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COMPETITION ISSUES ARISING IN THE INSURANCE INDUSTRY

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This paper looks at competition issues affecting the insurance industry. We focus on the insurance industry and examine issues that arise from the application of competition law. We highlight features of the insurance industry which may facilitate anti-competitive behaviour and which may confront competition authorities as they seek to enforce competition law in this sector of the economy.

Issues In The Application Of Competition Law In The Insurance Sector

This paper seeks to address two questions:

- Are there particular features of the insurance industry which favour collusion or other anticompetitive practices? Is standard competition law adequate for controlling these practices? and

- Are there particular practices (such as horizontal or vertical agreements) in the insurance industry which might fall within the jurisdiction of competition law, but which may yield efficiency benefits? Can these practices be designed in such a way as to minimise any anti-competitive effects?

In particular, we address the following practices:

- Agreements on the sharing of information on losses;

- Agreements for cooperation in the insuring of large risks; and

- Agreements on standardised policy terms and conditions.

Sharing Of Loss Information

It is common for insurers to cooperate by sharing “loss statistics” - information on the number and size of claims and the characteristics of the claimants. This is justified as follows:

> “The loss statistics which individual companies possess would fall a long way short of what is needed for proper rating of risks. Co-operation between insurance companies would therefore be 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 in the provision of services... Especially if claims are relatively infrequent and risk categories are relatively numerous, 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 cooperate in the pooling of claims experience.”[1]

Armentano (1989) describes this process as follows:

> “A pool of historical data that encompasses a large number of relatively homogeneous units of risk exposure can provide a high degree of predictive accuracy with respect to future cost. And since individual firms are unlikely to have a large enough loss-experience base for accurate anticipation of future costs, the pooling of loss experience is essential for efficient cost estimation and rate-making. The more extensive the pooling, the greater the accuracy (presumably) in predicting costs,

[1] Faure and Van den Bergh (1995), p. 68.

and the more efficient the industry will be (presumably) in tending toward an equilibrium price and output".[2]

The sharing of loss information between insurers may therefore be pro-competitive. In the absence of such cooperation, small insurers would be placed at a disadvantage relative to large insurers. Small insurers would not be able to offer as many separate risk categories and would need to incorporate a larger "risk premium" into their prices.

Such cooperation may also facilitate collusion, particularly if:

(a) The information is not available on fair, reasonable and non-discriminatory terms to all existing and potential insurers;

(b) The shared information includes information on actual prices charged (or mark-ups over costs, commissions payable to intermediaries or other mechanisms for calculating prices) or forecast what prices or commissions will be in the future;

(c) The shared information facilitates the division of the market between insurers on geographic or other lines; or

(d) The institutional arrangements supporting the sharing of information act as a vehicle for the formation of wider agreements.

In regard to the availability of the information, it is clear that the shared information should be available to all existing and potential insurers (and, indeed, non-insurers) on non-discriminatory terms. Where certain competitors (such as foreign insurers or new entrants) can be excluded from the information sharing arrangements, competition will be constrained. In addition, for many large companies self-insurance is a good substitute for insurance services available in the market. For these companies, the availability of loss information would greatly facilitate both the accurate pricing of self-insurance and the evaluation of the self-insurance option in comparison with alternatives. Therefore the shared information should be made available to non-insurers on the same terms and conditions.

Similarly, where the shared information contains information on prices charged to customers, insurers will be able to more easily sustain a cartel agreement because they will be able to more easily detect and punish deviation from an agreed schedule of prices. Even where the information shared simply corresponds to so-called "pure premiums"[3], collusion may be facilitated if, as a result, insurers need only come to agreement on a single figure (the common percentage "mark-up" over pure premiums) and not on an entire schedule of prices.

The sharing of information may also facilitate market-sharing agreements, such as agreements to divide markets geographically or by product line. If the shared information permitted the identification of the insurer supplying the information, other insurers would be able to more easily detect violations of such agreements and could more easily enforce collusion. In addition, we may note that information on the identity of the company that submitted the information is not essential for the intended purpose of the shared information (the forecasting of future losses).

In addition, it should be noted that in the case of some risks, forecasts of expected future losses are *not* based on historic loss information. In these cases the sharing of information is unnecessary. Examples

[2] Armentano (1994), p. 736.

[3] *I.e.*, the pure expected claim losses, and not including administrative, commercial and other costs and a profit margin.

might include the insuring of risks based upon, say, stock market movements or the insuring of risks based upon weather patterns (in both cases a substantial amount of risk information is already available).

These considerations suggest the following check-list of questions that might be considered when analysing an application for approval of a horizontal information sharing arrangement in the insurance industry:

(a) Does the agreement only cover the sharing of loss information for risks for which historical loss data is essential for forecasting future losses?

(b) Will participation by insurers in the information sharing agreement be voluntary or mandatory?

(c) Does the agreement provide that the information will be made available to all who request it at fair, reasonable and non-discriminatory terms?

(d) Will the shared information include information on premiums charged by insurers or on commissions payable to intermediaries, or would it permit the calculation of those prices?

(e) Will the shared information permit the identification of individual insurers who submitted the information?[4]

Co-operation In The Insurance Of Large Risks

As we saw in the previous section, for a broad class of risks, insurers typically seek to reduce their exposure to risk through reliance on the principle of the "law of large numbers" which states that for a sufficiently large number of independent risks, the expected loss will, with a high probability, be very close to the average. However, in the case of insurance of very large risks it may not be possible for any one insurer to underwrite enough independent risks to rely on the law of large numbers to reduce the overall risk. The risk to any one insurer can be reduced, however, by sharing the risk over a large number of independent insurers. By undertaking joint underwriting of these large risks, a co-operative arrangement between insurers may be able to sufficiently diversify risks to provide insurance that could not be written by one firm at all. Co-operation, therefore, may permit services to be provided that could not otherwise be provided.[5]

However, of course, co-operation may not always be essential to provide new services. Indeed, in the absence of co-operation there may be other firms (such as other large insurers or re-insurers) who may be in a position to adequately diversify the risk. In addition, such an agreement might restrict competition, by including more firms than is strictly necessary to adequately diversify the risk. Alternatively, the agreement might limit further new entry by extending to include all likely future competitors.

[4] We may note that the EC (in Commission Regulation 3932/92) has exempted certain information sharing agreements among insurers on the condition (amongst other things) that the information shared not identify the insurance undertakings concerned, that the distributed information contain a statement that it is purely illustrative and that the use of the information be voluntary in the sense that insurers or groups of insurers can choose to use alternative sources of information.

[5] The Preamble of EC Regulation 3932/92 exempting such forms of co-operation from EC competition law states that "the establishment of co-insurance or co-reinsurance groups designed to cover an unspecified number of risks must be viewed favourably in so far as it allows a greater number of undertakings to enter the market and, as a result, increases the capacity for covering, in particular, risks that are difficult to cover because of their scale, rarity or novelty".

These considerations suggest the following checklist of questions that might be considered when analysing an application for approval of a co-operative arrangement in the insurance industry:

(a) Is the co-operation for the purpose of providing services that could not be provided in the absence of co-operation?

(b) Does the agreement include more firms than is necessary? (*i.e.*, could the services be provided with fewer parties to the agreement?)

(c) Does the agreement extend to provisions that are not strictly necessary for competing in this market (such as agreement on co-operation in other markets)?

Agreements Related To Policy Terms And Conditions

In many OECD countries, the terms and conditions of insurance policies are explicitly regulated by the state. In other cases (such as in the EU), insurance companies are granted an exemption from competition law in order to facilitate agreement on common terms and conditions of insurance contracts.

It is sometimes argued that the market for the supply of insurance services lacks transparency so that consumers are unable to compare insurance policies offered by competing insurers. Where consumers are unable to easily compare insurance policies, competition is hindered. Consumers are unable to determine which of two policies is a better deal, or whether a new product introduced to the market offers better value than existing products.

Furthermore, consumers may be reluctant to purchase where they cannot be sure that the insurance contract covers their needs and does not contain hidden surprises. "Policies containing sharply formulated exclusions, of which the exact implications can only be assessed by a specialised lawyer, might be difficult to read for an average consumer."[6]

These observations typically do not apply in the area of industrial and commercial insurance. In this arena insurers are confronted with sophisticated, well-informed buyers who negotiate in detail over each of the terms and conditions of each contract. This lack of transparency, to the extent that it exists, primarily arises therefore in the case of "mass" or consumer insurance products.

Agreements to standardise contract terms and conditions (or regulations to achieve the same effect) may have several drawbacks. First, such agreements may facilitate collusion. Standardising contracts not only facilitates price comparison by consumers, but also by competitors who may, as a result, be in a better position to detect violations of a cartel agreement. In addition, a successful cartel agreement which fixes prices will typically simply re-direct competition into non-price areas, such as the terms and conditions of contracts. The attempt to standardise contracts can therefore be seen as a necessary support or corollary to successful collusion on price.

More importantly, such agreements may restrict product variety. Up to an point, consumers are made better off with more variety as they can choose a product more closely suited to their needs.[7] Therefore "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."[8] In an extreme

6 Faure and Van den Bergh (1995), p. 73.

7 "Up to a point" because, arguably, oligopolistic markets may yield "too much" product differentiation, partly as a barrier to entry.

8 Faure and Van den Bergh (1995), p. 73.

case, standardisation of insurance contracts may prevent insurers from profitably insuring certain unusual risk classes, causing insurers to withdraw from these markets entirely.

In addition, standardisation of insurance contracts will restrict innovation. By limiting deviation from established standards consumers may be forced to forego the benefits of innovative new products employing a completely different approach.

Some of these drawbacks can be offset if the standardised contracts are non-binding on insurers (perhaps with a requirement on insurers who choose not to offer standard contracts to disclose this fact to consumers). Alternatively, standardisation might apply only to some part of the overall insurance contracts. Either approach would both make collusion more difficult and would permit continued development of new and innovative products.

There are alternative means of promoting the efficiency of insurance markets without standardising insurance products. In many countries consumers are protected against adverse contractual terms and conditions through consumer protection laws. In addition, where consumers have trouble comparing insurance contracts they may be prepared to pay to have this task done for them by, for example, an independent insurance broker. Lastly, regulations may enhance comparability of products by mandating standards for presentation of key pieces of information (rather than the contractual terms themselves).

These considerations suggest the following checklist of questions might be considered when analysing an application for approval of a co-operative insurance industry arrangement to standardise contractual terms and conditions in the insurance industry:

(a) Does the agreement relate only to consumer products?

(b) Is the agreement binding on all insurers?

(c) Does the agreement relate to entire contracts or only to part of overall contracts?

(d) Will the agreement prescribe certain contractual terms or simply proscribe the use of undesirable terms?

(e) Would the agreement make it difficult to introduce new and/or innovative products in the future?

Other Issues

Agreements Related To The Settlement of Claims

It is generally recognised that the use of the legal system to settle claims can be extraordinarily costly, especially for small disputes. Therefore, insurers may be able to reduce their overall costs (to the benefit of consumers) by mutually agreeing to avoid use of the legal system, through the use of alternative dispute resolution mechanisms, or through devices which do not allocate fault at all. For example, car insurers may agree to each pay 50 per cent of the total damages incurred, without inquiring whose client was guilty.

Although devices which do not take account of fault discriminate against careful drivers, such agreements do not seem to raise competition concerns and, provided they are not binding on all insurers, do not seem to raise public policy concerns at all.

Co-operation On Risk-Reducing Activities

Insurers may seek to reduce their exposure by undertaking various soughts of activities to reduce loss. For example, fire insurers may inspect premises for the presence of fire-extinguishers or flame-retardants. In most cases the benefits of these activities can be fully captured by the insurer, but in some cases they cannot. For example, any one insurer could not expect to capture the benefits of a national publicity campaign encouraging drivers to slow down. As a result, not enough of such activities will be undertaken. As before, co-operation between insurers may therefore permit a reduction in risk and should, in certain circumstances, be encouraged.

Maintaining Registers Of Information On Risks

In general, the more information that an insurer has about a potential risk, the more accurately it can price the insurance. However, in certain cases, individuals who are bad risks can conceal this fact. This raises insurance costs and therefore prices for individuals (such as new drivers) who cannot demonstrate a clean record. In such cases, it is possible that overall welfare is improved if insurers could distinguish bad risks from drivers without any driving history. This could be achieved if insurers jointly maintained registers of information on drivers with a certain number of accidents.

Moreover, in the absence of mechanisms for credibly demonstrating a claims record, individual drivers may be reluctant to change insurers as this might mean foregoing any benefits of bonuses from a lower-than-average number of claims. Although insurers can and do regularly provide certificates of claims histories, competition between insurers might be enhanced if such information were available easily to all insurers at the time of application of a prospective customer. Again, this could be achieved if insurers jointly maintained registers of information on the claims records of all drivers.

Provided the same conditions that were discussed above apply (*i.e.*, provided participation is voluntary; provided the information will be available to all interested parties; provided the information does not allow the identification of individual insurers, etc.), these forms of agreements do not seem to raise competition concerns.

Re-Insurance And Vertical Arrangements

Another common practice in the insurance industry, is for insurers to shift a proportion of their risk to a reinsurer. Indeed, reinsurance is an alternative to cooperation (discussed in the previous section) as a mechanism by which insurers may be able to offer competitive cover for risks that are too large for an ordinary insurer to offer.

However, as in other industries, the vertical relationships that arise through reinsurance may act to facilitate collusion. In particular, a situation might arise where the upstream reinsurance market is relatively concentrated. In this circumstance the downstream insurers may be able to utilise the reinsurer as a tool for enforcing collusive arrangements. For example, the insurers (via the reinsurer) argue that “uniformity of premiums and policy conditions is required to make the calculation of the tariffs for reinsurance possible”.[9] The reinsurer, by enforcing tariff uniformity (at the cartel price) becomes the mechanism by which collusion is enforced.

[9] Faure and Van den Bergh (1995), p 72.

Compulsory Membership of a Guarantee Fund

Many states of the US and countries in the EU require membership in some form of joint insurance fund. These funds may have a number of different roles, such as seeking to compensate policyholders in the event of bankruptcy of their insurer or seeking to compensate victims of uninsured or unidentified drivers.

These arrangements may, in some circumstances, restrict competition. If the requirements for membership in the fund are strict, new entry may be deterred. The EU notes:

> "In some cases, insurance undertakings which want to offer motor insurance products in another member state without an establishment there are discouraged from doing so because of specific requirements concerning joining the Motor Insurance Bureau and the Guarantee Fund ... The Commission has contacted the member states concerned to assess the compatibility of their national law with Community Law".[10]

Armentano notes that participation in the Guarantee Fund may be a mechanism for obtaining information on (and, in some cases, control over) rivals:

> "Guaranty funds, mandated in many states, allow some insurers to monitor the economic performance of other insurers in order to determine whether their financial condition is 'hazardous' and merits state remedial action. Such coordinated activities, where competitors can make recommendations concerning the economic solvency of rivals, and where they can make recommendations for governmental intervention, may well contain some inherent antitrust difficulties".[11]

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[10] EC (1997).

[11] Armentano (1989), p. 740-741.