

Key Note Speech by Ross Dawkins of Europe Economics — delivered at the CEA's 2nd Motor Insurance Conference, Representation of the Free State of Bavaria to the EU, Brussels, 4th March 2010

Supporting material for this speech is contained within the “Retail Insurance Market Study” undertaken by Europe Economics for DG Internal Market and Services of the European Commission. A link to a webpage where this study can be downloaded is immediately below

http://ec.europa.eu/internal_market/insurance/motor_en.htm

Good morning. Thank you for inviting me to address the 2nd Motor Insurance Conference.

To understand what is happening in European motor insurance, the natural starting place is still with the national markets. Well known differences in contract law, social systems, market practice and so on mean that the national markets retain many idiosyncratic features.

This is not to say, however, that the only reference points are national ones. There are a number of factors that have been playing an increasing co-ordinating role.

First, M&A activity has internationalised the operators. In the last decade this has been particularly notable in Central and Eastern Europe. On the other hand, M&A has also, of course, driven domestic consolidation but the number of individual operators in Europe as a whole remains fairly high despite the secular decline highlighted in past CEA reports and which is likely to continue.

Second, the internet is driving significant change in distribution patterns: but the pace and nature of this is closely linked to the inherited position. So, a market previously geared towards independent brokers is having — and is going to have for at least a while yet — a divergent experience to that of one geared historically towards tied agency.

Third, EU-driven legislation has played both an enabling role and also a coordinating role. Mandatory 3PL insurance, liberalisation and the establishment and utilisation of the two Freedoms (of Establishment and of Provision of Services) has added another form of European dimension to nearly all of the “national” motor insurance markets within the EU.

I do not have long today, so I will focus mostly, but not exclusively, on this third theme of cross-border trade. This also links in with one of the later panel discussions.

Let me begin, by reminding us all of the major economic importance of the motor insurance industry. The motor insurance markets in the EU generated premiums of about €119 billion in 2008. This is a little below one per cent of overall GDP. The signals for 2009 are a little mixed so far: greater consumer focus on price and value everywhere, but at least in some markets a drive by insurers towards increased prices to make good past losses.

In the UK — and I think elsewhere — there has been criticism of the absence of usefulness in some areas of the financial services sector. I do not have time today to find general issue with that thought, but in the specific context of a competitive motor insurance industry, the social utility cannot be questioned.

Nearly all of the firms active in all markets are generalist, multi-lines insurers. Where there are motor specialists, these are often doubly specialised — focusing not just upon motor insurance but upon one segment of that market (say vintage cars or young drivers).

The recent — poor — profitability experience is highly suggestive of markets where competition has been fierce. In fact, the industry as a whole at an aggregated European level has struggled to achieve underwriting profits in the past decade. Looking ahead to the panel debate on product innovation, this poor profitability performance increases the incentive to innovate on the one hand,

whilst restricting the resources available for innovation on the other — in other words it will shape the nature of innovation that we see.

However this overall picture masks some variation in profitability in both between different national markets and within national markets, between different market segments. So some of the largest markets — such as UK's and Germany's — appear chronically unprofitable, whilst a few markets (and it is a few) have a healthy profit record (e.g. the Czech Republic). Typically (but not always) M3PL is the least profitable segment.

There has been some convergence in the past few years — in that the more profitable markets have become a little less so and some loss-making markets have recovered. There are of course local factors at work here, but the key common factors promoting such convergence have been international entry and the ongoing impact of liberalisation. As an aside, it is interesting to note that the profitability of the auto insurance market in the USA and that of the European market have also become notably similar since 2004.

Another way of looking at competitiveness is to consider degree of concentration: commonly used measures of concentration indicate that the “manufacturing” side of motor insurance is “highly concentrated” in a number of markets. In some countries there is an ongoing transition from a state monopoly that existed previously and which has often retained market leadership. For instance, in Poland, the market leader still has over 40 per cent of the market whilst in Slovenia it is higher still. Then some smaller markets, such as those of the Scandinavian countries, also tend towards high levels of market concentration. At the other extreme, Germany has the least concentrated retail insurance market in the EU. Indeed, the second largest firm has just over a five per cent market share. This is about half the equivalent share (or less) in nearly any other market.

However, there is no great degree of correlation between such concentration and the degree of profitability. Partly this is because one needs to consider the structure of distribution too (which, sadly, I do not have time to do today); but also, particularly within a given national market, the product itself is sufficiently undifferentiated that price competition can and has become very fierce.

There is a significant international dimension at work here: there are no markets within the EU without some form of presence by non-local firms. Just under one third of the acquisitions since 1999 have been cross-border. Acquirers from elsewhere in the EU27 outnumber those from anywhere else by three to one. This is Europeanization rather than globalisation.

This M&A activity has been relatively very high in some East European states — particularly Estonia, Lithuania and Romania. But M&A is not of course the only way to establish a foreign presence and some firms (or firms from some countries) have a relative preference for branching, with UK firms being a key example. This is driven by relative cost, perceived consumer preference and the relative natures of the supervisory regime in the two markets.

However, a permanent presence — of any form — is much preferred to operation on a FPS basis because it is more cost-effective overall to understand local risk factors and organise local claims handling from within the country of sale than across borders. There is a widespread perception that the absence of a local presence in the policyholder's country of residence significantly impacts upon customer demand by adversely affecting the quality of customer service and for the insurer, it may also make the scope for adverse selection greater and perhaps limit the ability to detect fraud.

If we separate cross-border activity into business written under Freedom of Establishment (or branching) and under Free Provision of Services, how large-scale is it? Our work indicates that motor insurance premiums written on the Freedom of Establishment basis currently represent

about 1.7 per cent of the total motor insurance market in the EU. A further 0.6 per cent of the total market is written under Free Provision of Services.

So, Free Provision of Services business remains relatively small scale, but it still performs a constructive role — for instance, servicing niche markets such as an expatriate community. For example, Luxemburgish companies are active predominantly in the neighbouring states of Belgium, Germany and France servicing the insurance needs of the estimated 6–8,000 Luxemburgish who have relocated to these countries.

More generally in terms of where this business is coming from, and where it is going to — well, UK, French and Belgian firms that have the most branches by number — over half the total. And in terms of volume of business it is the branches of UK, Belgian, French — and Irish — firms that dominate (accounting for 77 per cent of the total business written in this way). UK-headquartered firms alone account for about one third of the total. The top destinations are Belgium, Germany, Ireland, Italy and the UK.

In Free Provision of Services, fully 80 per cent of the motor insurance sold on this basis in the EU is written by UK and Irish firms (although Luxembourgish and Maltese firms are also important, relative to the scale of their respective local markets). The destinations now are well-spread across all of Europe.

There is significant reciprocity at play. This is particularly marked between the UK and Ireland. Just under one quarter of the motor premiums written on either basis are from Irish firms to the UK or British-based firms to the Republic of Ireland. Since there are 350 possible alternative two-way relationships between members of the EU, this is rather remarkable. Whilst common language and similar product traditions explain a good deal, the scale of business done — again, simply in terms of the twin Freedoms — is an order of magnitude above that involving German insurers in Austria or Austrian insurers in Germany.

We find that cross-border provision is mostly associated with the availability of supply-side resources, by the size of the destination market (and hence the opportunity), and by geographical distance (which, will still tend to reduce the marginal cost of service provision). Often it is the largest firms in the most developed markets that will look at neighbouring countries, with a preference for those locations where the market opportunity is largest.

The degree to which this promotes competitiveness is a more complex question, because understanding of the market dynamics of the manufacturers and distributors is required, as well as the cultural and legislative backdrop. The scale of cross-border trade that I have described contributes to the competitive landscape, but given its scale it is likely to be a marginal effect only at present in most countries.

From the supply-side: differences in insurance contract law limit the cross-border opportunities, leading to costs being incurred in checking compliance with local law (and also potentially related to the re-design of those products) or even expose the insurer to additional risk; availability of the statistical data necessary to populate the actuarial models underpinning the calculation of premiums is also perceived to be an issue in at least some markets; and cross-border claims management remains complex and expensive for insurers.

Given these factors, and their lack of tractability, it is my view that trade under Free Provision of Services is likely to remain — in the grand scheme of things — a relatively small-scale activity. However, even so, it is making its own contribution to the ongoing Europeanization of motor insurance.