most famous instance seems to be Lloyd's of London (the Lloyd's). According to Insurance Companies Act 1982, all insurance companies in UK should be regulated by the DTI. However, as Lloyd's has a long-lasting contribution to this country and also possesses an important status in the financial market, the LLoyd's Acts 1871 ~ 1982 vested regulating powers in the elected Council of Lloyd's. In other words it can have an exemption from the direct regulation of DTI if it meets certain requirements.

The self-regulation of Lloyd's is always a controversial issue. It was argued that self-regulation may reduce the cost and substantial expenditures to the government accounts, give the members more flexibility and avoid unnecessary interference from the government. However, the result of self-regulation always became loose and inefficient. In fact, the Council of Lloyd's (the self-regulator) couldn't control their members very well because powerful members seemed to have some privileges in this entity. It made other members doubt the authority of the Council. In some cases, some members even ignored the regulation and conspired with others to transfer an illegal interest. This is the main reason why so many litigation cases arose between Lloyd's and its members in recent years.

Although Lloyd's had several reforms for its self-regulation regime, there have not been any remarkable improvements for the market. From the point of public interest protection, if the Lloyd's cannot regulate itself efficiently, it doesn't just damage the interest of its members, but probably endangers the public interest. Therefore, it is submitted that the DTI should require the Lloyd's adopt stricter regulatory doctrines or revise the relative provisions in ICA 1982 and Lloyd's Act to repeal the exemption privilege of the Lloyd's. In fact, there has been a unanimous understanding in parliament that self-regulation in this insurance market has proved a disastrous failure. Recently, some Members in the Parliament even urged the ending of self-regulation of Lloyd's[32]

## NOTE :

1.R.L. Carter; Handbook of Insurance; (loose-leaf, London, 1994)A.4-03.

2.See further in 2.2.c of this paper for the government's policy objectives.

3.Edward P.M. Gardener; UK Banking Supervision, Evolution, Practice & Issues, (1986) pp29~30.

4.Robert I. Mehr, Emerson Cammack & Terry Rose; Principle of Insurance; (8th ed., Illinois, 1985) p716.

5.Ibid, p715.

6. Gardener, op. cit., p25.

7.Jorg Finsinger, Elizabeth Hammond & Julian Tapp; Insurance: Competition or Regulation; (IFS Report Series No. 19, The Institute for Fiscal Studies, 1985) p8.

8.Mehr, Commack & Rose; op.cit. p717.

9.Josephine Steiner; Textbook on EEC Law; (3rd ed., London, 1993) p117.

10.Finsinger, op. cit., p7.

11.Bill Pool; The Creation of the Internal Market in Insurance ; (Commission of European Communities, Luxembourg, 1990) p10.

12.Ibid.

13.Mehr, Cammack & Rose; op. cit., p756.

14.See the Schedule 2 of ICA 1982.

15.This issue concerns about the illegality of an insurance contract. see Bedford Insurance v. Institutio de Ressaquros de Brazil [1984] 3 All ER 766; also Phoenix General Insurance v. Administratia Asigurailor de Stat [1987] 2 All ER 152; and Re Cavalier Insurance Co. Ltd. [1989] 2 LLR 430. However, the rules established in these cases were fundamentally changed after the implementation of the Financial Services Act 1986. According to the para. 3 s.132 of the Act, providing that an agreement, where the insurer is not authorised to make it, is not void but is unenforceable by the insurance, the assured may either enforce the agreement as if it were lawful, or plead it as unenforceable and recover payments made of premiums, plus compensation for his/her temporary loss such payment.

16.Finsinger; op. cit., p15.

17.Joseph Jude Norton, Capital Adequacy Standard: A Legitimate Regulatory Concern for Prudential Supervision of Banking Activities?; (vol.49: 1299, Ohio State Law Journal, 1989) p1302.

18.Ibid, p1303.

19.Ibid, pp1303~1304.

20.Under the unique system, it comprises four levels of security that underlies all Lloyd's policies, namely premiums trust funds, funds at Lloyd's, confirmed personal wealth and Central fund.

21.Mehr, Cammack & Rose; op. cit., p751.

22.In February 1995, the Baring Bank was plunged into a crisis by losses estimated at 600 million Sterling Pounds or more, incurred by one of its traders in Singapore office. Nick Lesson, the trader, incurred the losses on the Nikkei-225 futures contracts (one type of derivative contracts), which is traded on Simex in Singapore and in Osaka.

23.Finsinger; op. cit., p15.

24.Mehr, Cammack & Rose; op. cit., p758.

25.S.R. Diacon & R.L. Carter; Successin Insurance; (3rd ed. 1992) p245.

26.Mehr, Cammack & Rose; op. cit.,p258.

27.Diacon & Carter; op. cit.,pp251~252.

28.J.M. Black,"Which Arrow?": Rule Type and Regulatory Policy, (1995 Public Law, Spring Issue) pp2~3.

29.Rider, Abrams & Ferran; Guide to the Financial Service Act 1986; (2nd ed. 1989) p26.

30.Ibid.

31.Ibid, p.31.

32.See generally the Times in 1995.