Consultation about the preliminary findings presented in the Interim Report on the business insurance sector inquiry by the European Commission

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EE&MC welcomes the transparent and open consultation process of the European Commission in the business insurance market. The nature and functioning of the business insurance market as well as the role of the reinsurers are outlined in principle in a sound and well-founded way. EE&MC appreciates these activities of the European Commission and is of the opinion that the Interim Report illustrates most of the relevant aspects of the insurance industry in a very comprehensive manner. In addition, the Interim Report provides a solid basis for further discussions.

EE&MC is also pleased to take part in this consultation process and would like to make some additional remarks focusing on two issues, namely the combined ratios (Q.1) and the horizontal cooperation (Q.11).

In this respect, EE&MC would like to stress the important role of the reinsurers in the business insurance market: While analysing the structure of the market and market outcomes in the close relationship between insurers and reinsurers is an important factor. The reinsurance quota of some insurers amounts up to 90%! Insurers depend heavily on reinsurance activities. Since "everything" in this industry is about the provision of capital, in turn both insurers and reinsurers depend on the development of the capital/stock markets.

The reliance of insurers on reinsurers is very well documented in economic research: Reinsurers supply financial capital to the insurers. Reinsurance capacity is an important element in the insurers' capability to make offers to their clients.[1] Reinsurers in turn depend on capital markets. Since the main costs of reinsurers are costs of capital[2], international capital/stock markets determine in fact reinsurers' capacities and conditions.[3] In years with equity growth, low claims and high investment income, the supply of reinsurance capacity expands: reinsurance prices fall. Conversely, shrinking equity, low returns on investment and catastrophic/giant losses result in price increases.[4] Capital markets are in fact from the economic perspective perfect functioning

1 Albrecht/ Schradin, Struktur der Versicherungswirtschaft, Universität zu Köln, S. 10.
Schweizer Rückversicherungsgesellschaft, Einführung in die Rückversicherung, Zürich, 2002, S. 12.

2 Schweizer Rückversicherungsgesellschaft, Versicherung und Risikokapital oder: Die „Value proposition" der Schweizer Rück, Zürich, 1996, S. 15.

3 Schweizer Rückversicherungsgesellschaft, Der Versicherungszyklus als unternehmerische Herausforderung, Zürich, 2002, S. 6.

4 AONNews Sonderausgabe 11/2001, S. 3 und 4.
Schweizer Rückversicherungsgesellschaft, Der Versicherungszyklus als unternehmerische Herausforderung, Zürich, 2002, S. 6.

markets. This means, prices always raise, when the return on equity in the reinsurance industry is low or negative, or when equity is shrinking.[5] The equity squeeze usually coincides with massive declines in stock prices. The stock markets affect equity directly by impacting the value of the stocks on the asset side of the insurers' balance sheets.[6] Thus, developments on stock markets and capital markets in general affect directly the provided reinsurance capacity, reinsurance prices and thus again the profitability of the insurers.

Thus in fact, the capital/stock markets are the driving forces in the insurance industry. In particular, this is true in the business insurance industry because of the high amounts of money involved. These important dependencies have to be kept in mind while analysing the business insurance market.

Q.1 Combined Ratios

The Interim Report discusses combined ratios to measure the profitability of the insurance industry and draws the remarkable conclusion that high and sustained profitability might be the result of the exercise of market power. On page 58, the Interim Report even states that "[…] annual combined ratios, which are regularly, significantly lower than 100% may be a strong indication that insurance companies are exerting market power."

While such a conclusion might be true in some markets, it is not the case in the business insurance industry. Therefore EE&MC does not agree with this conclusion. From our point of view, the simple conclusion, that high profitability means exertion of market power is too general in this business. Reasons are the strong relationships between the insurance/reinsurance markets and the capital markets, as mentioned before and acknowledged in the Interim Report too. Nobody would be well advised to reach the conclusion that significant returns on investments in capital markets are the results of exercise of market power. Instead the close-by argument would be that investors made a good investment decision. The same line of argumentation is true for the business insurance industry.

From a competition economic point of view, the conclusion that high and sustained profitability in business insurance is the result of the exercise of market power cannot stand therefore. The Interim Report did not discuss a sound and solid analysis required to reach that conclusion either.

[5] Schweizer Rückversicherungsgesellschaft, Der Versicherungszyklus als unternehmerische Herausforderung, Zürich, 2002, S. 6.

[6] Schweizer Rückversicherungsgesellschaft, Der Versicherungszyklus als unternehmerische Herausforderung, Zürich, 2002, S. 7.

Instead, the Interim Report referred to the cyclical fluctuations in this industry and elaborated that the financial success in this business depends on claims and losses which might differ significantly from year to year. Thus, the Interim Report itself provides the arguments why this conclusion cannot stand.

Due to the above described dependency of reinsurers especially non-life insurance typically goes through price cycles that extend over several years and are particularly pronounced in the industrial insurance lines.[7] Insurers thus have to cope with extreme fluctuations in revenue and expenditures due to these price fluctuations.[8] These fluctuations impact the insurance companies' profits[9] and thus result in the cyclical fluctuations of combined ratios. In other words, the insurance industry is characterized by so-called "underwriting cycles"[10]: periods of high combined ratios are followed by periods with low combined ratios and so on. This means that even a long period with low combined ratios, i.e. high profits, is - like in capital/stock markets - a normal phenomena in the insurance industry. Based on this understanding of the insurance market, high profitability in some periods should not be a problem at all. However, the short-cut, not well-founded conclusion that high profitability might be a strong indication for an exercise of market power is simply wrong in this industry.

Annual combined ratios, which are regularly, significantly lower than 100%" cannot serve as a strong indicator for market power. More thorough analyses are required to reach such a conclusion.

Moreover, a comparability of different combined ratios in different countries is extremely difficult. This means that the conclusion in the Interim Report, that significant difference across product lines and countries over time might indicate lack of competition is questionable. A comparison of different countries and different product lines is difficult, as claims and losses differ as well. For example, the non-life insurance penetration varies considerably in the EU (cp. page 36 Interim Report). Similarly, a comparison between different product lines is pretty difficult, because the risks covered by underwriting may be different in these different lines too. The Interim Report itself mentions the drawbacks taking combined ratios as a proxy to assess market power (cp. page 58 Interim Report).

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7 Sepp, Thomas/ Bäte, Oliver, Den Underwriting-Zyklus beherrschen, nicht erdulden in Versicherungswirtschaft Heft 21/2003, S.1688.

8 Schweizer Rückversicherungsgesellschaft, Der Versicherungszyklus als unternehmerische Herausforderung, Zürich, 2002, S. 3.

9 Schweizer Rückversicherungsgesellschaft, Der Versicherungszyklus als unternehmerische Herausforderung, Zürich, 2002, S. 3.

10 Stewart/Stewart/Roddis, A brief history of underwriting cycles, 1991, S. 2.

Thus, caution is required while comparing different countries and lines. Furthermore, general statements and conclusions should be avoided based on these comparisons. Rather a detailed and exhaustive analysis taking into account the special characteristics of each country and product lines is required.

Q.11 Horizontal cooperation

The Interim Report states that the level of cooperation among insurers varies substantially from one Member State to another. Due to these differences doubts arise about the justifications of such cooperation and about the scope of exemption currently granted. The removal of the present Block Exemption is a serious option to evaluate.

The misapprehension in this argument is that the differences in the Member States with respect to the level of cooperation are not correlated to the concentration in these markets. This is especially true for Germany: In Germany the level of cooperation is remarkable, the insurance market is highly competitive and the degree of concentration is the lowest one in Europe.

Thus, while deciding to remove the Block Exemption or not the argument used should not rely on the different use of the Block Exemption in the different Member States. Further, more detailed and comprehensive economic analyses would be required to reach well-founded conclusions. Moreover, the existence of the Block Exemption results in manifold advantages such as benefits for new markets entrants from having access to shared information, i.e. lower costs of entering a new market.

Our opinion is that the removal of the Block Exemption should be evaluated carefully. Again, this discussion does not benefit from short-cut conclusions as illustrated above but requires systematic thoughts and top-to-bottom evaluations.