

# Competition on the European Market for Liability Insurance and Efficient Accident Law

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## Competition on the European Market for Liability Insurance and Efficient Accident Law

### § 1. Introduction

In the economic analysis of law, the advantages of liability insurance have been extensively discussed. Liability insurance is considered as the optimal instrument to remedy the risk aversion of the injurer without increasing the size of the expected losses. Thanks to the control devices used by the insurer, it can be guaranteed that the injurer, although insured, will still have appropriate incentives for taking care. It has been argued also that these benefits of liability insurance only apply when there is sufficient competition on insurance markets.<sup>1</sup> In spite of the latter warning, one notices increasing co-operation between insurance companies, especially as far as larger risks are concerned. Professional organizations, such as associations of insurers, provide either so-called market advices to the affiliated insurance companies or outright standard policy forms that can be used by the members. These forms of co-operation may obviously limit competition between insurance companies.

The co-operation between insurance companies can take different forms, as the following examples from the Dutch market illustrate. In the second half of the 1990s, the Dutch insurers' association formulated the advice to change the coverage for employers' liability from loss occurrence to claims made coverage, especially for so-called occupational diseases. As a consequence, an individual employer will no longer have the possibility to obtain coverage for occupational diseases on a loss occurrence basis in the Netherlands. Another example is that in the same country, the insurers agreed in the 1950s that for some risks considered to be catastrophic (more particularly

1. This paper draws on earlier research. See M. Faure and R. Van den Bergh, 'Restrictions of competition on insurance market and the applicability of EC anti trust law', 48 *Kyklos* 1 (1995), 65-85 and M. Faure and R. Van den Bergh, 'Aansprakelijkheidsverzekering, concurrentie en ongevallenpreventie', in T. Hartlief and M.M. Mendel (eds.), *Verzekering en maatschappij*, (Kluwer, 2000), 315-342.

earthquakes and floods) no insurer was allowed to provide coverage. The latter example shows that these practices not only limit competition, but equally limit the availability of insurance coverage. Indeed, in some cases it can be doubted that these particular risks (for instance floods) are indeed uninsurable from a technical insurance perspective.

The question arises whether limitations of competition on insurance markets can be economically justified. We will address this question by taking a look at the way European competition law deals with restrictive practices and provide a critical perspective of that approach. The focus will mainly be on liability insurance for the following reason. Many scholars hold that the scope of liability itself should be linked to the availability of insurance. It can be argued that the availability of insurance may only be increased if insurers are allowed to share information, for instance statistics on risks or information concerning the optimal preventive mechanisms. On the one hand, an exchange of information may thus be necessary to increase insurability. On the other hand, such an exchange provides the framework for limitations of competition. It should be clear from the outset that it is very difficult to discuss a co-operation between insurers in black or white statements. It is not always easy to make a distinction between desirable and useful co-operation between insurers, which increases the availability of insurance, and damaging restrictive practices.

This paper is set up as follows: first it is explained why competition law is a crucial instrument to support an efficient accident law (2). Then the question is addressed to what extent competition law should be applied to the insurance world. This question is partially answered by the European Commission in its Regulation 3932/92 of 21 December 1992<sup>2</sup> which provides a block exemption for insurance companies from the cartel prohibition (3). The conditions for the exemption will then be critically discussed (4) and it will be shown that restrictions of competition may endanger some of the efficiency goals of liability law (5). Finally attention is given to the Report of the European Commission to the Parliament of 12 May 1999<sup>3</sup> concerning the application of the mentioned exemption (6) and a few concluding remarks are formulated (7).

## § 2. Competition Law as an Instrument to support an efficient Accident Law

The central idea of the economic analysis of accident law is that the foresight of being held liable *ex post* will give potential injurers *ex ante* an incentive for taking efficient care and choosing an optimal activity level. In case of full insurance coverage, these incentives are, however, no longer given by liability law, since the threat to have to

2. [1992] O.J. L398/7.

3. Report of the Commission to the European Parliament and to the Council of 12 May 1999 concerning the operation of Exemption Regulation 3932/92, COM(1999) 92 final.

compensate the victim in case of liability is shifted to the insurer. The incentives for prevention must therefore be provided by the policy conditions of the insurance. If the insurer can optimally control the risk of moral hazard through a policy that reflects the behaviour of the insured, this can lead to a behaviour of the insured as if there were no insurance coverage. Hence, liability insurance has a very important social function: it must guarantee that the control by the insurer of the behaviour of the insured injurer will provide the latter with sufficient incentives for the prevention of accidents.

In the ideal situation the policy conditions will optimally align to the individual risk posed by the insured. As far as possible, this means that the premium will be adapted to the individual risk posed by the insured, as a result of which the insured will have optimal incentives for the reduction of risk. The key notions here are risk differentiation and risk classification.<sup>4</sup> How can competition contribute to an optimal risk differentiation? Competition should increase the likelihood that the premiums charged align with the actuarially fair premiums. The actuarially fair premium corresponds with the probability of the damage multiplied by the expected magnitude of the damage. When an insurance market is sufficiently competitive, insurers will compete to reduce administrative costs and profits. The result will be that the difference between the price charged for the insurance and the actuarially fair premium (the size of the losses multiplied by the probability of their occurrence) will not be too large. In other words: the process of competition guarantees that actual premiums charged will correspond as much as possible with actuarially fair premiums and may avoid insurance companies making inefficiently high profits (implying that they can charge premiums that largely exceed the actuarially fair premiums).

On insurance markets, prices (premiums) will be fixed as a result of supply and demand. When demand for insurance products increases (for instance as a result of the introduction of compulsory insurance), in principle the supply of insurance can be increased without the necessity to increase premiums.<sup>5</sup> In other words: in case of an increased demand there should in principle not be premium increases. Premium increases should only occur when the actuarially fair premium (the probability multiplied by the expected damage) increases.

Not only does the competitive process avoid the creation of inefficient profits; it can also guarantee that the actuarially fair premium is fixed correctly. As long as the premium correctly reflects the risk, moral hazard will be cured optimally, implying that

4. See on the optimal method of risk differentiation: Borenstein, 'The economics of costly risk sorting in competitive insurance markets', 9 *International Review of Law and Economics* (1989), 25-39 and see also W.P.J. Wils, 'Insurance risk classifications in the EC: regulatory outlook', 14 *Oxford Journal of Legal Studies* (1994), 449-467.
5. See H.E. Frech and J. Samprone, 'The welfare loss of excess non price competition: the case of property liability insurance regulation', 23 *Journal of Law and Economics* 2 (1980), 429-440.

injurers will not have an incentive to increase their activity level or to decrease their level of care simply because they are insured. This first best solution can of course only be realized in an ideal world where insurance companies can optimally observe the insured and where moral hazard can be controlled optimally. Here again, the competitive process can play an important role: insurers should compete with each other concerning the way in which higher care by the insured will be rewarded with a premium reduction. In other words: the competitive process can help the control of moral hazard. The competitive process is therefore important to guarantee that an insurer rewards the insured for increased care with a premium decrease. Thus risk differentiation, the key element to control moral hazard, can only be guaranteed on competitive insurance markets. In the absence of competition, insurers will have too little incentive to control moral hazard optimally.

The conclusion so far is therefore relatively simple: in order to have an optimally functioning liability insurance, it seems important to apply competition law also to the insurance market. However, this conclusion does not seem obvious in the insurance world, where it has been often argued that competition law should not unequivocally be applied to insurance markets. In the following section, we will discuss the arguments that have been advanced in that respect and evaluate them critically.

### § 3. The Application of Competition Law to Insurance

#### A. THE ARGUMENTS

Insurers have advanced several arguments to support the conclusion that insurance is clearly different from other services and should therefore be exempted from the application of competition law. Usually five arguments are advanced to justify the exemption of the insurance companies from the scope of the competition rules:

1. Co-operation between insurance companies is necessary to make premium calculation possible (premium calculation argument).
2. Since insurance risks tend to become larger, pooling of risks and reinsurance becomes indispensable; this tendency would preclude the applicability of competition law (reinsurance argument).
3. Due to the lack of market transparency consumers are unable to compare different insurance policies; these information problems require regulation instead of enforcement of competition rules (market transparency argument).
4. Since the provision of insurance coverage is not dependent upon production costs insurers could extend their capacity without limits; this would cause a tendency towards ruinous price competition in insurance markets (capacity argument).
5. Competition may lead to bankruptcies, which would make it impossible for the insurance companies to fulfil their obligations *vis-à-vis* the insured; the latter have to be protected against this insolvency risk (insolvency argument).

None of these arguments is, however, sufficient to justify granting the insurance sector a general exemption from the prohibition of cartel agreements.<sup>6</sup> Let us discuss each of the arguments in turn.

## B. PREMIUM CALCULATION ARGUMENT

One of the main arguments used by the insurance industry to justify the exemption from the competition rules relates to the difficulties concerning the calculation of premiums. It is argued that the loss statistics which individual companies possess fall a long way short of what is needed for the proper rating of risks. Co-operation between insurance companies is therefore necessary. After a collective analysis of loss statistics practical guidance for the writing of policies can be obtained. This kind of co-operation would make the calculation of the necessary technical reserves possible and ensure that income and expenses balance so that there is no risk of insolvency. Hence, the argument goes that co-operation with respect to premium calculation contributes to an improvement of the provision of services and therefore meets the first condition for an exemption.

At first sight the argument seems correct. First, the insurer's risk premium is a function of large numbers. The insurance industry may be 'naturally monopolistic'. The technology of production may be such that larger firms can produce at lower unit cost over all relevant output levels. Second, the peculiarity of the business of insurance undertakings lies in uncertainty. To determine the precise cost of the claims and thus to be able to calculate the premium the insurer has to rely on forecasts concerning the probability of the insured event and the foreseeable extent of the loss. The assessment of the frequency and the extent of claims implies access to meaningful statistics. Co-operation would therefore be necessary to provide information which is sufficiently general to enable the calculation of average values, which have to be known to fix the premiums. Especially if claims are relatively infrequent and risk categories are relatively numerous, then the larger the firm, the better the actuarial calculations based on internal claims experience. There is a clear incentive for firms either to merge or to co-operate in the pooling of claims experience. The premium calculation argument is an example of the public good nature of information: once one firm has a claim, that fact can be made available to all other firms at very low cost. Hence, the applicability of competition rules should not hinder an appropriate calculation of tariffs in the insurance sector.

However, there are at least four problems with the premium calculation argument. First, it should be noted that insurers are of course not the only producers of services that have to deal with uncertainty. The uncertainty which is in this case related to necessary information for premium calculation is a normal business risk of an entrepreneur and

6. This analysis is partially based on M. Faure and R. Van den Bergh, 48 *Kyklos* 1 (1995), 65-85.

does not in itself justify the existence of cartels. Second, the premium calculation argument is formulated in terms which are far too general, without distinguishing between different classes of insurance. Möschel distinguishes with good reason between 'Zufallsrisiken' (risks determined by coincidence) and 'Änderungsrisiken' (risks relating to a change in the dangerous situation itself). The former can be calculated on the basis of the law of the big numbers. In many classes of insurance the necessary figures can be obtained without difficulty. The production of mortality tables does not require co-operation since the life expectancies of people are widely known for several years and are not subject to important changes. Information is also readily available as far as the frequency of illnesses and accidents are concerned. Difficulties do arise in the determination of industrial risks (e.g. fire and operational failure) but these are mainly due to the long duration of the insurance contracts.<sup>7</sup> Hence, the setting of minimum premiums for life insurance on the basis of a limited list of mortality tables and an obligatory inventory supplement and the practice of long term contracts in fire insurance merely indicate the desire of the insurance companies to limit competition. Third, uncertainties regarding the calculation of risks can be overcome by instruments other than cartel agreements. A good example can be found in the field of liability insurance. Assume that an insured would wish to change insurance companies. After a relatively long contract period the insurance company could have a relatively good view of the individual risk of the insured, based among others on the number of accidents in the past. This information could be made available to the insured, e.g., by giving him a personal certificate or register with his personal record with this insurance company. It becomes then easier for the insured to change insurance companies without having to start at the highest premium for beginners with his new insurance company. This example illustrates that if insurers are willing to think along these lines, many instruments can be developed to pass on information on risks that even promote competition instead of limiting it by making cartel agreements on premiums. Finally, the public good argument requires that the information on loss statistics is made widely available. The key issue to ask is who has access to this information. An insurance cartel will not be inclined to make the statistical studies results available to outsiders. It would be a superior outcome to force the cartel to provide the competition authorities with this information, which could then publish the loss statistics and make them known to competitors and consumers. As long as this information is not passed on to new entrants, co-operation with respect to premium calculation may give market power to the incumbent firms and artificial entry barriers may be created.

The EC Commission could of course reply that Article 3 of Regulation No. 3932/92<sup>8</sup> clearly states under (a) that the exchange of information is limited to data that are

7. W. Möschel, '§ 102 GWB', in U. Immenga and E.J. Mestmäcker (eds.), *GWB. Kommentar zum Kartellgesetz*, (Beck, 1981), 20-24. See also J. Finsinger, *Verbraucherschutz auf Versicherungsmärkten*, (Florentz, 1988), 60-62.

8. [1992] O.J. L398/7.

neutral with respect to competition and that the calculations are established and distributed only by way of indicative reference. In Consideration 6 the Commission also emphasizes that the exemption only applies to indicative pure premiums. The concerted practices on commercial premiums, i.e. the premiums actually charged to policy holders and comprising a loading to cover administrative, commercial and other costs, a loading for contingencies or profit margins, are not exempted. The difference between the pure premiums and the commercial premiums are indeed the administrative, commercial and other costs and the profit margins. These may differ considerably between insurance companies. However, this argument is not convincing. First, one should note that important differences exist as far as risk calculation is concerned between various insurance sectors. It would be more useful therefore to differentiate between those sectors instead of granting a block exemption from the cartel prohibition. Individual exemptions are a better alternative to cover the limited range of situations where information exchange between insurers is indispensable to make premium calculation possible. Second, it should be noted that within the not yet fully integrated European insurance market, premium calculation is still mainly done on a national basis. The problem with the block exemption is that it allows these national principles of risk calculation to remain in existence, which makes it impossible for an insurance company with international activities to compose homogeneous risk groups across country borders.<sup>9</sup> A generalized exemption from the cartel prohibition therefore has adverse effects as far as the achievement of an internal European insurance market is concerned. Third, there is only a thin line between the so-called indicative premiums and real horizontal price agreements. A cartel authority should know that recommended prices are often used as a substitute for fixed prices (e.g. vertical price fixing) and therefore require intensive control. The European Commission would do better to listen to a piece of good advice from Adam Smith, who wrote as early as 1776:

People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices...But though the law cannot hinder people of the same trade from sometimes assembling together, it ought to do nothing to facilitate such assemblies...<sup>10</sup>

By allowing indicative premiums which ‘have only reference value’<sup>11</sup> the European Commission is effectively sending invitations to insurers, suggesting meetings where cartel agreements can be reached. When insurers during a conference discuss frequency tables and circumstances that may influence the number or size of claims they may find

9. See R. Eisen, W. Müller and P. Zweifel, ‘Entrepreneurial Insurance. A New Paradigm for Deregulated Markets’, 18 *Geneva Papers on Risk and Insurance* 66 (1993), 1-56
10. Th. A. Smith, *An inquiry into the nature and the causes of the wealth of nations*, (1937), 127-128.
11. See Consideration 6 of Regulation 3932/92, [1992] O.J. L398/7.

it hard to resist the temptation to make some general agreements on commercial premiums during the coffee-break as well.

### C. REINSURANCE ARGUMENT

This argument holds that co-operation in the form of co-insurance and reinsurance is necessary to meet the needs of the modern insurance markets, where insurers are increasingly asked to cover risks of a magnitude exceeding the assets of an individual insurance undertaking. It must be admitted that there are natural reasons which lead towards co-operation or merger in the insurance market. The reinsurance argument restates the fact that several aspects of the insurance business may be characterized as naturally monopolistic. As has already been stated above, the insurer's risk premium itself is a function of large numbers: the more independent risks covered, the more diversified the portfolio, the lower the fair premium. Both the frequency of claims and the diversifiability of risks may make some classes of insurance naturally monopolistic. If insurers are faced with risk which is not diversifiable internally, they may either diversify through merger, or co-operate with other insurers in a reinsurance arrangement. Although the reinsurance argument thus has some merit, it should be stressed that not all classes of insurance are naturally monopolistic: it all depends on the frequency of claims and the diversifiability of risks. Consequently a blanket exemption from antitrust provisions across all classes of insurance may not be optimal.

Pooling arrangements and arrangements which make reinsurance on a larger scale possible might contribute to an increased level of competition. In high risk lines, certainly for catastrophic risks, pools permit small insurance companies to participate in a particular market.<sup>12</sup> If these arrangements were absent, only a few large insurance companies would be able to provide insurance coverage for specialized and risky activities. Allowing smaller firms to pool will in fact increase the number of competitors. Co-insurance should therefore not as such be regarded as a restriction of competition. Pooling might also facilitate the purchase of reinsurance. With reinsurance the capacity to insure will increase. The ceding insurer will also be protected against accumulation of losses arising out of catastrophic occurrences, which helps to stabilize operating results.<sup>13</sup> The same line of reasoning goes for pooling arrangements on the reinsurance market. As a result, the insurance market could become more competitive through reinsurance arrangements. However, if pooling and reinsurance arrangements are combined with further restrictions, which are not necessitated by insurance technical reasons, the final users will not receive a fair share of the resulting benefits and inefficiencies might appear. Examples of such cases of inefficient reinsurance can be

12. See Havens and R.M. Theisen, 'The application of United States and EEC Antitrust Laws to Reinsurance and Insurance Pooling Arrangements', *The Antitrust Bulletin* (1986), 1300-1301; J. Finsinger, *Verbraucherschutz auf Versicherungsmärkten*, 70-72.
13. Havens and R.M. Theisen, *The Antitrust Bulletin* (1986), 1300-1301.

found in the nuclear insurance industry: pooling of risks in so-called national nuclear insurance pools leads to high premiums, a low availability of insurance capacity and low financial limits on the liability of the licensee of a nuclear power plant as a result of the lobbying power of the nuclear insurance pool and the nuclear industry.<sup>14</sup>

Hence, the question arises as to where to set the bottom line of the restrictions from an antitrust policy. According to the insurers, restrictions on price competition (premiums) are a part of the acceptable limitations. However, horizontal price restraints may hinder the passing on of the benefits realized through the accepted restrictions, to the consumers of insurance. The argument that uniformity of premiums and policy conditions is required to make the calculation of the tariffs for reinsurance possible is very weak.<sup>15</sup> In this respect the European Commission is indeed quite careful. Article 11 of Regulation 3932/92 provides that the exemption only applies if the insurance products underwritten by the participating undertakings do not represent more than 10% of the market in case of co-insurance or 15% of the market in case of co-reinsurance.

#### D. MARKET TRANSPARENCY ARGUMENT

It is often argued, also to justify the exemption, that the supply of insurance services lacks transparency so that consumers are unable to compare insurance policies offered by competing insurers. The policy terms are sometimes described as 'hermetic'.<sup>16</sup> Information deficiencies do indeed hinder the functioning of the market mechanism and can lead to inefficient results. Regulation would therefore be warranted. The standardization of policy terms would thus be the correct regulatory answer to an alleged market failure.

In absolute terms this argument is erroneous both in its formulation and in the proposed remedy. The assertion that consumers of insurance services are always incapable of evaluating the contents of insurance contracts is as such too general. This may be true as far as some clauses in mass insurances are concerned. For instance, policies containing sharply formulated exclusions, of which the exact implications can only be assessed by a specialized lawyer, might be difficult to read for an average consumer. By contrast, in the area of industrial and commercial insurance, insurers are confronted with well-informed buyers who appear to be tough bargainers, as the current policy terms and premiums for these types of insurance show. Again, one also has to distinguish between different classes of insurance to check the veracity of this market transparency

14. For example, it is remarkable that on the nuclear insurance market the nuclear pools insure the nuclear power plant itself for much higher amounts than the third party liability of the licensee (for a critical analysis see M. Faure and R. Van den Bergh 'Liability for nuclear accidents in Belgium from an interest group perspective', 10 *International Review of Law and Economics* 1 (1990), 241-254).

15. According to J. Finsinger, *Verbraucherschutz auf Versicherungsmärkten*, 71-72.

16. See further J. Finsinger, *Ibid.*, 71-72.

argument. Even though there may be serious information problems in the field of mass insurance, this market failure does not, however, automatically imply that direct regulation of policy conditions is the most appropriate solution.<sup>17</sup> Where market imperfections exist one should first look for market oriented remedies. Only if the flow of information cannot be improved should direct regulation of policy terms be considered. There are, however, many possibilities to increase the availability of information regarding the extent of insurance coverage to non-commercial buyers.

In this respect the role of insurance brokers should be emphasized. A competitive supply of insurance brokers could assist the consumer in finding an insurance policy that fits his preference as far as premium and policy conditions are concerned. Standardization of policy conditions has the disadvantage that it does not allow for enough risk differentiation and makes it difficult to take into account the individual risk of the insured.

In some countries there is also experience with a control of policy conditions *ex post* through courts or through an independent authority which shows that many possibilities to protect consumers against unreasonable policy conditions exist which can still guarantee competition between insurance companies. These *ex post* controls can do a better job as far as consumer protection is concerned since they still allow for a variety of policies to be supplied on the market and for competition between insurers.

Again the European Commission seems to have seen the problem. In Consideration 7 of Regulation 3932/92 it is argued that standard policy conditions have the advantage of improving the comparability of cover for the consumer. However, the Commission argues that the exemption should only apply if the standard policy conditions are not binding, but serve as non-binding models. Therefore Article 6, 1(a) also stipulates that the standard policy conditions can be established and distributed explicitly only by way of indicative reference. This implies that the Commission believes that antitrust law is not a useful instrument to guarantee the transparency of policy conditions. In that respect civil law remedies against unfair policy conditions can do a better job. The Regulation now in fact provides for an invasion of antitrust law in the civil law of obligations. This is clear in Article 7 of the Regulation which especially provides for a long list of prohibited (black list) clauses which may not be contained in the standard policy conditions if the insurers want the exemption to apply.

17. R. Eisen, W. Müller and P. Zweifel, 'Entrepreneurial Insurance. A New Paradigm for Deregulated Markets', 18 *Geneva Papers on Risk and Insurance* 66 (1993), 17-18.

## E. CAPACITY ARGUMENT

This argument holds that insurance markets show a tendency towards ‘ruinous price competition’, because insurers can extend their capacity without limits. Unlimited competition in the insurance industry would result in the excessive risk of some insurance companies going out of business in view of the special characteristics of the supply of insurance services, being largely independent of production costs. Competition on prices would therefore be particularly keen and, if it were unlimited, cause many bankruptcies.

The capacity argument is not supported by convincing theoretical or empirical proof. It should be obvious that supply is not unlimited as regards quantity. The administrative costs of insurance amount to one third of the awarded damages. It is, moreover, necessary to increase reserves in relation to capacity in order to guarantee the performance of insurance contracts. Possibilities to extend the supply are also in many classes of insurance restricted by the limited number of insurable objects: for instance, in the cases of industrial fire insurance, insurance against operational failure and motor vehicle insurance. Furthermore, the availability of reinsurance protects against ruinous competition.<sup>18</sup> Finsinger has drawn attention to the fact that a tendency towards ruinous competition would only prevail if economies of scale in the production of insurance were important. This may be the case from a theoretical point of view (the law of the large numbers) but in practice economies of scale are also realized by small insurance companies so that larger rivals have no significant advantages related to their size. Risks are above all determined by the correlated stochastic components of the insured risks and the general business risk.<sup>19</sup> The risk is not *a priori* dependent upon the size of the enterprise. From an empirical point of view the low degree of concentration and the small number of bankruptcies in non-regulated insurance markets (e.g., Great Britain) also rebuts the capacity argument.<sup>20</sup>

Finally, the desirability of exempting the insurance industry from the scope of competition rules on the basis of the capacity argument is incomplete unless existing government regulation is taken into account. The option to increase capacity is limited in many Member States by requiring solvency margins and minimum guarantee funds. The capacity argument is therefore not a convincing reason to generally exclude cartel agreements in the insurance sector from the cartel prohibition.

18. J. Finsinger, European Integration of Insurance Markets. Preliminary but novel perspectives, Working Paper Universität Lüneburg Nr. 75, (1989), 70-72.
19. J. Finsinger, *Ibid.*, 59-60.; R. Eisen, W. Müller and P. Zweifel, ‘Entrepreneurial Insurance. A New Paradigm for Deregulated Markets’, 18 *Geneva Papers on Risk and Insurance* 66 (1993), 23-24.
20. J. Finsinger, E. Hammond and J. Tapp, *Insurance: competition or regulation? A comparative study of the insurance markets in the United Kingdom and the Federal Republic of Germany*, (Institute for Fiscal Studies, 1985), 169.

## F. INSOLVENCY ARGUMENT

This argument is based on the consumer protection idea: regulation of the insurance sector is necessary to protect the 'innocent' insured against the risk of insolvency of his insurer. In this respect it should of course be stressed that free competition implies that unprofitable undertakings go out of business. On the other hand, in the event of the insurers' insolvency the insured remain uncompensated and the costs of their claims are thrown upon society. A balance must therefore be found between the requirements of the normal operation of competition and those of the public interest which demand that a contract of insurance must always be honoured.<sup>21</sup>

This argument is also flawed. If, as a policy matter, one accepts that the contractual obligations of an insurer should always be honoured, this could be guaranteed through means other than cartel agreements. In this respect one can point at specific institutions which provide effective protection if insurance companies fail. In the area of motor vehicle insurance in most EC Member States a guarantee fund operates. This fund is financed by levies on all insurance companies offering automobile insurance. The fund will pay compensation to injured traffic participants, among others in case of bankruptcy of the insurance company. This guarantee fund adequately protects the policy holder in the event of insolvency without strict, distorting regulations on premiums. This method allows competition in the market and also allows bankruptcy to occur. Losses in efficiency, which would be caused by the inapplicability of competition rules and bankruptcy law, are thus prevented. Moreover, the existence of minimum capital requirements and solvency margins should again be stressed. Hence, the insolvency argument is no excuse for cartel agreements on premiums between insurers.

In sum, the conditions for the exemption from the cartel prohibition are not fulfilled in general. One should rather examine whether in individual cases there are arguments to exempt certain agreements in a specified insurance sector from the cartel prohibition. Therefore we believe that individual exemptions for certain agreements are less inefficient than the generalized exemption for all insurance branches and all kinds of agreements, as has been promulgated by the European Commission in the Regulation under discussion.

In sum, there seem to be very few reasons not to apply competition law to the insurance branch. Nevertheless, the European Commission granted a group exemption on 21 December 1992 for cartel agreements in the insurance branch. The structure and the text of Regulation 3932/92 make clear that the arguments discussed above certainly have

21. See the opinion of Advocate General Darman in Case 45/85 *Verband der Sachversicherer* [1987] ECR 447 et seq. (no. 21 of the Opinion).

influenced the opinion of the European Commission.<sup>22</sup> The problem is that the contents of the exemption seems to reach further than what could be justified for the efficient functioning of the insurance market. Before analyzing what the possible negative effects of the exemption may be on liability insurance (see below § 5), we will look at some of the still occurring practices of co-operation in the insurance world and relate them to the group exemption.

#### § 4. Regulation no. 3932/92 and some Practices on the Liability Insurance Market

##### A. AGREEMENTS ON PREMIUMS

The most far reaching form of a restriction on competition is outright price fixing. Today this practice is probably rare in the European liability insurance market. In some countries advice is given by insurers associations, e.g. on the way individual insurance companies could apply the tariffication. In this respect, one can refer to the system of experience rating applied in motor vehicle liability insurance, referred to as the *bonus malus* system. As a result of this system, the experience rating in motor vehicle liability insurance is in many countries standardized. However, this *bonus malus* system in most countries only applies to tariffication after the accident and is usually not binding. The system can well be considered as a relatively low cost efficient system of adapting the insurance premium to the individual behaviour of the insured. Moreover, in most systems the individual insurance company is totally free to apply a *malus* after an accident or not. In addition, the individual insurer is also free in fixing the initial premium.

The same could be said as far as another practice is concerned, namely the use of standard form policies. For instance in the Netherlands the Dutch insurers association<sup>23</sup> provides a standard form policy for liability insurance for companies.<sup>24</sup> These policy models usually contain a few provisions concerning the way in which the premium can be calculated, the payment of the premium and the possibilities for the insurer to adapt the premium, but these are left blank in the standard policy form.

Article 3 of Regulation 3932/92 provides that the exemption shall apply on the condition that the calculations, tables or study results are purely illustrative and that they do not include in any way loadings for contingencies, income deriving from reserves, administrative or commercial costs. In other words: the tables and co-

22. For a comment on this regulation see G. Levi and H. Cousy (eds.), *La politique Européenne de concurrence en matière d'assurance*, (Bruylant, 1994).

23. Verbond van Verzekeraars.

24. De aansprakelijkheidsverzekering bedrijven (AVB) policy model 1996, published in 4 *Aansprakelijkheid en Verzekering* 6 (1996), 151-160.

operation are only possible concerning the calculation of the average cost of risk cover (the so-called pure premiums). Obviously one could argue that it is only a small step from co-operation concerning pure premiums toward pure price fixing. In order to avoid that risk, a strict control by competition authorities remains important.

## B. STANDARD FORM POLICIES

As we just indicated, the co-operation between insurance companies often takes the form of a standard form policy model. Many countries use standard form models launched usually by national insurers associations, e.g. for motor vehicle liability insurance. The crucial question is again whether it is acceptable (or in economic terms efficient) that an insurers' association undertakes research e.g. on the optimal method of coverage and passes on this information to its members in the form of a standard policy form.

Again, the answer of the group exemption is relatively simple. Article 6 of Regulation provides that the exemption shall apply on condition that the standard policy conditions are established and distributed with an explicit statement that they are purely illustrative and expressly mention the possibility that different conditions may be agreed upon. Finally, these standard policy conditions should also be accessible to any interested person and provided simply on request. The standard policy forms applied e.g. in the Netherlands certainly meet that test. For instance in the Netherlands a new liability insurance model for enterprises was introduced in 1996. It was certainly made accessible to any interested person (it was even published in a liability law journal) and the standard form policy itself clearly indicates that the provisions are purely illustrative and that every individual insurer is allowed to apply different conditions. Also the Dutch literature stresses that this model is purely illustrative and that therefore the insurer is free to apply different conditions.<sup>25</sup>

Again, one can hold that from a purely legal point of view this practice of standard form policies is allowed under the group exemption and therefore unproblematic. However, referring to the criticisms formulated above, one can again ask the question whether such a standardizing, under the argument of market transparency, should always be allowed. It cannot be denied that such a standard policy form definitely has the effect of restricting competition. Taking the example of the Netherlands, one can argue that the policy conditions e.g. provided in the liability insurance model for enterprises of 1996 are on paper purely illustrative and that every insurer is therefore free to agree upon different conditions; but in practice this never happens. As a consequence, it will be impossible e.g. today for an employer in the Netherlands to obtain coverage for

25. See for instance O.A. Haazen and J. Spier, 'Amerikaanse toestanden en de nieuwe aansprakelijkheidsverzekering voor bedrijven en beroepen', *Nederlands Juristenblad* 2 (1996), 45.

employers liability on a loss occurrence basis, even if he were prepared to pay the corresponding premium, simply because the new standard form policy now has changed the system of coverage to claims made.

As a matter of principle, the question remains why the European Commission uses competition law to guarantee transparency of policy conditions. The law of obligations and contract law rules, which guarantee the consumer clear standard form policy conditions, could far better serve the goal of market transparency. However, these critical comments of law and economics scholars will hardly pose any problem for Dutch (and other) insurers that use standard policy conditions. As long as they comply with Article 6 of Regulation no. 3932/92 they are allowed under EC competition law.

### C. POOLING

As we argued above, co-operation between insurers is often justified by the argument that a huge capacity is necessary to be able to cover either complex or very 'expensive' risks. Pooling of risks is therefore a well-known phenomenon in the European insurance world to cover high risk activities. For instance the environmental risk is covered in many countries on the basis of pooling. Pooling is also used very often for the coverage of the nuclear risk. Although pooling is definitely a useful instrument to increase the capacity of insurance markets, it was equally indicated above that the necessity to pool risks should not as such justify an exemption from the cartel prohibition.

Also the European Commission seems relatively careful as far as the allowing of pooling is concerned. It is therefore held in Article 11 that the advantages of the exemption no longer apply if in the case of coinsurance groups, the participating insurance undertakings represent more than 10% of all the insurance products that are identical or regarded as similar from the point of view of the risks covered. In case of co reinsurance, this is the case if the participating insurance undertakings represent more than 15% of all the insurance products.

However, it is held in Article 11, second paragraph, that these percentages do not apply where the group covers catastrophic risks where the claims are both rare and large and in case of aggravated risks which involve a higher probability of claims because of the characteristics of the risks insured. However, the latter derogation is subject to the condition that none of the concerned undertakings shall participate in another group that covers risks on the same market and still it is held that with respect to groups which cover aggravated risks, the insurance products brought into the group may not represent more than 15% of all products.

The question of course arises how this applies to the nuclear insurance market. Indeed, in most Member States the nuclear risk is covered by the so-called nuclear pools, which basically act as monopolies and which do not allow for any competition. Since Regulation 3932/92 does not seem to allow for any exception for the nuclear risk, the question arises how the nuclear insurance pools can deal with the requirement in Article

11 of the Regulation that the market share of the whole group may not be higher than 15%. It seems that if this condition has not been met (which will be the case for most of the nuclear insurance pools) the pools principally fall under the cartel prohibition.

This, by the way, also seems justified. Indeed, it was already argued above that although pooling of risks is as such to be considered as an efficient instrument allowing smaller insurance undertakings to participate also in the coverage of catastrophic risks, pooling is only justified under this assumption that it leads to increased competition. Indeed, without pooling one could argue that only larger companies could provide insurance coverage for catastrophic risks and that without pooling competition would therefore be too limited. If, on the other hand, pooling results in fact in a very high concentration on insurance markets, which seems to be the case with the insurance of the nuclear risk, the end result is obviously not efficient.

#### D. BINDING DECISIONS

In some countries, for instance in the Netherlands, it was also customary for insurers' associations to issue so-called binding decisions to the whole insurance market. This happened especially with regard to the consequences of natural disasters, such as the flood risks and earthquakes. Dutch insurers believed in the 1950s that they were confronted with huge difficulties in the coverage of those risks, so they decided not to cover these risks any longer. This uninsurability thus was the result of a so-called binding decision of the insurers' association guiding all the members and instructing them not to cover those risks.

From the point of view of insurability, the problem with these kind of agreements is of course that they are based on a judgment concerning the insurability of e.g. flood risks, whereas the uninsurability is *de facto* only the result of the cartel agreement of the insurers not to cover those particular risks. The result of those binding decisions was that no insurer in the Netherlands wished to cover the consequences of natural disasters. It is obvious that a cartel agreement of insurers collectively not to insure particular risks may be potentially socially damaging. The consequence is indeed that public interventions (e.g. collective compensation funds) will have to intervene, also for those forms of damage which are technically speaking insurable.

An agreement between insurance companies not to cover certain risks can never benefit from the exemption of the cartel prohibition on the basis of Regulation 3932/92. Consideration 8 preceding the regulation explicitly states:

Standard policy conditions may in particular not contain any systematic exclusion of specific types of risk without providing for the express possibility of including that cover by agreement and may not provide for the contractual relationship with the policy holder to be maintained for an excessive period or go beyond the initial object to the policy.

The same requirement can be found in Article 7 (1) (a) which provides that the exemption shall not be applied where the standard policy conditions exclude certain risks from the cover, without indicating explicitly that each insurer remains free to extend the cover to such events.

The simple conclusion seems therefore to be that the so-called binding decisions, whereby an insurer's association more or less prohibits its associated insurance undertakings to cover certain risks violate competition law and cannot be exempted under Regulation 3932/92.

## § 5. The Group Exemption and the Efficiency Goals of Liability Law

In section 2 of this paper we explained why competition on insurance markets is important for the proper functioning of an efficient accident law. In case of restrictive practices it is to be feared that less differentiated insurance policies will be offered on the market, with less product differentiation as a result. This restricted risk differentiation may in turn lead to an insufficient control of moral hazard and hence increase the accident risk. The exchange of information between insurers could also create a framework which may be abused and result in price fixing. This again could mean that premiums are not optimally aligned to the insured risks. A further consequence of restrictive practices may be that the government becomes dependent on larger insurance undertakings or pools, which may be inclined to provide improper information on the insurability of certain risks. Taking into account these potentially negative consequences as far as the efficiency goals of accident law are concerned, it seems important to stress once more that insurance markets should remain sufficiently competitive to optimally reduce accident risks.

### A. TOO LOW PRODUCT DIFFERENTIATION AND INCREASED ACCIDENT RISK

A well-known consequence of concentration on markets is an increase in prices. The same is of course true for insurance markets. Research by Finsinger has shown in countries with a high degree of government regulation and concentration on the insurance market premiums are on average 117% higher than in countries with less regulation and more competitive insurance markets.<sup>26</sup> Also the Price Waterhouse report on 'The costs of non Europe in financial services' demonstrated that, again dependent upon the type of insurance under discussion, premiums in competitive insurance markets are considerably lower than premiums in highly regulated markets.<sup>27</sup>

26. J. Finsinger and F.A. Schmidt, *Prices, Distribution channels and regulatory intervention in European insurance markets*, Working paper, University of Vienna, Business Economics Institute, (1992).

27. Price Waterhouse, 'The costs of non Europe', in *Financial Services*, Brussels, EC Commission, (1988).

A further problem resulting from restraints on competition is that insurers will have insufficient incentives to provide a large variety of individualized insurance policies.<sup>28</sup> This may again be illustrated with empirical evidence. It was shown that the variety of insurance policies is much larger on the competitive British market than on the concentrated German market.<sup>29</sup> If premiums are fixed, one would at first sight expect that insurers would focus more on non-price competition and would therefore offer a wider variety of policies. However, in order to exclude non-price competition, cartel agreements, premium regulation and standardized insurance policies are combined. In the end, only inefficient instruments of non-price competition, such as aggressive advertising remain.

In the economic analysis of accident law liability rules are seen as instruments to achieve a reduction of accident costs.<sup>30</sup> These rules should give incentives to potential injurers to behave carefully (i.e. to take efficient care) and not to engage in dangerous activities in an excessive way (i.e. to adopt an optimal activity level). If the losses are not borne by the injurer himself but shifted to an insurance company, the latter should take over the deterrent function of liability rules.

On a competitive insurance market the deterrent function of liability rules remains unaffected. The reason is that moral hazard will be controlled in an optimal way. Competitive pressures will indeed lead the insurers to provide an optimal adaptation of premiums or policy conditions to the behaviour of the individual insured.<sup>31</sup> Therefore, competition law should complement liability rules in preserving their deterrent function. Effective competition ensures that premiums and policy conditions relate to the individual behaviour of the insured and that moral hazard is reduced as far as possible.<sup>32</sup> Competitive insurance markets will thus enable a narrowing of risk pools, which is crucial to avoid the risks of moral hazard and adverse selection.<sup>33</sup> To overcome the dangers following from moral hazard and adverse selection and in particular to guarantee the insurability of the risks, product variety on the insurance market is indispensable. This implies a wide gamut of policies. We have indicated above that this will, on the one hand, enable risk-averse individuals to maximize their utility by

28. See M. Adams, *Ökonomische Analyse der Gefährdungs- und Verschuldenshaftung*, (R. v. Decker's Verlag, 1985), 215-216 and H.E. Frech and J. Samprone, 23 *Journal of Law and Economics* 2 (1980), 429-440.
29. J. Finsinger, E. Hammond and J. Tapp, *Insurance: competition or regulation?, A comparative study of the insurance markets in the United Kingdom and the federal republic of Germany*.
30. S. Shavell, *Economic analysis of accident law*, (Harvard University Press, 1987).
31. See Adams, *Ökonomische Analyse der Gefährdungs- und Verschuldenshaftung*, 232-233; K. Arrow, 'Uncertainty and the Welfare Economics of Medical Care', 53 *American Economic Review* 5 (1963), 941-973; M. Pauly, 'The Economics of moral Hazard', 58 *American Economic Review* 3 (1968), 531-537.
32. Adams, *Ökonomische Analyse der Gefährdungs- und Verschuldenshaftung*, 237.
33. See G. Priest, 'The current insurance crisis and modern tort law', 96 *Yale Law Journal* 7 (1987), 1521-1590.

purchasing insurance coverage corresponding with their demand for insurance, and on the other hand, will lead to an optimal control of moral hazard.

The arguments above clarify the importance of competition for preserving the deterrent function of liability rules. In concentrated markets insurance companies have too little incentive to offer individualized policies. Therefore, premiums will not reflect the behaviour of the insured and there will be no optimal control of moral hazard.

Empirical research has shown, particularly with respect to motor vehicle insurance, that a high degree of concentration on the market may indeed have negative effects. For instance in Germany the degree of differentiation of policies and the individualization of the risk is much lower than in the United Kingdom. According to Adams, the high degree of concentration in the German insurance markets, combined with German insurance regulation, provided too few incentives for the insurers to control the behaviour of their insured. Adams claims that this has led to a significant increase in the number of fatal car accidents in Germany.<sup>34</sup> This leads to a worrisome conclusion: with too little competition on the insurance market, standardization of policy conditions and too little risk differentiation there will not be a strong enough incentive for insurance companies to control moral hazard, which might lead to a higher accident rate. It may be questioned whether the European Commission fully realizes that competition is an absolutely necessary condition for the efficient functioning of insurance markets. If cartel agreements impair the efficient functioning of insurance markets, this can in the end lead to an increase of the accident risk.

#### B. EXCHANGE OF INFORMATION: CHALLENGES AND POTENTIAL DANGERS

The Block Exemption confirms the benefits of a collaboration between insurance undertakings concerning the exchange of information. Consideration 6 preceding the exemption regulation provides in that respect:

Collaboration between insurance undertakings or within associations of undertakings in the compilation of statistics on the number of claims, the number of individual risks insured, total amounts paid in respect of claims and the amount of capital insured makes it possible to improve the knowledge of risks and facilitates the rating of risks for individual companies (...). Joint studies on the probable impact of extraneous circumstances that may influence the frequency or scale of claims, or the yield of different types of investments, should also be included. It is, however, necessary to ensure that restrictions are only exempted to the extent to which they are necessary to attain these objectives.

34. Adams, *Ökonomische Analyse der Gefährdungs- und Verschuldenshaftung*, 246-254.

From the perspective of an insurer executing joint research with respect to the insurability of certain risks can obviously result in important advantages of scale. For instance, duplication of costs can be avoided if not every separate insurer asks health experts to examine what, within the framework of employer's liability, is the risk that insurers will be confronted with claims based on new occupational diseases. In this respect, important cost savings can be achieved thanks to co-ordinating work by an insurers' association. One could think of an arrangement whereby the insurers' association undertakes the joint research (thus benefiting from the scale advantages) and would pass on information to insurers on which occupational diseases may in the future lead to employer's liability in specific sectors. This information can then allow individual insurers to determine which employers may be the good or the bad risks and on the basis of this information risk groups can be constituted. Hence, the joint initiative can provide useful information for an optimal risk differentiation by insurers and at the same time it can serve a social interest. Above it was explained that only when an insurer is able to respond adequately to the real risks (via an optimal differentiation of risks) can insurance play its socially important function of prevention of accidents in an optimal manner.

As far as gathering information on factors which may influence risks a co-operation between insurers can therefore be important. The goal of this information is to obtain information which will allow individual insurers to define individual risk groups as narrowly as possible. Thus they can provide adequate remedies to moral hazard and adverse selection. Therefore one can understand that this type of joint research is allowed by the group exemption. Still, the various individual insurers can use the available information each in their own way to offer attractive policy conditions on the market. Hence, the available information can still be used as a tool of competition and can hence increase the competitiveness of the market.

Nevertheless, it always remains important to be cautious and to listen to the wise advice of Adam Smith. By allowing an information exchange on a large scale, the European Commission in fact provides an open invitation to insurers for the type of meetings that Adam Smith feared because they are potentially restrictive for competition. Therefore, competition authorities will always have to be cautious and check that insurers who on the one hand engage in exchange of information on accident frequency and pure premiums are not also seduced afterwards to make a 'gentleman's agreement' with respect to gross premiums. The latter agreements limit premium competition and hence endanger the efficiency goals of accident law. If one can avoid the latter risk then a co-operation and exchange of information may go hand in hand with competition concerning premiums and policy conditions.

### C. UNRELIABLE INFORMATION CONCERNING INSURABILITY

There is another major disadvantage of high concentration on insurance markets. The government may become dependent on the insurance market for the provision of information on insurability. From the moment that there is a high concentration on

insurance markets, it appears to be extremely difficult to obtain reliable information on insurability in general, but more particularly on the capacity, from the insurance market.

Private interest theories of regulation have predicted that well organized industrial sectors (e.g. in a cartel) have low transaction costs on the market for regulation and their potential success in the field of lobbying may be large. This justifies the question whether the extent of liability should be judged on the basis of information provided by monopolistic insurers concerning insurance possibilities. If the argument that liability should be 'insurable' is taken seriously, it is obviously of great importance for the policy maker to require reliable information on the actual insurability of certain risks. Precisely for that goal a well-functioning competitive market is of importance, so that the policy maker can inquire with several companies what the precise possibilities of insurance coverage are.

Experience with nuclear liability insurance has revealed that the information provided may be unreliable if the policy maker becomes completely dependent upon information provided by a monopolistic insurer. Take the example of nuclear insurance which, as mentioned before, is dominated in every country by the so-called nuclear pools. In the Netherlands the Dutch government relied almost blindly on information provided by the Dutch nuclear pool on the availability of coverage for liability insurance when fixing the liability limit in the Dutch Act on Nuclear Liability of 26 June 1991.<sup>35</sup> Minister Kok declared during the parliamentary debate that 'during the whole preparation of the draft negotiations have taken place with the nuclear pool. In all cases the nuclear pool could agree with the proposals. There has hence been an optimal involvement of the sector'.<sup>36</sup> Critical voices have asked the question whether the liability limit for the licensee of a nuclear power plant had to be set at the amount of 500 million Dutch guilders and should not be tested periodically according to the increasing possibilities of coverage on the private insurance market,<sup>37</sup> but the availability of insurance remained fully based on information provided by the nuclear pool.<sup>38</sup>

The fact that the policy maker often relies on information provided by monopolistic insurers to judge the capacity of the insurance market is obviously not merely a Dutch phenomenon. Precisely the same took place when the Belgian Act of 22 July 1985<sup>39</sup> concerning the liability of the licensee of a nuclear plant was discussed in parliament.

35. *Staatsblad* 1991, no. 369 and no. 373.

36. Parliamentary Documents, Second Chamber of Parliament, 23 April 1991, 72-4061.

37. See in this respect among others the critical questions by Van Rijn-Vellekoop, Second Chamber of Parliament, 23 April 1991, 72-4046 and of the De Korte, Second Chamber of Parliament, 23 April 1991, 72-4052.

38. For further details see M. Faure, 'De verzekering van het nucleaire risico', in H.A. Bouwman and A.J.O. van Wassenaar van Catwijck, *In volle verzekerdheid, Essays offered to Prof. Mr. A.J.O. Van Wassenaar van Catwijck*, (Tjeenk Willink, 1993), 241-254.

39. *Belgisch Staatsblad* 31 August 1985.

Also in Belgium the government contacted the Belgian nuclear pool, Syban, with the question whether an amount of more than 4 billion Belgian Francs would be available for third party liability coverage. Syban, the nuclear pool in Belgium, fiercely denied this. Later it turned out that the nuclear power plant itself is insured in first party insurance (property insurance) for an amount of more than 40 billion Belgian Francs. It is obviously relatively unclear why the nuclear pool only had an amount available for third party liability insurance of 4 billion Belgian francs, whereas the damage to the nuclear installation itself could apparently be insured for 40 billion Belgian Francs.<sup>40</sup> This Belgian act has, by the way, recently been changed, since the parliament accepted a legislative proposal (launched by two 'green' ministers) to increase the amount of the licensee of a nuclear power plant to 12 billion Belgian Francs.<sup>41</sup> But that obviously does not change the points made here: again the amount was based on the insurability according to insurers.

These nuclear examples show that one should be careful with judging the 'insurability' of a particular risk, more particularly concerning the capacity aspect, on the basis of information provided by insurers, at least when there is a high degree of concentration on this insurance market. It is striking that with respect to the nuclear insurance all national pools do not compete (in order to increase the capacity) but again co-operate. The national nuclear pools indeed only insure the nuclear installations on their own territory, so that there is no competition between these pools. This example shows, once more, that in the nuclear case the pooling takes the restrictions of competition further than would be necessary to increase the insurability of the nuclear liability risk.

The discussion above has shown that one has to be very careful with the argument that capacity may be limited. The policy recommendation is to allow co-operation between insurers on the condition that it increases competition, which is precisely the spirit of the report of the European Commission of 12 May 1999 on the operation of Regulation 3932/92.

## § 6. Report of the Commission to the Parliament and to the Council of 12 May 1999

In 1999 the European Commission drafted a report directed to the European parliament and to the Council on the operation of Commission Regulation no. 3932/92 concerning

40. For a critical analysis see also M. Faure and R. Van den Bergh, 10 *International Review of Law and Economics* 1 (1990), 241-254.

41. See Parliamentary Documents, Belgian House of Representatives, Doc 1999/2000, 50 0560/001, of 3 April 2000. The act has meanwhile been passed and has become the Act of 11 July 2000, *Moniteur Belge*, 4 October 2000. For a comment see T. Vanden Borre, 'Recente ontwikkelingen in het nucleaire aansprakelijkheidsrecht: innovatie of renovatie?', *Milieu- en Energierecht* (2000), 25-49 and T. Vanden Borre, *Efficiënte preventie en compensatie van catastroferisico's. Het voorbeeld van schade door kernongevallen*, (Intersentia, 2001), 323-326.

the application of Article 81, (3) of the EC Treaty to certain categories of agreements, decisions and concerted practices in the field of insurance. The purpose of this report was to make clear in which way the Regulation has been applied and to discuss proposals for amendment. The report is particularly interesting since it makes clear in which way the Regulation has been applied in legal practice so far and what criteria the European Commission used to judge whether certain practices could benefit from the exemption or not. Of course it is not possible within the scope of this contribution to discuss this report in detail; there are however various aspects that certainly merit discussion.<sup>42</sup>

#### A. CO-OPERATION AS FAR AS PREMIUMS ARE CONCERNED

In the first place the Commission discussed the well-known exemption concerning co-operation with respect to pure premiums and claims statistics. The Commission stressed again that it was important that the co-operation should be limited to what was really necessary to be able to fix pure premiums. The question of to what extent an insurer needs really to co-operate with its competitors as regards calculation of premiums would, according to the Commission, also depend on its size. In this respect, the Commission did not rule out that a large insurer might on its own have a sufficient size to cover sufficient similar risks to obtain reliable statistical data.<sup>43</sup> As far as practical experience is concerned, the Commission among others discussed a case involving the Belgian professional association of insurance companies (UPEA). This professional association had established a minimum pure premium for the coverage of hospital expenses in the case of group contracts. The Commission established that there was nothing to indicate that this recommendation was based on statistical data and hence the Commission concluded that this recommendation was not in conformity with the exemption.<sup>44</sup> In general, one can notice that the Commission was extremely careful as far as the necessity of co-operation in the field of premium calculation is concerned. At various instances, the Commission repeated, also when discussing future prospects, that this co-operation should be limited to the necessary data collection which is needed from a statistical point of view to calculate the premium. Hence, the Commission clearly held that if insurers depart from the joint calculations of the average pure premium, the Commission would judge if the agreement in question restricted competition in an appreciable way.<sup>45</sup> Within these relatively small margins co-operation between insurance undertakings remains possible. This co-operation does not seem to pose any problem as far as it merely concerns an exchange of information and no co-operation as far as premiums is concerned.

42. See COM(1999) 142 final of 12 May 1999.

43. See Report, no. 6, 4.

44. Report, no. 9, 5.

45. Report, no. 12, 7.

## B. AGAIN: THE BINDING DECISIONS

Probably more interesting are the considerations in the Commission's report concerning standard form policies. The European Commission dealt extensively with the so-called binding decisions, which were applied by the Dutch insurers' association. The Dutch insurers had argued that they should be allowed to exclude flood risks by common agreement since flood risks were said to be uninsurable in the Netherlands. Therefore the national organization of insurers had decided to prevent insurers from offering cover for the particular risks. The Commission's services rightly queried why there was any need for such a decision if insurers considered the risk to be uninsurable anyway. In that respect, one could indeed argue also that an individual insurer could come to the insight that the risk was uninsurable.

The Commission reported that in the end the Dutch insurer's association brought its binding decision into line with Article 7.1 sub a by simply converting it into a non-binding recommendation, leaving each insurer free to extend cover to flood risks.<sup>46</sup> Therefore, the problem of the Dutch binding decisions seems to be solved, at least as far as the flood risks are concerned.

## C. WHAT ABOUT POOLING?

The Commission also dealt extensively with the issue of pooling. The issue of pooling has also been discussed by the European Commission in its already mentioned report to the European Parliament and to the Council of 12 May 1999 concerning the operation of Regulation 3932/92. The Commission clearly discussed the common coverage of certain risks, which we have referred to here as 'pooling'. The Commission stated that the starting point remained that any institutionalized grouping is in itself restrictive of competition. However, a pool can benefit from the block exemption if the market share of its members does not exceed the thresholds as specified in the exemption regulation.<sup>47</sup> The Commission however remained flexible and recognized that in some areas of insurance an insurer must, in order to be present on a market without incurring excessive risk, insure a sufficient number of risks so that the risk profile of its portfolio corresponds to the average for the totality of risks in the category. The Commission continued:

There therefore needs to be a strong probability that the real level of claims incurred by the insurer will be the same as the average level of claims of all insurers. This strong probability can only be obtained above a certain number of risks covered by the insurer. Certain catastrophic

46. See report, no. 18, 9.

47. Report, no. 26.

risks may be such that no individual insurer is capable of insuring it alone. In such a case, the pooling of capacity does not restrict competition. If anything, the pool strengthened competition since it allows several insurers who are unable alone to provide cover for the risk at hand to put their resources in common and create a new competitor for the benefit of customers in need of such cover.

The Commission further found:

In any event, the Commission will consider that pools no matter how high their market share is, are not covered by article 81-1 (ex-article 85-1) when they are necessary to allow their members to provide a type of insurance they could not provide alone.<sup>48</sup>

This probably may save nuclear and other pools who could argue that (no matter how high their market share is) they are necessary since without a pool this type of insurance for these risks could otherwise not be provided.

The European Commission also discussed the perspectives for the future and announced that its services have just launched their investigation into 'co-insurance or co-reinsurance pools dealing with environmental risks and nuclear risks. Several of those pools have been notified (The French environmental pool Assurpol was actually granted an exemption in 1991. This exemption expired last year). All these pools will be assessed in the light of the tier legality test spelled out above'.<sup>49</sup>

In other words, there is to be expected more news from the competition authorities of the European Commission with respect to the legality of the co-operation within environmental and nuclear pools.

As far as pooling is concerned it is, moreover, interesting to notice that the European Commission once more has shown itself extremely flexible towards the so-called Protection and Indemnity clubs (P&I Clubs). These clubs engage in the coverage of (among others) damage caused by marine oil pollution.<sup>50</sup> On 16 December 1985 the Commission had already decided that these P&I clubs should be granted an exemption on the basis of the old Article 85, (3) of the EC Treaty. It was argued in the literature that it is doubtful that the conditions for such an exemption for the P&I clubs were

48. Report, no. 28 (B).

49. See report, no. 32.

50. See M. Faure and G. Heine, 'The insurance of fines: the case of oil pollution', 16 *The Geneva Papers on Risk and Insurance* 58 (1991), 39-54.

fulfilled.<sup>51</sup> These arguments apparently have not convinced the European Commission. Indeed, in the report the Commission again showed a great amount of latitude towards the P&I clubs. It is argued that the co-operation between the P&I clubs is necessary to allow its members to offer the level of cover they now offer. This is remarkable in the light of the fact that the Commission at the same time established that the Protection and Indemnity clubs cover about 89% of the world market for maritime contractual and third party liability insurance.<sup>52</sup>

#### D. INFORMATION EXCHANGE IS ALLOWED

Finally, it is important to repeat that agreements that remain limited to the exchange of information concerning risks are still exempted from the cartel prohibition. This was already clear from the Consideration 6 preceding the Regulation, which was quoted above. In the report to the European Parliament and to the Council on the operation of Regulation 3932/92, the Commission also examined whether systems of keeping registers or exchanging information on aggravated risks were allowed from a competition policy perspective. The Commission held<sup>53</sup> that these agreements on keeping registers or exchanging information had the aim of making it possible for insurers to know better the nature of the risks to be insured. These agreements do not fall formally within Article 81 (1) (ex-Article 85 (1)) of the EC Treaty if they restrict themselves to giving information on aggravated risks. In any case, the Commission held that a simple exchange of information on the nature of a risk does not appear to have the aim of restricting competition between insurers. However, the European Commission was careful and argued that it was different if the exchange of information was accompanied by an agreement aiming to adopt a common attitude with regard to the risk in question. For example, recommendations to refuse to cover the aggravated risks in question or to raise the risk premiums for these risks fall clearly within the scope of Article 81 (1) (ex-Article 85 (1)) and do not appear exempt under the terms of Article 81 (3) (ex-Article 85 (3)), so the report reads.

This report thus clearly states that also from a European competition policy perspective an exchange of information on risk between insurers is allowed – at least in Europe – in order to increase the availability of reliable statistics and data. At the same time the limits of such a co-operation are made clear as well: exchanging information is allowed,

51. See M. Faure and R. Van den Bergh, *Objectieve aansprakelijkheid, verplichte verzekering en veiligheidsregulering*, (Maklu, 1989), 331-336.

52. See report no. 29, 13-14.

53. See report, no. 47.

formulating recommendations to refuse coverage or to raise risk premiums obviously not.<sup>54</sup>

## § 7. Concluding Remarks

After the publication of Regulation no. 3932/92 critical comments have been formulated in the literature on exempting insurance undertakings from the cartel prohibition. These warnings still remain valid. In this contribution, we argued that competition on insurance markets remains essential as a condition for an efficient functioning of accident law. If that basic notion is lost from sight this may not only lead to a premium increase, but also to adverse effects in terms of accident prevention. In this respect one can recall the risk of one-sided information on insurability, too little risk differentiation and, as a result of this all, an increase of the accident risk. It is certainly not to be argued that in all European insurance markets this would, empirically, be a real danger. However, it remains important to point to the importance of competition on insurance markets. This can avoid one simply neglecting the possible negative effects of restrictions on competition markets for accident law in general.

Many forms of co-operation between insurance companies on the European market now take the form of either an exchange of information or recommendations from national associations of insurance undertakings. Some of these recommendations, e.g. to move from loss occurrence to claims made coverage, follow the advice insurance economists would otherwise give insurers as well and can therefore hardly be criticized as such. However, it remains important that these recommendations should in practice remain non binding. That would mean that if an insured individual would wish to obtain coverage e.g. for employer's liability on the basis of loss occurrence coverage, this should still be possible. If, however, the co-operation becomes such that certain types of coverage are effectively no longer offered on the market, then a recommendation leads to a too limited product differentiation and therefore to inefficiencies.

However, a co-operation between insurance companies can have important beneficial effects as well. An important asset of this co-operation is that it allows the provision of information e.g. on the elements that influence the risk. When information gathering by an insurers' association takes place, this can lead to scale economies and thus to welfare gains. These could in turn lead to even a widening of the supply of insurance products. However, the well known warning of Adam Smith that when entrepreneurs meet they will seldom be able to resist the challenge to make agreements that are not in the public interest remains valid even in the 21st century. The European Commission also is fully

54. See on the applicability of the cartel exemption to insurance more generally, M. Faure and R. Van den Bergh, 48 *Kyklos* 1 (1995), 65-85 and M. Faure and R. Van den Bergh, in T. Hartlief and M.M. Mendel (eds.), *Juridische beschouwingen over de maatschappelijke rol van verzekeringen en verzekeringsmaatschappijen*, 315-342.

aware of this. Information exchange is clearly allowed; taking the same attitude towards the coverage of risks clearly not. Thus it should be possible to enjoy the benefits of co-operation (such as the economies of scale in gathering information) without having the dangers and disadvantages. Still the competition authorities will always have to make sure that this dangerous balance remains maintained.

As far as catastrophic risks are concerned, further news can be expected from the European Commission. One can hope that the European Commission does not too rapidly accept the argument that a total exclusion of competition is necessary to be able to offer coverage of catastrophic risk. Even when pooling is considered necessary, such as in the case of the nuclear risk, this should of course not lead to an exclusive insurance by national insurance pools (such as is the case today), but to a European or national market with competing nuclear insurance pools. Only if there is effective competition between the national pools (which is not at all the case today) can one expect that the offer on the nuclear insurance market will be increased.

The discussion on competition on insurance markets also shows that competition should not necessarily be considered as a negative aspect for the insurance sector, but rather more as a challenge. The insurer who, for instance with the help of specialization, can obtain better information on the good and the bad risks and on the effective preventive measures would be able to offer attractive policy conditions to the good risks. Information can thus become an attractive instrument of competition. If insurers see these challenges and possibilities for a competitive European insurance market, they will be able to increase and strengthen their market position by attracting good risks. In the end, this should result in insurance markets which will allow tort law and accident law in general to be able to fulfil its function of the minimization of accident costs.