CEA Insurers of Europe

Position Paper

# CEA response to the European Commission inquiry into the European business insurance sector pursuant to Article 17 of Regulation 1/2003

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| Contact person: | William Vidonja, Head of Single Market | E-mail: | vidonja@cea.assur.org |
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## 1. Introduction

CEA is the European insurance and reinsurance federation. Through its 33 member bodies comprising of national insurance associations, CEA represents all types of insurance and reinsurance undertakings, be they pan-European companies, monoliners, mutuals or SMEs. CEA represents undertakings which account for approximately 94% of total European premium income. Insurance makes a major contribution to Europe's economic growth and development. European insurers generate premium income of €978bn, employ over one million people and invest more than €6,300bn in the economy.

CEA welcomes the opportunity to comment on the preliminary findings of the European Commission further to its inquiry in business insurance. By undertaking a number of inquiries in the financial services sector, including insurance, the Commission is demonstrating that the European Union's financial services sector is amongst the best regulated in the world.

CEA sets out hereinafter the views of the European insurance and reinsurance industry and provides the European Commission with the experience of the sector in the different fields covered by the interim report. We hope that our remarks and subsequent recommendations will be taken into consideration by the European Commission in view of its final report.

The Commission has made a substantial effort to analyse the European business insurance sector in detail. However we are concerned that many of its preliminary conclusions, for instance those concerning the Block Exemption Regulation, go beyond the scope of the enquiry and affect personal lines of insurance. Equally CEA would welcome clarification on the Commission' methodology for the calculation of ratios, for instance by mentioning the source of data.

## 2. CEA Policy Recommendations

In view of the drafting of the final report, CEA particularly recommends to the European Commission:

- Regarding the financial aspects of the industry
  - To take into account the cyclical pattern of insurance and consequently increase the timespan of its analysis.
  - To better take into consideration the capital required by insurance with indicators such as the Return on Equity or cost of capital.
  - To consider adequately the specificities of countries and business lines when comparing them with other countries and business lines.
- Regarding the distribution of Business Insurance
  - To recognise that the existing variety of insurance distribution channels enhances competition.
  - To gain further experience from the implementation of the IMD before drawing any conclusions in relation to potential 'conflicts of interest'.
- Regarding horizontal cooperation
  - To ensure that the scope of conclusions regarding the horizontal cooperation is limited to business insurance only.
  - To take into account the existing differences in maturity, size and level of concentration in the various national markets as well as the different legal characteristics of insurance lines amongst the factors explaining the different level of use of the Block Exemption Regulation.
  - To consider the current lack of clarity and inappropriateness of certain conditions for exemption provided by the Block Exemption Regulation, including the definition of the "Relevant Market", the concept of "new risk" and the 20% limitation concerning cooperation between insurance companies may be inadequate.
  - To further identify and assess the full benefits brought by the block-exempted forms of cooperation to business and consumer insurance customers, insurance undertakings and the wider economy, and reciprocally to evaluate in-depth the disadvantages of any restriction of the scope of the Block Exemption Regulation or its abolition.
  - To investigate the possibility to extend the scope of the Block Exemption Regulation to claims settlement agreements.

## 3. Financial aspects of the industry[1]

The analysis of the profitability situation across Europe as an indirect measure of the price level of the insurance industry is a relevant indicator. However the methodology used by the European Commission in analysing the financial aspects of the insurance industry raises some issues which are further detailed below.

### 3.1 Discrepancy of combined ratios

Discrepancy of combined ratios

- Q.1: Are there compelling justifications for the apparent discrepancy in the level of combined ratios of SMEs and LCCs observed in some parts of the EU-25?

From CEA's perspective, the analysis of differences between small and large clients does not lead to the appropriate conclusion and one can question whether these discrepancies are relevant. The interim report focuses its attention on a few Member States where the combined ratio is lower for SMEs than for large clients while on the one hand, it is not a widespread situation (only four Member States) and on the other hand, we observe a decrease in the differential between large and small companies on almost every market.

Moreover, differences in the profitability ratio between small and large clients may find their origin in differences in needs between companies. Large companies may have the capacity for self-insurance of specific risks that small companies do not have, and large companies may request specific cover that is not useful for smaller companies.

Finally from a methodological point of view, the report does not indicate at all whether these differences are statistically significant or not.

### 3.2 Methodological issue

#### 3.2.1 The choice of indicator

##### 3.2.1.1 Investment income

The European Commission's interim report estimates the level of investment income at 16% for the period 1994-2004 on the basis of a Swiss Re paper[2]. This period has been characterised by a large increase in investment income up to 2000, followed by the collapse of the stock market in 2000-2003 and a slight increase since then. Applying this rate solely to the period 2000-2005 (and more specifically to the combined ratio observed in 2005) is fairly weak from a statistical point of view, since the return on investment is currently much lower than in the second half of the nineties and has been greatly reduced by the financial crisis of 2000-2003.

In addition, insurers participated in a very asymmetric way in the ups and downs of the market: while insurers participated fully in the stock market crash, they benefited only partially from the upturn, as many insurers had to reduce their stock market exposure in 2002/03.

Moreover, the way investment results are taken into account in the interim report does not differentiate by line of business and country: as the time period between premium payments and loss payments differs substantially between lines of business and countries, combined ratios indicate results that are too negative for long tail business and too positive for short tail business.

[1] See part VI of the interim report, from p.52 to p.66.
[2] Swiss Re, 2006, Measuring the underwriting profitability of the non-life insurance industry, Sigma, 3

#### 3.2.1.2 Level of risk

A further disadvantage of the combined ratio as an indicator of profitability is that the level of risk, and therefore the level of required capital, is not appropriately taken into account: capital needs differ a lot for risks covered (both across lines and geographies) as loss volatility differs. The profit is the remuneration for a level of risk taken by the insurance company. The conceptually appropriate measure for the issues the European Commission seeks to address (profitability by line of business and country) would be the Return on Equity[3] (ROE) by line of business. The less sophisticated insurers thereby take account of capital cost by applying loadings according to the riskiness of the business (often the loading also refers to regulatory capital required or the capital required by rating agencies). Others use more sophisticated methods like RORAC (return on risk adjusted capital) or EVM (Economic value management).

An alternative approach is not to allocate different capital to different lines, but to use the different cost of capital as a benchmark for judging the profitability of a business line by using models such as the Capital Asset Pricing Model. A specific methodology to compute "the cost of equity capital by line of insurance for the property-liability insurance industry"[4] has been developed by J.D. Cummins and R.D. Phillips.

All these models allow the profit to be related to the risk level supported by the insurer, and avoid then overstating the profitability of business lines with higher risk as is the case with the methodology used by the European Commission.

#### 3.2.1.3 Inter-industry comparisons

In order to make an inter-industry comparison (i.e. with the bank industry, manufacturing industry), the combined ratio, which corresponds to a technical return on sales, is not relevant as the underlying capital requirements change. The cost of capital or the Return on Equity would be a much more appropriate indicator for this purpose.

### 3.2.2 Timespan and business cycle

The cyclical nature of the insurance industry is a well recognised fact, both in the classic literature[5] and in the interim report which stresses that "cyclical patterns, typically running over a period of six to nine years (peak to peak), tend to be especially pronounced in insurance markets"[6]. By restricting its analysis to the period 2000 to 2005 and focusing more precisely on the year 2005, the interim report does not take into account this specificity of the insurance sector and gives an idealised but misleading picture of the industry.

Taking the year 2000 as a benchmark, instead of 2005, would have led to an underwriting loss of 11% of income and to a very different conclusion. It is therefore crucial to rely on a longer timeframe (10 years or even more) in order to correctly reflect this specific aspect of the insurance sector. An ideal timeframe correctly reflecting the whole insurance cycle is the period 1994-2004 like the one chosen by Swiss Re in its analysis of underwriting profitability (op cit). If one were forced to rely on the sample data provided by the interim report, the appropriate procedure would involve consideration of mean values over the entire period 2000-2005 and thus lead to the conclusion that underwriting profit for the sector could be estimated at 1%.

3 ROE: [Sum of technical profits (premium minus losses) plus investment income] divided by the shareholder capital needed to support the business.

4 J.D. Cummins and R.D. Phillips, 2005, Estimating the Cost of Equity Capital for Property-Liability Insurers, Journal of Risk and Insurance, 72(3): 441-478

5 Cummins and Outreville, 1987, An international analysis of underwriting cycles in property-liability insurance, Journal of Risk and Insurance, 54(2): 246-262

6 See p.22 of the interim report.

The interim report also does not take into account the distortions caused by catastrophic events, which may substantially distort underwriting results.

Finally, it has also to be stressed that competition has been suggested as a cause of the insurance cycle. In the words of Cummins and Outreville (op. cit.): "The typical explanation is that the insurance industry causes the cycle more or less on its own, through periods of destructive competition followed by cutbacks in supply".

### 3.2.3 Definitions and statistical issues

The granularity of data which is used to judge profitability by lines of business in insurance companies is not always available on a country basis, and it is not at all uniform across countries.

From the point of view of the definitions, the content of business insurance may differ strongly between countries (according to national legislation), as well as the possibility of differentiating between large and small clients.

When ratios are compared across countries or across business lines or according to the client (e.g. small versus large clients), the statistical significance of the differences is not highlighted by the Interim report and does not allow one to know whether the differences are relevant or not.

## 3.3 Specific issues

### 3.3.1 Estimation of profitability in Europe

The European Commission reports an estimate of 25 percent for the ratio profits on premiums (p.55). From a sample of European countries representing approximately 70% of the European market, we calculate an average of 1.3 percent for the period 1995-2004 for the whole non-life activity. Such a level is hardly to be considered an evidence of excess market power.

Choosing, as the interim report does, to present the (estimated) combined ratio for 2005, at 91 percent, totalling the estimated investment yield for 1994-2004 of the UK, Germany and France (stated as 16 percent) and concluding that the resulting 25 percent ROS is an unbiased estimate of the average pre-tax profit ratio of the European insurance sector is misleading and biased towards overestimation of insurer's profits.

The 2000-2005 average of the combined ratio, in fact, at 99 percent[7] can be seen as more representative of the average underwriting profitability of the sector. This figure means the underwriting results of the insurance industry as a whole are barely above the break-even point if considered over an appropriate time span.

Additionally, the report should take into account differences in taxation between European countries in order to compare the real profit level in each Member State.

7 See the table VI.1, p.56 of the interim report.

### 3.3.2 Volatility in technical profit

The interim report concludes that profitability in business insurance is high and has been sustained over time[8]. This conclusion is contradicted by several facts:

- First of all, this conclusion does not take account of the insurance cycle which is recognised by the interim report and by the literature.[9]
- Second, such a statement does not take into consideration the difficult years that affected the industry in the years 2000/2003. This period was characterised by a large decrease in own funds (estimated at their market value) held by the insurance sector. This decrease of almost 50% for some companies has placed many of them in a difficult situation, requiring an increase in capital.
- Thirdly, if we compare the combined ratio (i.e. the return on sales - ROS) of the insurance industry to an estimate of the ROS from other industries (retail, auto, industrial, media, chemical, tech) we find that volatility is much higher in the insurance industry than in other industries. The ROS for other sectors is calculated from the price/earnings (PE) and price/sales (PS) ratios from Bloomberg as follows: ROS=PS/PE.

Table 1: 100-combined ratio and ROS by sector

| year | Insurance | RETAIL | AUTO | INDUS | MEDIA | CHEM | TECH |
|---|---|---|---|---|---|---|---|
| 2000 | −11.00 | | 1.89 | 3.79 | 3.48 | 5.48 | 5.95 |
| 2001 | −10.00 | | 1.06 | 1.34 | | 1.78 | |
| 2002 | −6.00 | | 2.11 | 1.48 | | 2.97 | |
| 2003 | 5.00 | | 1.25 | 1.71 | 0.82 | 3.03 | 0.90 |
| 2004 | 8.00 | 2.50 | 2.18 | 0.70 | 1.24 | 4.51 | 6.24 |
| 2005 | 9.00 | 2.77 | 3.00 | 4.01 | 7.32 | 5.84 | 7.73 |
| Var | 70.47 | 0.02 | 0.43 | 3.15 | 4.95 | 1.70 | 6.71 |

The finding that insurance profit margins are in fact more volatile than those of other industries should come as no surprise, given what has been said above about the underwriting cycle. It gives no justification to the Interim report in asserting that "the magnitude of the combined ratio is not volatile over the medium term trend".

### 3.3.3. Variation in business lines and Member states

Another conclusion of the interim report indicates that profitability varies significantly both in term of business lines and Member States.[10] Several factors may explain this variation:

- Variations in combined ratio across business lines may be explained by at least two factors other than profitability: on the one hand, the long or short tail nature of the business line is an important indicator of the investment income which may compensate for underwriting losses; on the other hand, claims frequency is crucial for the stability of the combined ratio; business lines with a low frequency (e.g. natural catastrophes or environmental liability) may pass through several consecutive years without serious claims and one year with very high claims for which the premiums for the year will not be sufficient.
- Variations between Member states are not so significant if we relate them to homogenous groups. Few EU15 countries are far from the EU15 average while larger deviations from the average in new Member States may find their origins in differences in the speed of development and in the starting point at the time of the opening up of the market. Moreover, for the same line of business, the level of risk included in the

8 See p.65 of the interim report.
9 See 3.2.2 Timespan and business cycle.
10 See p.61 and p.65 of the interim report.

combined ratio may be very different across countries due to differences in legal framework. For instance, the calculation of claims provision for bodily injuries in motor insurance in Spain is subject to legal rules which are not applied in other states. Finally, the level of risk also varies strongly across countries (e.g. natural catastrophes) and explains differences between Member States.

### 3.3.4 Profitability and expense ratio

The report states that new Member States tend to have systematically higher underwriting profitability ratios and higher expense ratios than in the EU15.[11] This observation is largely explained by the high administrative costs borne by the new Member States in recent years in order to rapidly implement the European directives and gain access to the EU. Moreover, new Member States are relatively 'fresh' markets (only 15 years of market economy) and have not yet converged towards the level of more competitive markets of the EU15.

Additionally, discrepancies in the level of expense ratios can be explained by the level of total premiums. The lower the premium, the higher the expense ratio may be. Also the kind of services classed as expenses differs from one Member State to another (services for prevention, claims recovery etc). In-kind services are generally significantly more expensive for insurers than indemnities.

Finally, it should be underlined that expense ratios have decreased on many markets between 2000 and 2005 and particularly in new Member States. The insurance sector thus seems to have compensated for the reduction in investment income through efficiency gains, which is a behaviour typical of competitive markets. If European insurers were operating in uncompetitive environment, there would have been little incentive to pursue the route of cost reduction.

### 3.4 Conclusions

The analysis of the European Commission of the profitability of the insurance industry gives rise to serious concerns regarding the methodology used. On the one hand, it is inappropriate from an economic perspective, to make a connection between the net investment results for a period characterised by high investment results (and thus high loss and expense ratios) and a figure for another year in which investment results (and, consequently, the loss and expense ratios) were quite low. On the other hand, by focusing on the combined ratio, the Interim report does not take into account appropriately the level of risks relating to the activity, which is a strong determinant of the level of capital required to support the activity. It would be advisable to use a better indicator such as Return on Equity or the cost of capital, both of which allow comparison between business lines and countries on a sound basis taking into account the level of capital required.

The second important problem relates to the time span of the analysis. Most of the conclusions of the report rely exclusively on the year 2005 and do not take into account the cyclical pattern of insurance activity. It would be advisable for the EC to use a longer time frame (1994-2004 would be adequate) or at least to use aggregate figures for the period 2000-2005 to avoid misleading conclusions.

These methodological issues as well as the specific issues relating to volatility, the differences between clients, expense ratios, etc should be revised by the Commission in order to appropriately reflect the profitability situation in the insurance sector.

11 See p.63 of the interim report.

# 4. Reinsurance[12]

## 4.1 Best terms and conditions

"Best terms and conditions" clause

- Q.2: How widespread is the use of the so-called "best terms and conditions" clause in the reinsurance and in the co-insurance markets? Where does this type of clause originate?
- Q.3: At what stage in negotiation does this type of clause appear and which/how many participants ask for its introduction?
- Q.4: How is the clause enforced?
- Q.5: What is the effect of this type of clause on the market?

The Commission identifies one practice in the reinsurance market which it believes may be anti-competitive, namely the insertion by reinsurers of "best terms and conditions" clauses into contracts with insurance companies. This clause is not very widely used around the European reinsurance market. It is our opinion that the use of such clauses is neither in the best interests of the reinsurer nor of the insurer.

## 4.2 Impact of Solvency

Concerning the choice of reinsurers[13], in the absence of an effective and risk based current Solvency regime, financial ratings are one of the market's current best tool to assess reinsurers' robustness and ability to meet their obligations. By choosing among the best rated reinsurers, direct insurers seek to minimise the risk of their counterpart's default and ultimately safeguard the interest of their policyholders.

With the introduction of Solvency II, the protection of policyholders and beneficiaries lies at the heart of the future framework. Insurers will be expected to choose from among those reinsurers that have a 1 in 200 year risk of default. The future framework is expected to introduce a risk-based economic approach probably outperforming current rating models. Dependency on financial ratings is therefore expected to decrease overtime.

## 4.3 The international aspects of reinsurance and competition in the reinsurance market

Using different statistical sources, the interim report makes reference to market shares at national level for evaluating the level of competition in the industry. But market shares at national level have no meaning in reinsurance, where the pertinent market is neither national nor European but truly international (except in the case of protectionist laws, which is not the case in Europe). When considered at an international level, the reinsurance market is truly open and competitive. In principle, professional competence is respected in the reinsurance market from the early stages in which negotiations are carried out with different reinsurers to agree on conditions and prices. From that moment, insurers can approach any reinsurers they want to (either directly or via a broker) to establish the conditions these reinsurers are ready to offer them. Therefore, at this stage of the process, there is clear competition among reinsurers, as the different conditions they are able to offer will be used as the basis for future negotiations.

12 See part VIII of the interim report, from p.74 to p.88.
13 See from p.80 of the interim report.

### 4.5 Block Exemption Regulation

Reinsurance being the insurer of last resort for extreme events, that is for rare but costly events, it must be shared in order to be effective. For very extreme events, it is rare to find a reinsurer willing to underwrite the risk alone: such events are insurable only if the risk can be fragmented and shared. Without the Block Exemption Regulation, such events may no longer be reinsured and therefore may not be insured; there is a risk that the market will fail and the public sector may have to substitute for the private sector.

## 5. Duration of contracts in the Business Insurance sector[14]

Long-term agreements

- Q.6: Have you experienced that the duration of insurance contracts represented a barrier to entry for insurers wishing to penetrate new markets and/or acquire new customers? Please explain your answer also taking into account the existence of termination and of automatic renewal/extension clauses.
- Q.7: Have you experienced that the duration of insurance contracts was a serious obstacle for switching to a different insurer? Please explain your answer also taking into account the existence of termination and of automatic renewal/extension clauses.

CEA does not have any experience regarding long-term agreements. Therefore we invite the European Commission to consider the replies of our national member associations on this matter.

14 See part VII of the interim report, from p.67 to p.73.

## 6. Distribution of Business Insurance[15]

Intermediaries' remuneration

- Q.8: To what extent do independent insurance intermediaries (brokers and multiple agents) disclose remuneration paid by insurers (i.e. commissions, contingent commissions including profit commissions, fees for services provided and other payments) to their insurance broking clients?

Commission rebating

- Q.9: In your Member State, do independent insurance intermediaries rebate commissions to their clients? How common is this practice for SME clients? How common is it for LCCs?
- Q.10: Are there any agreements between insurers and independent intermediaries not to rebate commissions to insurance broking clients? Are there any other practices that would discourage independent insurance intermediaries from rebating commissions to insurance broking clients?

We do not have any specific remarks regarding the abovementioned questions. However, we wish to comment on two other issues covered by the interim report, distribution structures and potential "conflicts of interest".

### 6.1 Distribution structures

In relation to the part of the interim report dedicated to distribution structures[16], CEA believes that the wide variety of insurance distribution channels has been proved to enhance competition and to be in the interests of customers, insurance undertakings and the economy. The existence of those channels should therefore not be called into question.

### 6.2 Transparency and potential "conflicts of interest"

It is worth stressing that the Insurance Mediation Directive[17] (hereinafter IMD), especially its Chapter III on 'Information requirements for intermediaries', provides adequate responses to some of the European Commission's concerns about a possible lack of transparency and the existence of potential "conflicts of interest".[18]

For instance, Article 12 'Information provided by the insurance intermediary' of the IMD obliges the intermediaries, prior to the conclusion of the insurance contract, to inform the customer whether they are under a contractual obligation to conduct their mediation business exclusively with one or more insurers (Article 12§1(ii)) or whether they give advice based on a fair analysis (Article 12§1(i)). In addition, the intermediaries should explain the reasoning underpinning the advice. Moreover, the IMD expressly allows Member States to maintain or adopt stricter provisions regarding the information requirements – and certain Member States have indeed required that additional information be given to the customer.

Nevertheless, CEA understands that the Commission was not in a position to take into account the impact of the IMD's provisions in an appropriate manner in its interim report, since the latter had not been transposed or had been only very recently transposed in many Member States[19] when the enquiry was carried out. The

15 See part IX of the interim report, from p.89 to p.132.
16 From p.90 to p.101 and p.132 of the interim report.
17 Directive 2002/92/EC of 9 December 2002 of the European Parliament and of the Council on insurance mediation.
18 From p.101 to p.131 and 132 of the interim report.
19 According to the Commission's figures, less than half of the Member States have transposed the IMD in time, i.e. before the 15 January 2005 deadline. One year later, early January 2006, the transposition of the Directive has been notified to the

description and conclusions of the interim report do therefore not reflect a true and accurate picture of the market situation. The situation in terms of customer protection has risen since then and is expected to continue rising as a result of the Directive – when correctly implemented at national level. In that respect, on 19 March 2006, CEIOPS[20] submitted to the European Commission a report on the implementation of the IMD's key provisions which concludes that "(…) the IMD's goal of achieving a high level of consumer protection has been achieved in all Member States. [Insurance intermediaries] are required to provide comprehensive information to the customer before contracts are signed (…)".

However, although all the Member States have now transposed the IMD, it will certainly still be too early for the full and concrete impact of the Directive to be properly appreciated and reflected in the European Commission's final report. CEA recommends that the Commission should gain further experience before drawing any conclusions in this field. In this context, we recall that the abovementioned CEIOPS report may be used by the European Commission as the basis for a possible review of the IMD in 2008 or 2009.

European Commission in only 16 markets out of a total of 25. See DG Markt's tables on the transposition of FSAP Directives (including the IMD): http://ec.europa.eu/internal_market/finances/actionplan/archives_fr.htm

20 CEIOPS: Committee of European Insurance and Occupational Pensions Supervisors – http://www.ceiops.org

# 7. Horizontal cooperation[21]

While the enquiry carried out by the European Commission targeted business insurance, the Block Exemption Regulation applies to all insurance lines: life and non-life insurance, business and individual consumer insurance. CEA believes that the Commission's field of investigation, i.e. business insurance, cannot be used to draw meaningful conclusions calling into question general provisions on horizontal cooperation.

## 7.1 Factors explaining the different levels of cooperation

- Q.11: The enquiry's data concerning the various forms of cooperation among insurers shows substantial differences among Member States. How can these differences be explained?

Contrary to the European Commission's assumption[22], CEA believes that the variation in the level of cooperation between Member States does not raise doubts about the justifications of such cooperation or about the scope of the exemption granted by the Block Exemption Regulation. The usefulness of the latter and its benefits to insurance undertakings, policyholders and the wider economy is demonstrated in our reply to Q.12 and Q.13. The following range of factors explains mainly the different levels of cooperation among Member States:

- Differences in maturity, size and level of concentration in the various national markets. Any comparison between the EU15 and the 10 (now 12) new Member States must specifically take into account the fact that the latter, especially those markets which have been benefiting from a market economy and competition for only few years, are evolving from the dominance of state-owned insurance companies and from a lower level of insurance development. They need time for both adaptation and assessment of the potential offered by the Block Exemption Regulation.
- Different legal characteristics of insurance lines. Compulsory insurance, for instance, allows little deviation from standard policy conditions.
- The fact that particular lines of insurance are of little relevance in certain markets, for example, marine insurance in Austria.

### 7.1.1 Joint calculations, tables and studies

The size of the market is a significant factor explaining the different levels of use of joint calculations, tables and studies. For example, in order to have relevant statistics regarding car accident insurance, a minimum number of cars and accidents need to be monitored. In smaller markets such as the Belgian one, even the bigger players do not insure enough cars to collect these statistics themselves. Only big players in major markets are able to collect such statistics themselves.

The use of joint calculations, tables and studies may also differ because of the concentration level. The more concentrated the market is, the less use is made of this exemption. In such a case, insurers with high market shares generate sufficient statistics internally to be able to make reliable calculations.

21 See part IX of the interim report, from p.132 to p.144.
22 See the Commission's conclusions on horizontal cooperation, p.144 of the interim report.

### 7.1.2 Standard policy conditions and models

The variation in the frequency of use of standard conditions may depend on the level and modalities of European and national insurance regulations. In some countries, certain standard policy conditions are a direct consequence of specific national regulations. In this respect, the different level of use of standard policy conditions between Member States and between insurance lines may depend on the number, range and variety of compulsory insurances in the countries concerned. For instance the prescriptive nature of Motor Third Part Liability compulsory insurance may narrow the scope for individual policy conditions, since the standard policy conditions are based upon legal requirements. Article 18 §4 of the Austrian Motor Third Part Liability Insurance Act even obliges the insurer to indicate explicitly to the policyholder any deviation of his policy conditions from the standard policy conditions.

### 7.1.3 Common coverage of certain types of risks

The fact that pools are rarely used in a number of states does not mean that they have no use in general. Similarly the small number or absence of pools in a given market at a given time does not mean that there will not be a need for further pools in the same market in the future. Existing pools on nuclear risks are known by and useful according to customers. Tomorrow similar solutions may be needed for emerging, catastrophic or terrorism risks that are difficult to ensure.

Among the factor explaining the different levels of use of pools, there is the fact that they may be imposed by national legislation so as to ensure an insurance coverage which would otherwise not be available in the free market.

The existence of a number of pools and the risks they are used for, may furthermore depend on social and political expectations in a given state in respect of the role of the private insurance sector. Such expectations vary among Member States and so do the pools or other systems of common coverage. Differences as to the establishment of pools may for instance result from the public/private frontier at national level and from public authorities' decisions. This is the case for Workmen's compensation schemes, where in certain countries, e.g. Finland, Denmark, Portugal and Belgium it is managed by private insurers.

The lack of clarity and sometimes the inappropriateness of the conditions for exemptions and definitions provided by the Block Exemption Regulation may also hinder insurers from using them:

- A clearer definition of the "Relevant Market" for the purposes of article 7 (2) of the Regulation would be needed. The basic problem of determining which market should be considered relevant from both a geographical viewpoint and from the perspective of a branch or type of insurance remains to be solved.
- The concept of "new risk" is too restrictive and should be redefined. The present definition does not consider that a new risk includes those risks which have not previously been covered.
- The Block Exemption Regulation's limitations concerning cooperation between insurance companies may be inadequate. An insurance company may not, when it comes to common coverage, cooperate with a company that has a market share exceeding 20%. The rules mean that smaller insurance companies on some markets may have difficulty in managing their business. It should therefore be considered whether the 20% limit is always reasonable.

### 7.1.4 Security devices

Security devices may be less used in smaller markets because they carry too high a cost compared to the market size. It is also worth noting that security devices are the responsibility of different entity(ies) depending on national traditions; public authorities, loss prevention institutes, insurers or other stakeholders may be involved in specifications to which insurers may refer.

### 7.2 Benefits of the block-exempted forms of cooperation

- Q.12: Which sorts of benefits have you experienced, as a business insurance customer, from the forms of cooperation among insurers described in the present Report?
- Q.13: As a business insurance customer, have you ever found that the forms of cooperation among insurers described in the present Report were hindering competition?

Although the two questions above do not target CEA directly we would like to provide the European Commission with our experience. CEA is in favour of the principle of group exemption which we believe, far from hindering competition, benefits the European economy and policyholders and contributes to a competitive insurance industry. The Block Exemption gives a legal framework and legitimacy to a series of forms of cooperation which have been recognised since 1991[23] and which:

- Foster competition and leads to the opening up of markets. In Germany for instance, claims cost rates are proven to be useful with regard to cross-border competition. The claims cost rates drawn up by the German Insurance Association (GDV – Gesamtverband der Deutschen Versicherungswirtschaft) for the German market contribute substantially to the enforcement of competition. Because of the quality of the available data, GDV is in a position to draw up detailed cost claims rates especially in the area of motor insurance (third party liability and own damage insurance). As a consequence, motor insurers can compete strongly against each other on the basis of solid statistical data, and they do so. Foreign companies are provided with these data at their request as soon as, according to the reciprocity principle, they agree to deliver such data on their own business in future to the GDV. The statistical data puts them in a position to enter the German market without having to take over a German company. As an example, a foreign direct motor insurance company which was provided with the GDV's claims cost rates from the beginning of its entry into the market succeeded in raising its market share from 0.1% to 0.5% in seven years. This is all the more remarkable as there is strong competition between all German motor insurers. Another five foreign insurers raised their market shares in motor insurance during this time without taking over a German insurance company; three were able to maintain their position. These new players on the market enhance the variety of products and thus are to the advantage of the consumer.
- Assist in reducing costs with a positive effect on insurance prices. The security devices exemption represents one way for customers to save money since they do not have to invest in meeting a new set of standards when changing insurer within one Member State or cross-border when the same security device requirements are used in the new insurance company. Premium discounts may also be granted by insurers when the customer complies with certain loss prevention standards in terms of the quality of security equipment. The standard policy conditions also lead to potential administrative cost reductions on the insurers' side. Thanks to this form of cooperation, companies are able to save overhead costs since their staff concentrates on adapting the standard policy conditions to their own necessities rather than developing them from scratch.
- Provide operators with adequate legal certainty, clear group rules and uniform application in all Member States, thus creating a level playing field for operators. In particular, the Block Exemption Regulation represents a fundamental guideline which is useful for national competition authorities and courts as well as for those active in the insurance field, including insurers. If the Block Exemption Regulation were to be abolished or one of the forms of cooperation which it covers were withdrawn, there would be a risk that,

23 Council Regulation (EEC) No 1534/91 of 31 May 1991 on the application of Article 85(3) of the Treaty to certain categories of agreements, decisions and concerted practices in the insurance sector.

even if it did not conflict with competition rules, some of the forms of cooperation between insurers would cease to exist as a precautionary measure. The legal validity of the remaining forms of cooperation would be managed by the various national competition authorities, thus undermining the creation of a single market in financial services and resulting in the fragmentation of markets. Moreover, the administrative burden resulting from insurance companies' self-assessment as to the compliance of forms of cooperation with competition law would increase and the related additional costs would ultimately be paid by customers. Restrictions or strengthening of the conditions for exemptions would create a significant burden in terms of adaptations and modifications to all the current procedures, policy conditions and models, systems, insurance solutions.

- Is useful for the promotion of consumers' interests. For instance, the use of standard policy conditions helps to create transparency of the market by developing the comparability of products to customers' benefit. The security devices exemption permits CEA to deliver specifications which help the customers – consumers and small businesses – to choose the best security equipment available in terms of loss prevention.

### 7.2.1 Joint calculations, tables and studies

The exemption on joint calculations, tables and studies allows small and medium-sized insurance undertakings and new entrants to carry out calculations on a reasoned basis. Without joint calculations and studies, these undertakings would not possess sufficiently reliable data because of the restricted size of their portfolio. Separate calculations would, in the long run, exclude them from the market and result consequently in a more restricted choice in terms of providers and thus of products to the detriment of customers.

This exemption also benefits larger enterprises, since this allows them to obtain more precise statistics than the ones they would have to collect by themselves. It benefits all market players in non-concentrated markets since each individual operator, whatever its market share, would not be able to obtain representative and reliable data on its own.

It is worth stressing that insurers will increasingly have to collect data in order to evaluate in the most appropriate way the level of risk they support and to determine the level of capital which they need. In this respect, Solvency II will constitute an incentive toward a more risk based economic approach to capital requirements.

The exemption may also be needed in the context of the transposition of European legislation; for instance Article 5 (2) of the Equal Treatment Directive[24] of 2004 allows Member States to permit proportionate differences in individuals' premiums and benefits where the use of gender is a determining factor in the assessment of risk based on relevant and accurate actuarial and statistical data. Cooperation in this field would help to ensure the reliability and accuracy of the actuarial and statistical data on which the calculations are based.

### 7.2.2 Standard policy conditions and models

The standard policy conditions facilitate market access for small and medium-sized insurance undertakings and new entrants, help them to meet legal obligations and thus contribute to the variety of market players (e.g. via freedom of services). Standard policy conditions are crucial for the development of own products, especially for insurance undertakings from other Member States or third countries. Due to differing legal backgrounds and frameworks, foreign insurers cannot simply translate their own contractual terms. They also do not have the knowledge of the laws and court rulings for implementing a legally valid product. Instead, to draw up their own

[24] Council Directive 2004/113/EC of 13 December 2004 implementing the principle of equal treatment between men and women in the access to and supply of goods and services.

policy conditions, they need to employ a multitude of experts who are familiar with the national legal context. This is, on one hand, very time-consuming and, on the other, very expensive. If, however, it is possible to take standard policy conditions as a starting point for their own policy terms, investment costs for market entry can be reduced substantially, thus decreasing the market entry threshold, which is also beneficial for competition.

The standard policy conditions lead to potential cost reductions on the insurers' side. Companies are able to save overhead costs since their staff concentrates on adapting the standard policy conditions to their own necessities rather than developing them from scratch. This applies in particular to smaller insurance companies which cannot afford to maintain a large number of legal staff for preparing new general conditions and for keeping their existing general conditions up-to-date. On top of that, for new entrants and small and medium-sized insurance undertakings the cost effect is even more vital because they have to split the costs between fewer clients than large companies. Consequently, their products become more expensive and less competitive in comparison to the products of big insurers. Therefore, standard policy conditions have a positive effect especially for competitiveness and market access.

CEA believes that standard policy conditions create transparency for the customer and allow benchmarking. The conditions of individual companies may be assessed by rating companies, the press or brokers in comparison with standard policy conditions. Standard policy conditions enhance openness and transparency between insurers thus increasing competition. On the contrary, the absence of standard policy language in a subscription market would increase the need for customers to negotiate separately with multiple insurers thus generating cost, delay and confusion, all of which would work to the detriment of both consumers and insurers. The natural outcome would therefore be that some wordings become de facto 'standard'.

Finally standard policy conditions provide legal certainty for the customer. Standard policy conditions may be drafted jointly by experts from different undertakings who have an all-embracing overview of legislation and court rulings which govern contract conditions. The involvement of experienced and specialised staff ensures that policy conditions respect court rulings and laws. Customers can thus rely on the validity of the standard policy conditions and need not expect to be faced with retrospective adjustments or even terminations of their contracts after certain clauses have proved to be unsound. Moreover, consumer associations are sometimes involved in the drafting of the standard policy conditions by being given the opportunity to deliver an opinion. In the UK, the national regulatory body is working with the insurance industry to achieve contract certainty on all insurance contracts written in the UK, so that all policy terms and conditions are agreed before cover starts. The UK regulatory body recognises that model wording can help to achieve contract certainty, particularly for less complex policies that do not require bespoke wordings.

### 7.2.3 Common coverage of certain types of risks

Risk pooling and diversification is at the core of the insurance business. The common coverage of certain types of risks, i.e. pools, permits insurers to mitigate the risk, like reinsurance and securitisation which allow them to transfer, spread and diversify their risks. It fulfils the need to pool financial capacity which companies might not be able to find in isolation, and to pool technical means where progress is to be made on the insurability of complex or poorly understood risks. It permits consequently insurability by allowing insurance and reinsurance to be provided for risks which may be impossible to cover if not shared.

Pools help insurers and reinsurers to gain the necessary experience of risks with which they are unfamiliar. In the case of new risks in particular, insurers are not in a position to estimate and calculate any obligations arising from cover because detailed financial cost information of accidents from the past is rarely available. This makes it difficult to use historical information to establish reliable statistical data that could be used to predict the costs of future loss and establish the capacity needed to cover these risks. A good illustration could well be given in the environmental area where various pools operate throughout the EU.

### 7.2.4 Security devices

The security devices exemption favours risk prevention and helps to develop risk insurability. For instance, compliance with fire specifications at national and European level regarding security equipment may confine the propagation and intensity of fire, limiting thus the subsequent losses. Security devices can also be beneficial in providing a benchmark to insurers and reinsurers when assessing the extent of the risk they are asked to cover in a specific case, which depends on the quality of security equipment and of its installation and maintenance. Premium discounts may ultimately be granted by insurers for complying with certain standards.

For example, at European level, CEA provides specifications on security devices regarding fire protection systems[25] and security protection systems[26]. The CEA Fire/Theft specifications are available on the CEA website.[27] They result from a joint cooperation between insurance undertakings' experts and devices manufacturers and often inspire the European Committee for Standardization (CEN) afterward. Among the benefits brought by the CEA specifications, we would like to mention the following:

- The CEA specification procedure is an effective neutral way to approve new security devices. CEA is not financially linked to the security device providers, which safeguards an unbiased specification procedure and which therefore promotes competition in the security device industry. If the CEA procedure were not possible, the security device industry itself would start approving the security devices, and the specification procedure would not be neutral in relation to the security device providers.
- The CEA specifications are essential in promoting the possibility of bringing new technology and new security devices to the various EU national markets. The effective CEA specification procedure meets the needs of the fast-growing markets for security devices. A lengthy EU-standardisation procedure, including by the CEN, does not meet the needs of the insurance and security device markets from this point of view.
- The CEA specifications also represent one way to make it easier to change insurance undertakings. When different insurance companies use the same CEA specifications, it is easier for the customer to change insurer within one Member State and also cross-border when the same security device requirements are also used in the new insurance company. In the same context, it also permits customers to avoid additional costs in meeting a new set of standards. Without the CEA specifications, the variety of specifications in the field of security devices would increase and make it more difficult and expensive to change insurer since a previously approved security device may not be approved within the new insurance company.
- The CEA specifications help the customers – consumers and small businesses – to choose a security device. If the CEA specifications did not exist there would be many different kinds of standardisation in the market; this would make it difficult for consumers and small businesses to choose the device needed in order to meet the requirements of different insurance companies and in order to use the best loss prevention measures available.

25 For instance: specifications for fire extinguishing systems using non-liquified 'inert' gases and liquified 'halocarbon' gases, specifications for spark detection, spark extinguishing and spark diversion systems, specifications for natural smoke and heat exhaust systems, specifications for fire detection and fire alarm systems, specification for fire fighting systems using a gaseous extinguishant: specifications for sprinkler systems, specifications for the protection of cold areas etc.

26 For instance: automated teller machines, recommendations for remote monitoring centres, intruder alarm systems, specifications for centralised technical management systems, aim-oriented requirements for alarm transmission systems etc.

27 http://www.cea.assur.org. Click on 'Publications', then 'Brochures' and 'CEA Fire/Theft specifications'.

### 7.2.5 Claims settlements

CEA considers that the scope of the Block Exemption Regulation should be expanded to cover claims settlement agreements. Such agreements allow for a significant reduction of settlement periods, more rapid compensation, more efficiency, greater fairness, particularly with regard to claims following road traffic accidents, as demonstrated by the attached example regarding the Spanish CICOS (see annex).

Council Regulation No 1534/91 of 31 May 1991 on Block Exemption allowed the European Commission to insert claims settlement agreements (Article 1 (1) d)) in the Block Exemption Regulation. CEA is disappointed that the Commission has never used this Article 1 (1) d) to include claims settlement agreements in the Block Exemption Regulation. In recital 3 of the 2003 Block Exemption Regulation, the Commission indicated that it was lacking in sufficient experience in handling individual cases to make use of this power of inclusion. CEA would therefore suggest to the Commission that it investigates to gain sufficient experience allowing issuing uniform rules providing adequate legal certainty also in this field.

Another solution would be to supplement the Block Exemption Regulation with guidelines which evaluate such types of forms of cooperation. The insurance industry, however, operates a number of claims settlement agreements that might benefit from such an exemption.

### 7.3 Conclusion

CEA supports the retention of the current Block Exemption Regulation, which has proved to work efficiently. The need for cooperation that was used as a justification by the European Commission when adopting the Block Exemption Regulation in 1992 and again in 2003 still exists. As demonstrated above, experience shows that it provides the legal certainty which is necessary for market efficiency and stability, benefiting policyholders and the wider economy. It encourages comparability of insurance coverage and products and facilitates market access for small and medium-sized undertakings as well as for new market players. The Block Exemption Regulation is tailored to fit the insurance sector's specificities, thus resulting in clear efficiency gains for the market and promoting consumers' interests.

# Claims settlements – example from Spain: CICOS system

## | What is CICOS?

The CICOS system is a computing tool serving as a clearing house for motor insurance undertakings, which is linked to a direct settlement agreement[28]. By a direct settlement agreement, insurance companies commit themselves to meet the cost of material damages without waiting to see who is liable for the accident.

In brief, the direct settlement agreement works as follows:

- An accident occurs. Both drivers involved may or may not[29] fill in an Agreed Statement (Constat Amiable) with versions that may or may not match. Both drivers will report the accident to their companies.
- The insurance company of the non-liable driver communicates it to the CICOS system.
- Once the insurance company of the non-liable driver has the consent of the other insurance company, it proceeds to repair its insured's car or to pay those damages its insured might have had.
- Under the CIDE/ASCIDE agreements, all the procedures must be completed quite rapidly, since the insurance companies involved have to settle this kind of claim in a short period of time. This benefits both insured and insurance company.
- The insurance company of the liable driver pays a "module" (a fixed amount per claim, not related to the real cost) to the insurance company of the non-liable driver.
- Once a month, the modules owed by all companies are summed up in a single payment operation, i.e., if Company A owes 100 modules to B, and Company B owes 101 to A, there will only be a single transfer of one module from B to A.

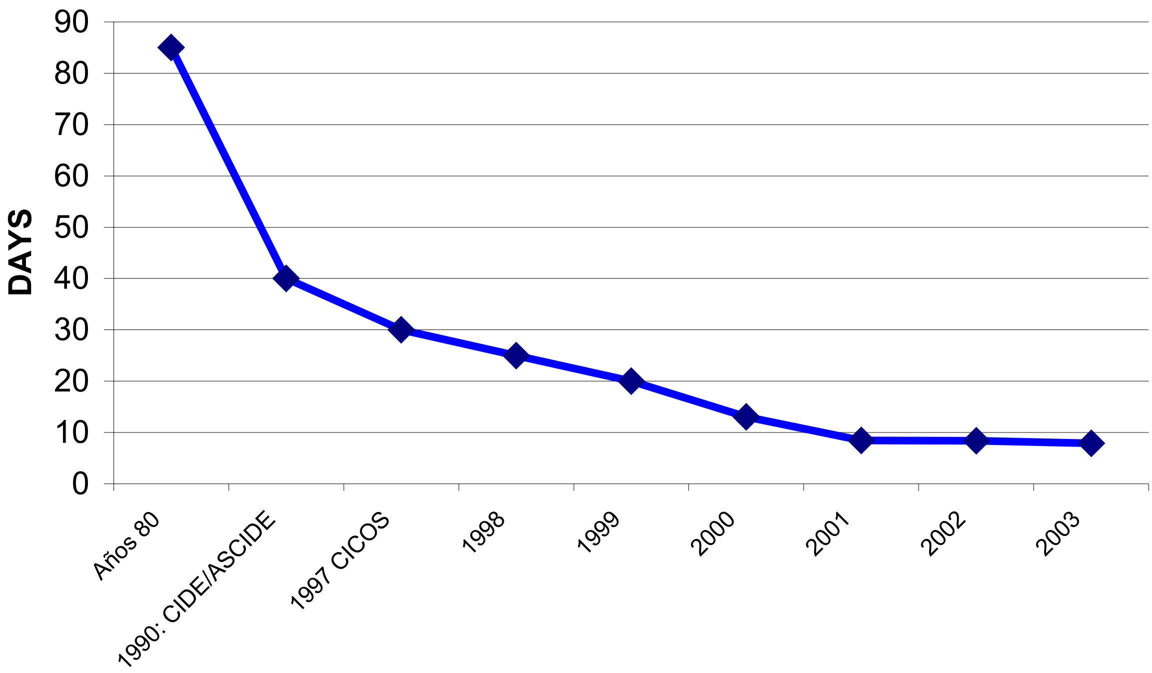
## | What are the benefits?

- In the 80's, the settlement of a motor claim could take between 70 and 100 days.
- After the CIDE/ASCIDE agreements, the settlement period was cut to 40 days.
- In 1997, when the CICOS system was already running, the settlement period was only 30 days. This period has been reduced progressively year after year, so by 2003 it took virtually 8 days only.

| YEAR | AVERAGE TIME FOR A CLAIM SETTLEMENT |
|---|---|
| 1997 | 30 DAYS |
| 1998 | 25 DAYS |
| 1999 | 20 DAYS |
| 2000 | 13.07 DAYS |
| 2001 | 8.45 DAYS |
| 2002 | 8.40 DAYS |
| 2003 | 7.91 DAYS |

28 Those settlement agreements are CIDE and ASCIDE.
29 Completion of the Agreed Statement is compulsory for the CIDE, but not for the ASCIDE.

## AVERAGE TIME FOR A CLAIM SETTLEMENT




Prior to signing the CIDE and ASCIDE agreements and the use of the CICOS computing tool, there were only some bilateral agreements between insurance companies. This used to cause long settlement periods and the excessive intervention of courts in those cases where companies could not reach an agreement.

Due to all those reasons, insurers had very high administrative costs and also a very bad reputation in terms of the public opinion.

As described above, in the 80's the settlement of a claim could take between 70 and 100 days. It is important to state that throughout this time the customer would have had no car. Until liability was established, none of the insurance companies would agree to cover the repair costs. In a system like this, the insured had two options: either wait without a car or pay for the repair at his own expense, waiting for the company to pay him afterwards.

For insurance companies this situation was not desirable either. When a client reported an accident to the company and only provided partial details of the third party vehicle (for example the number plate), the insurance company had to go through a tedious process, searching for the other driver, his insurance company, and within this company, for a valid person to talk to.

The worst case scenario could occur when, once all these situations had been worked through, there was a disagreement between the companies which ended up in court. In these cases, €100 of a standard loss would potentially turn into €10,000.