# 13 YOUNG, SINGLE, BUT *NOT* FREE – THE EU MARKET FOR FINANCIAL SERVICES[1]

Philip Booth

## Introduction

The EU has been increasing its role in financial regulation over the last four decades. At first, the main focus was on promoting trade within the union in a way compatible with the four freedoms: the free movement of goods, services, capital and people. As part of this agenda, the EU prohibited member states from introducing certain forms of regulation that inhibited free trade in services and the free movement of capital. Attempts to promote consistency of regulation tended to involve a process known as 'mutual recognition'. In other words, member states were broadly free to develop their own regulatory frameworks within which financial institutions operated; companies from one member state could then operate freely in other member states whilst being regulated by their home state. In discussing how regulation at the EU level has become detached from the original founding principles of the EU, this chapter will focus on the regulation of insurance services, though there will also be some discussion of other non-bank financial services. Banking is covered in Chapter 12.

Insurance often gets dwarfed in popular press discussion by debates over the banking sector. However, the insurance sector in the UK is the largest in the EU and makes up 7 per cent of the

1 Parts of this chapter borrow heavily from Booth and Morrison (2012).

total world market, employs 320,000 people and is responsible for the investment of £1.8 trillion.[2] A narrowly defined measure of non-bank financial services is only slightly smaller in terms of contribution to national income than the contribution of the banking sector defined widely; in turn, insurance is the largest sector within non-bank financial services.[3]

Elements of this mutual recognition approach remain with regard to trade in insurance services. The principle of EU law is still that insurance companies domiciled in one EU country can conduct business elsewhere in the EU under supervision of the home state. However, the European financial regulator now has an overarching authority. Furthermore – and much more importantly – more powers have accrued to the central authorities within the EU, and, as a result, regulation is in the process of becoming harmonised.

From 2011, supervision of financial services began on a pan-EU basis. The EU financial regulatory authority is made up of three supervisory bodies: the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA). The desire of these organisations to centralise regulation is clear. For example, the EBA states: 'Whilst the national supervisory authorities remain in charge of supervising individual financial institutions, the objective of the European supervisory authorities is to improve the functioning of the internal market by ensuring appropriate, efficient and harmonised European regulation and supervision.' ESMA notes that it aims to create a unified rule book. In the field of insurance, the Solvency II agenda is unifying regulation at the EU level. In effect,

2 See https://www.abi.org.uk/~/media/Files/Documents/Publications/Public/Migrated/Facts%20and%20figures%20data/UK%20Insurance%20Key%20Facts%202012.ashx (accessed 31 July 2014).

3 See Burgess (2011). The measure of banking output includes anything that is produced by banks, even if the services are not banking services as such.

national regulators are becoming subsidiaries of the EU regulatory bodies.

It is argued in this chapter that unifying regulation is not necessary to promote free trade in insurance and other non-bank financial services. Although unified regulation might reduce the transactions costs of trade between countries, it does not necessarily promote a better business environment in general, as a higher level of regulation may reduce overall economic activity in financial services. It is concluded that it would be perfectly reasonable for groups of states to develop unified approaches to regulation outside the remit of the EU if they believed that doing so would reduce costs and bring other benefits. However, the role of the EU, enforced through the ECJ, should simply be to ensure that national regulations do not impede or significantly distort trade: the EU should not create a level playing field or harmonise regulation.

## The regulation of insurance companies pre-1970

The justifications for insurance company regulation are different from those for banking regulation. Systemic risk is a much less important consideration in insurance.[4] Instead, issues such as dealing with information asymmetries and enforcing opaque contracts are much more important (see Booth and Morrison 2007). Furthermore, though there are protection schemes for customers of insurance companies – akin to deposit insurance schemes – they do not have the same importance as deposit insurance schemes in banking. The winding-up of failed insurance companies is normally much easier than the resolution of banks, and, especially in the case of life insurance, there is less time pressure when winding-up an insurance company.

4 The UK's insurance regulator, the Prudential Regulation Authority, states: 'Nevertheless it is clear that insurers are not systemic in the same way as banks.' See Debbage (2013).

Insurance markets in the UK were regulated between 1870 and Britain's entry into the then common market by a set of principles that were established in the 1870 Life Assurance Companies Act (see Booth 2007). Although it was amended and consolidated on various occasions, its basic principles remained clear for 100 years. A deposit was required for new entrants into the insurance market; all companies had to publish actuarial reports and publish the basis upon which those reports were calculated (though no specific basis was required); and a special mechanism was adopted for winding up failed insurance companies. These principles, whilst remaining in place for over a century, gradually evolved to give greater powers to the regulator (generally the Board of Trade) to intervene in the affairs of the company if an insurance company was close to insolvency. The 1870 Act was certainly very successful in the sense that it was not intrusive – except in one respect[5] – and led to a long period of very stable insurance markets, especially in the life insurance sector.

## The EU, the single market and free trade

Entry into the common market meant that UK insurance regulation had to be compatible with EEC regulation. In the early days of British membership, EEC regulation had two main aims. The first was to ensure that insurance regulation in member states was lightly coordinated. The second was to allow insurance companies in one member state to transact businesses in other member states.

In these early stages, there were various European requirements that had to be fulfilled, but the principle was one of 'mutual recognition', though that term was not always used explicitly. In

5 The deposit requirement may well have prevented new entry by small companies.

essence, there were some basic EU[6] regulatory principles that had to be enshrined in the laws of member states, but, beyond that, an insurance company domiciled in one country (say, the UK) could do business in another EU country (say, Belgium) through a branch whilst being regulated from the UK.

The basic EU regulatory principles included an explicit margin of solvency and some other regulations that were adopted by the UK in the Insurance Companies Regulations 1981.[7] These EU regulations did not add substantially to the regulatory burden in the UK, although it could be argued that their arcane, opaque and obsolete nature helped reinforce the mismanagement of Equitable Life, which was closed to new business because of its solvency position in 2000. Certainly, the adoption of EU regulation by the UK accelerated the erosion of what had been known as the 'freedom with publicity' approach to insurance regulation, which was enshrined in the 1870 Act.

Nevertheless, this system of mutual recognition allowed – indeed encouraged – regulatory competition. If insurance companies were over-regulated in Denmark, for example, it was possible for a UK company to establish a branch in Denmark, regulated by the UK Board of Trade, and sell into the Danish market. Of course, if customers preferred the more stringent regulation of the Danish insurance companies, they could still buy policies issued by Danish companies.[8]

There were certainly very wide differences between regulatory regimes in the EU at that time. The differences in regulation are summarised by the following quotation:

6 Henceforth, 'EU' will be used to describe what is now called the European Union – it having gone through various name changes since Britain joined.

7 These related to the valuation of assets and liabilities.

8 Consumer protection issues were not covered by EU competences, so UK companies operating branches still had to obtain product approval in some of the more dirigiste regimes.

> [In the] U.K., Ireland and to some extent the Netherlands a liberal system of supervision of insurance operates … At the other extreme is West Germany and the Scandinavian countries. The guiding principle there is one of tight supervision on conservative bases as the best means of protecting consumers (Ferguson et al. 1989: 455).

The later Third Life Directive, which had to be implemented by 1994, arguably strengthened the principle of regulatory competition, whilst, in general, promoting deregulation by prohibiting some forms of insurance regulation. For example, under this directive, a member state was not allowed to require foreign firms selling business to obtain approval for policy terms or impose restrictive conditions on the investment of assets (especially in relation to government bonds). These were prohibitions on regulation that were designed to promote trade and should not be seen as intrusive regulations.[9] It could certainly be argued that the Third Life Directive (and the associated directive in relation to non-life insurance) was a step towards a free-trade environment in which an insurer domiciled in one country could operate without hindrance in another EU country; it also encouraged deregulation in certain member states.

## The beginning of the end of mutual recognition and deregulation

The European Commission regarded the situation that existed under the Third Life Directive as unsatisfactory because it inhibited, in its view, the development of the single market. In the Commission's words:

9 See, for example, http://europa.eu/rapid/press-release_P-91-8_en.htm (accessed 4 September 2015).

> The rationale for EU insurance legislation is to facilitate the development of a Single Market in insurance services, whilst at the same time securing an adequate level of consumer protection … Many Member States have concluded that the current EU minimum requirements are not sufficient and have implemented their own reforms, thus leading to a situation where there is a patchwork of regulatory requirements across the EU. This hampers the functioning of the Single Market.[10]

It can certainly be argued that the Third Life Directive has not been a success in terms of encouraging the writing of cross-border insurance business. Figures are not available for the life insurance industry, but in 2010 the non-life insurance industry wrote only £731 million of cross-border business through branches rather than separately regulated subsidiaries:[11] this compared with over £22 billion of premium income written by Lloyds of London alone in 2010[12] and £13 billion of premium income written by a single insurance company (Aviva) through separately regulated non-UK subsidiaries in 2013. The value added by the EU cross-border insurance business under the Single European Passport is clearly tiny. However, there is a vast amount of trade in insurance services both within the EU and outside, but without using the single passport system

There are three logical responses to this situation. First, we could regard the mutual recognition and single passport approach as a 'bit-part player' that is complementary to the freedom of all EU insurance companies to establish subsidiaries in all other EU countries and be regulated by the country in which

10 See http://ec.europa.eu/internal_market/insurance/docs/solvency/solvency2/faq_en.pdf (accessed 4 September 2015).

11 Figure from Association of British Insurers Data Bulletin, 2011.

12 http://www.lloyds.com/~/media/files/lloyds/investor%20relations/2010/annual%20results/files/ar2010.pdf (accessed 4 September 2015).

the business is written. In other words, the EU could have just carried on with the existing system established under the Third Life Directive. Second, we could move in the direction chosen by the EU towards uniform regulation in all EU countries. Third, we could allow all countries to adopt their own independent regulatory frameworks. If the third approach were taken, trade in insurance services would only be possible through subsidiaries established in other member countries, but there would be no reason why pairs of countries or groups of countries should not choose to unify their regulation. This might be particularly beneficial for smaller countries and countries that share similar legal frameworks, and it will be considered below.[13] It certainly should not be thought, however, that free trade requires harmonisation of regulation, as is also discussed below.

## From common market to single market, harmonisation and centralisation

The EU has been able to centralise financial regulation at the European level with few political obstacles. From January 2011, three European Supervisory Authorities became responsible for supervising financial services across the EU. For the insurance sector, the relevant supervisor is the EIOPA. It is very clear that it is the role of the EIOPA to draft a single set of regulations, and the role of national regulatory authorities is merely to supervise firms and ensure that they apply the EU-wide rule book.

13 In meetings I had with the Polish and Bulgarian ministries of finance in the early 1990s, it was interesting to note that the English translations of both the 1990 Polish Insurance Law and the proposed Bulgarian Law (which, I believe, was never passed) were identical (with the same translation errors in both). Indeed, the proposed Bulgarian Law was probably translated into Bulgarian from the English translation of the Polish Law. Translation difficulties aside, this is a perfectly reasonable way for countries to move forward – adopting common regulatory frameworks if they so wish outside the structures of the EU.

One example of the way in which regulation is being centralised is the new system of insurance capital regulation known as Solvency II. This regulatory framework involves an extraordinarily complex system of calculating capital requirements that requires insurance companies to hold capital sufficient to ensure that they have, according to the models used, a probability of insolvency of less than one-in-200 over a one-year period. In taking this approach, those framing the regulation repeat exactly the same mistakes as the framers of the Basel approach to banking regulation (see De Soto (2009), and see below). The approach – which is largely incomprehensible except to the expert – requires exceptionally complicated rule books to deal with all types of business in 27 different countries. Other pillars of Solvency II require that insurance businesses are governed in a way that promotes effective risk management and enhances transparency and disclosure.

Whilst I do not approve of the new approach to insurance regulation and believe it will do little to promote free trade, it is worth noting that, in the absence of the centralisation of EU insurance regulation, the UK regulator would probably have developed a similar regulatory framework to that being adopted in the EU. Indeed, the UK has had substantial influence on the development of Solvency II. But the main purpose of this chapter is not to discuss the efficacy or otherwise of particular aspects of the EU regulatory system; it is to question the whole approach of centralising regulation at the EU level rather than allowing member states to determine their own approaches. The new labyrinthine regulatory system is merely an example of the effect of centralisation.

## Single market or free market?

As already noted, there is tension between the concepts of a free market and a single market. The two are not necessarily the same, though they were assumed to be by the Conservative government that ratified the Single European Act in 1986.[14] We are moving to a situation where the same regulations will apply across the financial sector and throughout the EU, but, at the same time, financial services companies will be heavily circumscribed everywhere within the EU. In other words, the market will be single but not free. Insurance is one notable example of this. Freedom to trade would be circumscribed – both within and between countries – by the restrictive regulatory framework that contrasts greatly with the tradition of 'freedom with publicity' and decentralised systems of regulation that existed in the UK until at least 1970. The whole philosophy of the UK insurance regulatory framework had been to allow insurance companies the freedom to do as they wished, as long as they explained what they were doing.

As noted above, an alternative to unifying regulation would be to allow each country within the EU to regulate insurance companies as they wished. At the same time, following the principle of free movement of services, any company from any country could be allowed to establish a subsidiary in another member country. A subsidiary of a UK company established in, for example, Spain would be regulated by, in that case, the Spanish regulator. That subsidiary could still buy services provided by the UK subsidiary, but the regulation of the business sold in Spain would be by the Spanish government.

14 See, for example, Mrs Thatcher speaking in 1988: 'Action to get rid of the barriers. Action to make it possible for insurance companies to do business throughout the Community. Action to let people practice their trades and professions freely throughout the Community. Action to remove the customs barriers and formalities so that goods can circulate freely and without time-consuming delays. Action to make sure that any company could sell its goods and services without let or hindrance. Action to secure free movement of capital throughout the Community. All this is what Europe is now committed to do. In 1985 the Community's Heads, Government gave a pledge to complete the single market by 1992. To make sure that it was not just a pious hope, they made that pledge part of the Treaty, as the Single European Act.' http://www.margaretthatcher.org/document/107219 (accessed 4 September 2015).

There would be no single market under this regime. There would be increased transactions costs from trade, and it is possible that freedom to trade could be circumscribed within countries that chose onerous regulatory regimes. However, this approach should not lead to discrimination between companies from different countries, and so freedom to trade between countries would be promoted, as long as subsidiaries were established to conduct business. British companies establishing in Spain would be treated the same way as Spanish companies. Free trade would certainly still be possible, and trade could not be prohibited by member governments under EU law. For example, the French government could not prohibit a UK company from selling insurance services in France as long as the UK company set up a French subsidiary. The economic activity could still be undertaken in the UK through the mechanism of the French subsidiary buying services from the UK head office: this happens in reverse with the offshoring of call centres by many UK insurance companies today. The benefits of trade and comparative advantage would be retained, but there would be no single market. Any vexatious regulation that inhibited trade (for example, requiring insurance companies domiciled in Spain to invest all assets in Spanish bonds and Spanish listed companies, or requiring insurance companies domiciled in Spain to only use Spanish-speaking workers to provide policy-administration services) would not be permitted and should be overruled by the ECJ in enforcing the basic freedoms within the EU, using appropriate legislation to do so.

## The costs and benefits of uniform EU regulation

The mechanisms put in place under the Single European Act have led directly to the centralisation of regulation. In the development of Solvency II, it appears that no attempt was made to promote regulatory competition using mutual recognition. Indeed, HM

Treasury (2008: 7) suggests that only two options were seriously considered by the European Commission in assessing the costs and benefits of Solvency II – one was to wait for an international solvency regime, and the other was the development of an EU solvency system. It appears that approaches that did not involve centralisation were not even considered – the only question was whether centralisation should be at the EU or at the world level. However, the problems of over-regulation that arise when regulation is centralised at the EU level could have been anticipated: indeed, they were explained in Migue (1993).

If the central authority of a federation of states or regions is given the power to regulate, then interest groups can influence the use of that power for their own benefit and to undermine the comparative advantage of other member states – thus introducing trade distortions in a subtle way. We saw after the financial crisis, for example, the attempts by EU member states to impose a financial transactions tax. If that had been enacted, this would have fallen disproportionately on the UK, with perhaps 50 per cent of all revenues coming from the UK. As it happens, the imposition of such a tax was impossible because of the unanimity requirement on matters of taxation. Matters to do with insurance regulation can, however, be determined by qualified majority voting and, given the processes that were set in place in the Financial Services Action Plan (see Bank of England 2003), this means that the EU bureaucracy or a collection of states can effectively determine insurance regulation across the EU to the detriment of certain countries that have a comparative advantage in insurance services, or to the detriment of consumers. The same applies to other areas of financial regulation (see below).

Vaubel (2007) shows how the institutions within the EU, post-the Lisbon Treaty and enlargement, are especially susceptible to rent seeking and the tactic of 'raising rivals' costs'. After 2017, legislation can be passed by a qualified majority representing only 65 per cent of the population of the EU (or 55 per cent of the member states). Migue (1993), recognising these problems, describes harmonisation of regulation as a 'menace' to true federalism, an impediment to freedom to trade and an impediment to ensuring that the appropriate regulatory environment is developed for each member state.

In addition to these problems, the adoption of uniform systems of regulation can make financial systems more prone to systemic risk. If the regulatory system fails, or if it distorts financial activity in the way that the Basel Accord encouraged securitisation in the banking system, for example, international regulation can increase the likelihood of the whole system failing (see, for example, the chapter by Alexander in Booth (2009)). In this context, it is interesting that HM Treasury (2008) states explicitly: 'Solvency II is based on a three-pillar approach used in the Basel II banking accord.' This document was published at the height of the banking crisis, without any apparent recognition of the failure of regulation in that crisis. Swarup (2012) shows how the design of insurance regulation under Solvency II is likely to encourage, perversely, insurance companies to invest in risky sovereign bonds. These incentives apply to all insurance companies in all EU countries, as they face the same regulatory requirements. If there should be a sovereign bond crisis, all EU insurers could be affected in the same way, given that the regulations will encourage herding.

Furthermore, a uniform approach to regulation, which rejects the concept of regulatory competition, also prevents us benefiting from a trial-and-error process, in which regulators in different countries can learn from the successes and mistakes of others. There is a real possibility that regulation will become fossilised at the EU level and will not be adaptable to the different situations pertaining in different EU countries in relation to, for example, different legal systems.

Of course, there are possible benefits from the harmonisation of insurance regulation. The UK Treasury undertook a regulatory impact assessment of regulatory harmonisation under the EU's

Solvency II process that was published in 2008 (HM Treasury 2008), though this was hardly rigorous. This assessment concluded that there would be ongoing net benefits of £96.6 million a year in the UK from Solvency II, and that potential benefits might include the following:

- increased security for consumers;
- fewer distortions to trade;
- more transparency for investors, and therefore reduced cost of capital;
- the ability to use different strategies for risk mitigation without discrimination;
- more efficient use of capital resulting from the ability to exploit efficiencies for groups operating across the EU.

The Treasury assessment also pointed out that UK firms would benefit from the fact that the Financial Services Authority imposes both the current EU capital requirements (pre-Solvency II) as well as an approximation to the forthcoming capital requirements under Solvency II. However, that is just an indication of how over-regulated UK insurers are currently, and not a justification for uniform regulation or any particular level of regulation.

In the analysis, however, no consideration was given to the possibility that a much more liberal regime would still provide incentives for insurance companies to be transparent to providers of capital and manage their businesses in such a way that policyholders were protected – this was the basis of the 'freedom with publicity' approach that was so successful in the UK from 1870 to 1970. It was assumed in HM Treasury (2008) that information asymmetries necessitated insurance regulation for consumer protection, and that benefits would flow from that. However, during the century from 1870 to 1970, there were only two failures of insurance companies – neither of which harmed non-profit policyholders – despite there being no explicit capital requirements for much of that period.[15] Furthermore, there was no discussion in the document of the problems of removing regulatory competition, the problems of using a 'one-size-fits-all' regime, or of the potential for the fossilisation of the regulatory regime as a result of it being determined at the central EU level.[16] There was also no discussion of the potential costs of the new EU regulatory regime imposing capital requirements that were too high in respect of certain types of activity, or of the costs of favouring particular asset classes such as sovereign bonds.

## Other areas of EU financial regulation

The EU has been in the process of trying to unify all aspects of non-bank financial regulation for many decades. This process does not just apply to insurance business; it also applies to hedge funds, private equity, pension funds, rules to which quoted companies must adhere, and so on.

Since 2005, companies issuing equity have been required to produce information in line with the Prospectus Directive (amended in 2010). The Directive requires that all companies with new issues of shares traded on a regulated market have to meet EU-wide harmonised requirements in terms of the information that they provide. This then provides a 'passport', which will allow shares to be traded on any regulated EU market, thus promoting a single market.

This approach is predicated upon two errors. The first is the assumption that the government or a government financial regulator needs to determine the information that is put before

15 See Booth (2007). It is a moot point exactly when capital requirements were brought in.

16 Although I do not approve of the changes to the regulatory regime that followed the Equitable Life crisis, the Financial Services Authority was able to react quickly. It is inconceivable that the central EU bureaucracy would react to events in a specific country within a decade, if at all.

the market before an offer for sale of shares. Such things can be determined by the stock exchange, and exchanges can compete according to the effectiveness of the requirements they impose on companies. A well-managed exchange with appropriate requirements for companies and a high degree of confidence amongst investors will be attractive to investors and lower the cost of capital.[17] Indeed, companies themselves have an incentive to provide the right sort of information to the market in order to lower their cost of capital. The second is that, even if the regulation of company information is determined by the government, different requirements imposed by different governments do not intrinsically inhibit trade. Some governments may choose to have no information requirements at all except those imposed by exchanges; some governments may accept the prospectuses authorised by other EU member states; and some governments may have their own requirements. The only reason for the EU to be involved would be if governments imposed requirements on companies domiciled in one member country that were, in effect, protectionist, or if they prohibited companies domiciled in another member country from seeking a listing or quotation on an exchange in their country.

There are several other Directives relating to 'market abuse', company transparency, the operation of markets (MiFID) and the compulsory application of accounting standards. More recently, the Alternative Investment Fund Managers Directive has been implemented. This applies regulations to previously unregulated sectors such as private equity funds and hedge funds. The regulations apply both to funds established in the EU (even if managed outside the EU) and funds marketed in the EU (even if managed and/or established outside the EU).

17 See Arthur and Booth (2010) for a discussion of this issue and Stringham (2015) for a comprehensive and original review of the literature.

The extension of EU competencies in these areas is not necessary for the free movement of capital or services, though it could be argued that it reduces the transactions costs of trade and reduces the costs of regulated entities complying with many different regimes. Arguably, regulation in these areas is not required at all – as the UK historical experience suggests. Furthermore, there can be no 'correct' approach to regulation, and, therefore, a multiplicity of approaches may provide opportunities for experimentation and learning from different approaches. Given that EU regulation in these areas is not necessary to achieve the key objectives of the Union, and that the desirability of any regulation at all can be disputed, it would seem sensible to take a different approach and allow cooperation between EU countries that wished to unify their regulation: cooperation that could be extended outside the EU if desired. This approach will be expanded upon in the conclusion.

## Conclusion

In all sectors of financial services, there has been increased centralisation of regulation at the EU level, together with an increase in the general level of regulation. We should be very clear what this entails. The EU has, in effect, tried to reduce the transactions costs of trade by unifying regulation. However, if this process leads to higher levels of regulation or inappropriate regulation, the costs of doing business, whether between or within countries, will be increased. As the EU develops its role in the financial sector further, there is no effective check on centralisation and increasing levels of regulation. A unanimity requirement for new regulation is probably necessary to achieve such a check.

If countries wish to obtain the additional advantages of unifying regulatory systems in order to lower transactions costs, they can do that through intergovernmental agreements. This is likely to be simplest amongst countries that have similar legal traditions, and it need not only involve EU countries. For example, there is no reason why the UK, Ireland, Canada, South Africa, Australia and New Zealand could not unify their insurance regulatory systems. Alternatively, they can agree to recognise each other's regulatory systems following the principle of mutual recognition.

If Britain were to leave the EU, it could be argued that its financial services industry would lose the protection of the EU institutions when it came to promoting free trade with the other member countries: other countries could impose regulation that raised the cost of UK firms doing business. However, against that, the UK would be free to develop its own regulatory system and negotiate agreements with other countries. The likely worst-case scenario is that UK companies undertaking business in the EU would have to establish subsidiaries abiding by EU regulation.

In summary, if the UK is to remain in the EU, the UK should demand reform along the following lines in order to promote an approach based on competitive federalism.

- All EU countries should be permitted to develop their own systems of insurance and securities market regulation.
- Any country that developed a system of regulation that distorted or impeded trade should be referred to the ECJ.
- Any pair or group of countries could freely choose to adopt the same systems of regulation, or mutually recognise each other's systems so that a company domiciled in one of the countries party to the agreement could operate in another country through a branch under the regulation of the country of domicile. These arrangements could also be made by EU countries with non-EU countries.
- The EU *could* have its own central system of regulation, into which member states could opt, and individual companies

could opt if they wished. This would reduce business costs for larger entities operating in a number of EU countries.[18]

- An insurance company or other financial entity from any member state should be able to operate in another member state by establishing a subsidiary in that member state regulated by the receiving state. The subsidiary could, of course, buy services from other subsidiaries within the group. As such, for example, a UK insurance group could set up a subsidiary in Slovakia, the capital and sales practices of which would be regulated by the Slovakian government. However, the Slovakian company could be entirely serviced by the UK subsidiaries. Both the free movement of capital and of services would be achieved through this mechanism.

Under this scheme, harmonisation, insofar as it is desirable at all, can occur through agreement between member states without being imposed from the centre.

This approach would enable free trade to be promoted without unifying regulation. Transactions costs would be higher, but these could be ameliorated by bilateral or multilateral agreements between member states and by the trading of services between subsidiaries under a holding company. Furthermore, multilateral agreements could be extended to non-EU countries. This approach would promote regulatory systems that responded to competitive pressure and allow best practice to be copied

The same principles apply to securities markets and corporate governance and reporting regulation. Different countries having different rules regarding the contents of prospectuses, accounting standards and so on does not, in principle, inhibit trade. Indeed, until 1986, such matters were not generally determined by government in the UK. Insofar as rules relating to such matters

18 This is not unlike the US system, where states have the responsibility for regulation but nearly all states adopt the same model.

are used for protectionist purposes by individual countries, they should be prohibited by the ECJ. The harmonisation of regulation at the EU level is neither necessary nor desirable.

It is highly unlikely that the EU will evolve in a liberal direction that will allow the approach suggested above to be adopted. The UK can remain in the EU with, it would appear, ever-more-centralised and costly systems of regulation. Alternatively, the UK could leave the EU, liberalise its financial regulation and cooperate with other countries that wish to promote free trade in financial services. The ideal, though, would be to return to a regulatory regime that was designed to promote the four freedoms within the EU and free trade outside. Unfortunately, that is not on offer.

As noted, it should not be assumed that a return to the liberal regulatory regimes on which a successful, respected and prudent financial services industry was built in the UK is immediately on the political agenda domestically, even if the UK were to withdraw from the EU. When it comes to financial regulation, the UK has moved a long way since the early 1980s, when it could point to a century-long liberal tradition, certainly with regard to non-banking financial services regulation (see Booth 2014). Indeed, in some areas, it is the British government that has been pushing for more regulation at the EU level.

## References

Arthur, T. and Booth, P. (2010) *Does Britain Need a Financial Regulator?* Hobart Papers 169. London: Institute of Economic Affairs.

Bank of England (2003) The EU financial services action plan: a guide. *Bank of England Quarterly Bulletin* 43(3): 352–65.

Booth, P. M. (2007) 'Freedom with Publicity' – the actuarial profession and insurance regulation from 1844–1945. *Annals of Actuarial Science* 2(1): 115–46.

Booth, P. M. (ed.) (2009) *Verdict on the Crash*. Hobart Papers 37. London: Institute of Economic Affairs.

Booth, P. M. (2014) Stock exchanges as lighthouses. *Man and the Economy* 1(2): 171–87.

Booth, P. M. and Morrison, A. D. (2007) Regulatory competition and life insurance solvency regulation in the European Union and the United States. *North American Actuarial Journal* 11(4): 23–41.

Booth, P. M. and Morrison, A. D. (2012) Promoting a free market by ending the single market – reforming EU financial regulation. *Economic Affairs* 32(3): 24–31.

Burgess, S. (2011), Measuring financial sector output and its contribution to GDP. *Bank of England Quarterly Bulletin* 51(3): 234–46.

Debbage, S. (2013) The rationale for the prudential regulation and supervision of insurers. *Bank of England Quarterly Bulletin* 53(3): 216–22.

De Soto, J. (2009) The fatal error of Solvency II. *Economic Affairs* 29(2): 74–7.

Ferguson, D. G. R., Croucher, P. E., Franklin, N. A. M., Henty, J. M., Parmee, D. C., Saunders, A. and Shaw, G. J. M. (1989) A single European market for actuaries. *Journal of the Institute of Actuaries* 116(III): 453–507.

HM Treasury (2008) Solvency II: a partial impact assessment. http://webarchive.nationalarchives.gov.uk/20130129110402/http://www.hm-treasury.gov.uk/d/solvencyii_finalia_090608.pdf (accessed 4 September 2015).

Migue, J. L. (1993) *Federalism and Free Trade*. Hobart Papers 122. London: Institute of Economic Affairs.

Slaughter and May (2004) *The New EU Prospectus Directive*. Slaughter and May: London, UK.

Stringham, E. P. (2015) *Private Governance: Creating Order in Economic and Social Life*. Oxford University Press.

Swarup, A. (2012) A well-intentioned folly: the macroeconomic implications of Solvency II. *Economic Affairs* 32(3): 17–23.

Vaubel, R. (2007) *The European Institutions as an Interest Group: The Dynamics of Ever-Closer Union*. Hobart Papers 167. London: Institute of Economic Affairs.