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REGULATORY ARBITRAGE AT THE EU INSURANCE MARKET – THE PHENOMENON IDENTIFICATION

Abstract: Regulatory arbitrage at the insurance market can develop as the consequence of fundamental law-making determinants in the EU (the specific nature of directives, common law and civil law), or can be related to the existing community regulations dedicated, in particular, to the insurance market (creating insurance products, supervision over insurance institutions), and can also result from regulations to take effect in the future (Solvency II). Regulatory arbitrage at the insurance (and financial) market cannot be ruled out, since wherever differences in legal restrictions occur there appear arbitrageurs who attempt to take advantage of these differences which, however, can be minimized by means of effective cooperation between the EU and national regulatory bodies, as well as the national and sectorial supervisory authorities.

Keywords: arbitrage, regulations, supervision.

1. Introduction

The EU regulations, referring to the common market functioning rules, are supposed to ensure both freedom of economic activities and their continuation, as well as create equal conditions for competition at internal markets and minimize the consequences of market imperfections. They also constitute an important policy component for the European identity construction and an attempt to cement various regulatory models in particular countries. In spite of these assumptions the Community law presents certain gaps referring to regulations, while some of its areas, related to the financial market functioning, are overregulated, which in both cases can be taken advantage of by market participants within the framework of regulatory arbitrage.

The objective of the paper is to identify and characterize the phenomenon of regulatory arbitrage at the EU insurance market and discuss a number of examples specific for this particular market.

2. The general characteristics of regulatory arbitrage phenomenon

Regulatory arbitrage refers to searching for a more attractive legal environment of the conducted activities and taking advantage of differences in the level of regulatory restrictiveness. Obviously, it is not just legislation intricacies which determine it, since meeting every regulatory requirement constitutes an expense for the regulated entity (at least a short-term one). For this reason the natural reaction of regulated entities is to investigate methods for minimizing costs and therefore the interest of an arbitrageur – less complicated and less burdensome legislation – is defined from an economic viewpoint. The condition for resorting to arbitrage is the proper scale of activities accompanied by the absence of limitations in allocating resources [Tarczyński, Mojsiewicz 2001, p. 242].

In the context of objectives underlying the regulations established for the EU financial market, the crucial issue referring to insurance sector entities is to ensure equal conditions for competition between domestic and foreign entities (seated in different member states and in the third countries) and with respect to the operations performed. This implies regulatory arbitrage presence at different levels:

- cross-sector (domestic) – using differences in the level of insurance sector activities regulation and the related ones ("at the same market but in different forms") and results from possibilities of the performed activities formal transfer to other financial market segments, where compliance costs are the lowest;
- supra-national at the EU forum – taking advantage of differences in the country of origin legislation, or the country where the activities are currently conducted, depending on which provisions are more favourable. This type of arbitration is justified by the freedom of residence and services provision;
- supra-national in the global scale (the third countries) – using differences in regulations occurring between the EU and other regions (countries) worldwide.

While the emergence of supra-national arbitrage with reference to the third world countries is outside the scope of the EU regulators, in case of both inter-sector and supra-national arbitrage at the EU forum there are two decisive elements determining the possibility of its occurrence:

- the Community and national legislation,
- market supervision architecture and the approach of supervision authorities towards the implementation of supervision goals (regulatory powers and the applied supervision practice).

The phenomenon of regulatory arbitrage at the EU financial market is the example (unfortunately a negative one) quoted while developing regulations for other markets. "Regulations should be developed in the manner which [...] prevents the recurrence of events that have taken place on financial markets as the result of regulatory arbitrage and consisted in performing transactions in the regulatory environment which is more flexible or less restrictive regarding the system of penalties" [Proposal for a regulation...].

3. Regulatory arbitrage at the EU insurance market – examples

Theoretically regulatory arbitrage should not occur at the EU insurance market, since the idea behind the Single Insurance Market establishment in 1994 was the harmonization of regulations, its most extensive unification, as well as integration and opening equal competition opportunities for entities functioning at this market. However, the number of areas in which diversified provisions can become the basis for regulatory arbitrage is infinite. It may be influenced by law-making foundations, the existing Community insurance regulations, as well as any new regulation which by enforcing its rigid provisions, even if it not resulting in differences between countries, is, anyway, exposed to the risk of circumvention attempts by means of various, complicated legal constructions.

The EU law enactment foundations, as the determinant of regulatory arbitrage at the insurance market, are related to the fact that it is the directives which play the main regulatory role, i.e. legislative acts which are not of normative nature but just specify the particular goal to be met. It allows the executive bodies (national regulators) for the "free" choice of measures facilitating the achievement of directive objectives. Its consequence is the possibility of differences between countries, both in regulations and approaches presented by these executive bodies. The differences which are taken advantage of within the framework of arbitration may also be due to the fact that in some member states common law is in force while in others civil law, which results in diversified approaches towards legislation enforcement, e.g. with reference to directives' provisions which use the following phrases: "if approved by adequate authorities", "to demonstrate the validity of such actions," "significant – insignificant," "relevant – irrelevant" [Mérő 2008, pp. 2, 3]. As a result the European insurance market has turned into the mosaic of different legal solutions the core of which is the same (Community Directives), while particular arrangements – beyond the scope of EU regulations – differ depending on the member state [CEA 2006].

Having considered the existing Community insurance regulations, regulatory arbitrage determinants may take the form of, e.g.: barriers in starting and extending activities, supervisory and public information disclosure, ownership and control spheres, limits regarding the allowable assets, price regulations, insurance guarantee schemes or disciplinary mechanisms regarding regulations interpretation ([Giordano 2009], cited after [Jajuga 2011, p. 117]).

The absence of regulations' harmonization, regarding capital requirements imposed on financial sector entities, may serve as the example of their unequal treatment and illustrates possibilities of inter-sector arbitration. Investors can transfer their operations from sectors featuring more stringent regulations (banking, insurance) to the related ones (investment funds) offering less restrictive legal environment. The Community law inconsistency is also manifested by unequal treatment of insurance sector entities – direct sales of insurance products carried out by their creators (insurance institutions) is not subject to the same provisions as sales

performed by intermediary agents – these gaps result in unequal conditions for the conducted operations, and even the directives referring to sales by intermediaries refer to the selling entities in a different way [Directive 2002/92/EC…], since some products and distribution channels are excluded from the directive requirements (e.g. when an agreement does not refer to life insurance and liability insurance and also when it covers a small amount of the annual premium – less than 500 euro).

The possibility of regulatory arbitrage occurrence on the insurance market may also result from the absence of complex approach to the regulated issues. Many directives should complement one another, while instead they overlap and duplicate each other resulting in ambiguities while approaching the "adequate" legal act. The provisions referring to unit-linked insurance, which are regulated by five directives referring to creators and issuers of such products and by two directives covering their sales [Communication from the Commission… 2009], can be quoted as an example. It is obvious that entities underlying such regulations take advantage of the most favourable, from their perspective, provisions.

Regulatory arbitrage may also take place as the result of inconsistent insurance guarantee schemes in force in the EU member states. The consequence of such inconsistency is manifested by purchasing insurance products featuring the most extensive guarantees. The problem of possible arbitrage and "substantive market disturbances" has already been raised by the European Commission which ordered the analysis of interdependencies between harmonization and application of systems in force in the EU and the country of origin principle after the implementation of Solvency II Directive [Insurance guarantee schemes…].

Arbitrage can also occur at the absence of regulations in some areas – for example the secondary life insurance market which is locally regulated in, among others, the United Kingdom and Austria legislation, while neither the EU common standards have been defined nor the need to establish them has been recognized. Differences in opportunities to invest in the shares of insurance funds, in case of with-profit insurance policies, result in the possibility of arbitrage also in this area. Owing to its attractiveness, resulting from high return rates, citizens of many EU countries transfer their free funds to these member states where internal legislation does not impose limits or restrictions in this matter (e.g. United Kingdom). Insurance institutions in the countries where restrictive limitations have been imposed (Poland) can only hope for the less informed local market clients and are obviously at a competitive disadvantage comparing to these member states which offer more liberal regulations.

Having considered the form of market supervision and the possible approach of national supervision authorities regarding supervision objectives implementation on the EU market, the "potential" of regulatory arbitrage is also identified by the limited capacity for mutual cooperation involving many supervisory authorities (at least one and frequently several supervisory authorities in every member state) which, however, is of greater significance in case of internationally active entities. 89

insurance groups were registered in 2011 in the European Economic Area (EEA) with respective 14 national supervisory authorities established as group supervisory authorities [EIOPA 2012]. Complex approach to the entire financial market supervision (the establishment of one supervisory authority) offers a chance to eliminate an inter-sector regulatory arbitrage, which has frequently been and still is quoted as the justification for sector integration of state supervision authorities (Poland, Germany, Great Britain). However, sector-oriented supervision structure persists on the markets of many EU member states which results in obstacles for ensuring both regulatory and supervision consistency covering the entire market. This opens opportunities for directing operations performed by the regulated entities to particular sub-markets (sub-sectors) offering more favourable conditions and thus making space for regulatory arbitrage at inter-sector level, and having considered the freedom of residence and services provision in the EU, this situation is also true in an international system.

It may seem that in an institutional dimension the new EU supervisory authorities, members of the European System of Financial Supervision (since 2011), having crucial coordinating and consulting tasks included in their activities profile, will reduce opportunities for regulatory arbitrage to occur, as well as its derivative – supervisory arbitrage. However, EIOPA's competencies are limited and of subsidiary nature with reference to operations of the respective national supervisory authorities. This means that the supervision of insurance institutions, despite Community regulations and the new approach to insurance markets supervision methods, is still of national dimension which, obviously, does not rule out opportunities for regulatory arbitrage to occur.

Market regulation is not justified at the absence of supervision, the task of which is to ensure compliance with accepted regulations by the supervised entities [Monkiewicz 2007, p. 3]. Regulations referring to insurance institutions' functioning cover standards common for all member states, however, some instruments are at the disposal of national supervisory authorities, which obviously opens opportunities for taking advantage of possible differences, especially in case of the so-called supervisory practices. Local decision-makers responsible for regulations, as well as supervisory authorities, can impose additional requirements on the supervised entities as the reaction to inconsistencies in the European regulatory framework which, however, results in the diversification of competition conditions between countries and thus constitutes an incentive for arbitrage to occur. Insurance institutions will always search for regulatory gaps and try to use them to their advantage, while adequate supervisory authorities will adapt their powers depending on the "approach" to the existing regulations. "Restrictive" attitude of supervisory authority may result in the supervised entities "fleeing" such jurisdiction and moving their operations to a different country. Although such approach is positive from the escaping entity perspective, in the global scale its consequences may be negative, since the deserted insurance market competitiveness keeps decreasing and the occurring loss of clients

may result in the local market being "punished" by capital outflow to countries featuring lower regulatory restrictiveness.

All EU legislation is enacted to "ensure reliable and consistent effect of international regulations," which is of particular significance for any supra-national market. Insurance market is, indeed, of supra-national character and the legislative efforts focus on ruling out possible regulatory arbitrage. However, the new regulations are also far from "perfect." The diversification of MCR or SCR levels, provided by Solvency II directive, depending on the risk, prefers large entities, which undermines equal competition conditions in the EU and encourages for insurance groups restructuring, aimed at the regulatory arbitrage based on differences in capital level requirements. Solvency II directive also allows for the situation in which the amount of capital mark-up for the parent company and its subsidiaries may be set at different levels. This tool is left at the disposal of national supervisory authorities which make the right to raise the required solvency level dependant on the situation development, and that can be used for arbitration purposes (it is only the legally binding EIOPA mediation which allows for the dispute resolution between supervisory authorities). In some countries – depending on the situation development, the adequate requirements will be restrained, while in others the concern of negative impact on local insurance market will become a sufficient preventive factor. Additional charges (higher "regulatory costs") can also enhance the transfer of performed activities to other financial institutions offering lower regulatory burden, which extends the phenomenon of inter-sector arbitrage.

The mechanism of supervisory authorities' individual approach to insurance institutions solvency, provided for by Solvency II, can generally be considered as positive, since it eliminates the "flat rate" approach used in Solvency I. However, the subjective aspect of supervisory assessment, as well as allowing special treatment for some insurance institutions, may give rise to precedents offering opportunities for other insurance companies to take advantage of them and open space for regulatory arbitrage. The latter phenomenon, for the time being, presents just a theoretical approach (as of May 2013 Solvency II is not yet in force), however, from the perspective of opportunities for supervisory arbitrage occurrence it has already been noticed as one of more significant gaps in Solvency II regulations.

4. Final remarks

The majority of mechanisms related to the phenomenon of regulatory arbitrage are common for the entire EU financial market, whereas Community law at the insurance market refers to cross-sectional legislation regulations, supplemented by market specific laws prepared at different pace and dedicated to different goals. By definition, the EU regulatory bodies, attempting to influence regional and local principles of insurance markets functioning, aim at ensuring equal chances for competition, the reliability of international regulations, and eliminating the phenomenon of regulatory

arbitrage, which, however, is not entirely possible. Paradoxically, the term "regulatory arbitrage" is frequently referred to in the EU legislation as the justification for subsequent regulations which are intended, precisely, to avoid regulatory arbitrage.

The contemporary insurance market does not take administrative borders into consideration and adequate framework construction for universal regulations is not itself a sufficient condition to avoid arbitration. Excessive regulation, on the one hand, opens opportunities for abuse in the form of national "interpretations" of regulations, which can have a distortive effect [Lascelles 2006, p. 92], and is particularly visible in the field of insurance supervision, whereas on the other, it does not fit in the dynamically developing world of international finance, where financial innovations can exceed the capacity of both regulators and supervisory authorities in fulfilling their roles.

The provision of stable and satisfying regulatory environment, as well as the elimination of differences resulting from the European legislation, is not an easy task. The risk of arbitrage is, in fact, ingrained in every regulation and offers opportunities for market participants to take direct or indirect advantage of it to their own benefit. As long as insurance market entities will function in the environment of different legal systems, internal provisions and various, even though more and more harmonized, supervisory methods and tools, regulatory arbitrage will persist and pose a threat to different regulations. It is a natural consequence of the fact that if differences, which allow for achieving certain benefits, occur there also appear arbitrageurs who wish to take advantage of these differences.

Owing to the fact that in many areas the EU just indicates the direction for legislation, the decisive role in the phenomenon of regulatory arbitrage minimization is played by effective cooperation between the EU and national regulatory bodies, as well as between national and sectoral supervisory authorities. Coordination and dialogue between them, as well as consistent and effective activities in respecting due requirements, are also of crucial importance. It allows for the establishment of equal conditions underlying competition between domestic and foreign insurance sector entities and covering the financial sector, and also reduces legal uncertainty and arbitration, which is to result in the protection of all insurance market participants' interests as well as the "common good" at the European Union level.

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ARBITRAŻ REGULACYJNY NA RYNKU UBEZPIECZENIOWYM UE – IDENTYFIKACJA ZJAWISKA

Streszczenie: Arbitraż regulacyjny na rynku ubezpieczeniowym może się rozwijać jako następstwo fundamentalnych uwarunkowań stanowienia prawa w UE (specyfika dyrektyw, prawo zwyczajowe i prawo cywilne), może być powiązany z istniejącymi wspólnotowymi regulacjami specjalnie dedykowanymi dla rynku ubezpieczeniowego (tworzenie produktów ubezpieczeniowych, nadzór nad zakładami ubezpieczeń) oraz może być efektem przepisów, które dopiero zaczną obowiązywać (Solvency II). Arbitrażu regulacyjnego na rynku ubezpieczeniowym (i finansowym) nie da się wykluczyć, ponieważ zawsze tam, gdzie będą różnice w restrykcyjności prawnej, będą się pojawiać arbitrażyści, którzy owe różnice będą chcieli wykorzystywać, jednak można go minimalizować drogą skutecznej współpracy między unijnymi i narodowymi regulatorami oraz między krajowymi i sektorowymi organami nadzoru.

Słowa kluczowe: arbitraż, regulacje, nadzór.