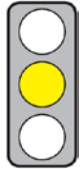


KEY ISSUES

Objective of the Green Paper: The Commission wants to increase the distribution of building insurance for elemental damage and ensure that industrial companies can afford to remedy environmental damage.

Parties affected: Owners of buildings, insurance companies, industrial companies, tax payers.



Pro: (1) The Commission correctly emphasises the advantage of risk-based pricing for disaster insurance. Thus flat-rate insurance premiums should be rejected.

(2) Liability insurance for industrial and off-shore companies is appropriate.

Contra: (1) Government compensation for damage to buildings caused by disasters amounts to an extreme subsidy for individual home-owners and will result in their failing to take out proper insurance cover ("moral hazard").

(2) Compulsory insurance should be rejected because it does not in fact encourage personal responsibility.

(3) The bundling of insurance should not be compulsory because it reduces the owners' freedom of choice and often gives rise to cross-subsidisation.

CONTENT

Title

Green Paper COM(2013) 213 of 16 April 2013: Insurance of natural and man-made disasters

Brief Summary

► General

- According to the Commission, natural disasters in Europe caused damage amounting to about € 450 billion (p. 4) between 1980 and 2011. It believes there is a danger that building insurance will become "prohibitively expensive" or even "unaffordable" in some areas (p. 5.) At the same time "it will exacerbate the budget difficulties of the Member States" if it continues "to generously compensate victims" (p. 12).
- According to the Commission, disaster insurance for buildings is not available in all Member States. It wants to use the Green Paper to find out whether measures to "improve" the market for insurance are necessary (p. 6 and 2).
- The Commission is looking into risk-based pricing as a concrete measure to increase insurance protection and refers in particular to
 - the bundling of various risks into one insurance policy,
 - uniform insurance pricing (flat-rate pricing),
 - compulsory insurance and
 - insurance pools.

► Risk-based pricing: Incentive creation and problems

- The Commission sees risk-based pricing as a strong instrument for providing "market-based incentives for risk prevention". (P. 12)
- However, risk-based pricing often gives rise to
 - the need for a high degree of information by the insurer and therefore high administration costs (p. 12),
 - social injustice where high risks result in unaffordable insurance tariffs, such as in areas at high risk of flooding (p. 13).

► Uniform insurance pricing (flat-rate pricing)

- Uniform insurance pricing irrespective of risk (flat-rate pricing) can, according to the Commission, improve insurance protection in high-risk areas. However, this gives rise to the cross-subsidisation of high risks by low risks and "exacerbates land use externalities" in high-risk areas because the residents in those areas do not take full account of the true risk. It would therefore be appropriate to tighten building regulations in these areas. (P. 13)
- The Commission asks whether flat-rate premiums should be introduced for specific disasters or whether other solutions are possible which would allow low-income consumers to take out disaster insurance (p. 13).

► **The bundling of insurance against various risks**

- Bundling insurance means that various types of risk - flooding, storm, earthquake - are bundled together in one insurance policy allowing for better distribution of risk. Ideally, the risks should be independent of each other. (P. 8)
- The Commission asks whether mandatory bundling of several types of peril into one insurance policy could "improve" insurance protection or whether "less restrictive ways" would be more suitable. (P. 8)

► **Compulsory insurance**

- According to the Commission, compulsory disaster insurance solves three problems (p. 8 and 9):
 - "Risk myopia": people underestimate the risk of a disaster to them and the financial consequences thereof.
 - "Free-riding": people rely on private or government aid.
 - "Adverse selection": insurance is purchased primarily by those who are at a higher risk which makes the premium "prohibitively expensive" and the pool becomes too small.
- The Commission asks (p. 8) what, if any, compulsory disaster insurance exists in Member States and whether
 - this involves an obligation on insurers to provide cover,
 - the customer has the right to opt out of specific risks
 - EU action would be useful.

► **Insurance pools**

- In the case of insurance pools, several insurance companies share the costs resulting from certain risks.
- According to the Commission, insurance pools can improve insurance protection if the market, without pooling, would be too small and/or the loss too great. The disadvantage is the restriction of competition. (P. 9)

► **Other ways of increasing insurance protection**

- Insurance protection may be improved by parametric index-based weather insurance which triggers a payment to the insured where a threshold is exceeded - irrespective of loss. These involve lower premiums due to the lower administration costs. The disadvantage is the fact that the payment may not match the actual loss. (P. 10)
- Catastrophe bonds issued by insurers may also improve insurance protection, according to the Commission. These loans, which only provide for repayment to the investor if a previously defined catastrophe does not occur, improve the insurer's risk diversification. (P. 11)
- Long-term disaster insurance contracts - annual contracts are currently the norm - may, on the one hand, according to the Commission, increase incentive for investing in risk reduction in that they provide for premium discounts for such investments. On the other hand, the longer contractual term leads to stricter capital requirements for insurance companies which puts up premiums. (P. 13)

► **Role of the state**

- According to the Commission, the state may (p. 10)
 - act directly as the insurer,
 - financially support private insurers or insurance pools by assuming loss over a certain level.
- The Commission asks how to avoid the problem of policy-holders behaving in riskier ways - in the expectation of state aid - i.e. by being under-insured or not insured at all ("moral hazard"). (P. 9)

► **Information requirements**

- The Commission complains that pre-contractual and contractual information requirements for non-life insurance are not harmonised at EU level. It asks whether there should be full or minimum harmonisation and in respect of which information. (P. 14)

► **Environmental damage by industrial companies**

- The Commission is considering extending the Environmental Liability Directive (2004/35/EC) - which does not include natural disasters - to include mandatory financial security for industrial companies to finance the removal of environmental damage which they have caused themselves.
- Insurance products could replace this financial security.
- The Commission asks whether there are sufficient data and tools available to perform an insurance analysis. (P. 18)

► **Offshore oil and gas operators' liability insurance**

- The Commission has found that major multi-billion-euro accidents in the oil and gas sector are not currently insurable in the EU. (P. 19)
- The Commission asks what kind of "innovative insurance mechanisms" could be appropriate for the offshore oil and gas industry (p. 20).

► **Transparency of company liability insurance**

- The Commission asks whether all companies should disclose the contractual conditions of their third-party liability insurance policies. This could facilitate claims handling. (P. 20)

Policy Context

On the same day as this Green Paper, the Commission also published a Communication on the EU Strategy on adaptation to climate change [COM(2013) 216]. On 30 July 2013, the Commission led an on-line consultation on insurance and compensation with regard to accidents in nuclear power stations.

Options for Influencing the Political Process

Leading Directorate General: DG Internal Market and Services

ASSESSMENT

Economic Impact Assessment

Ordoliberal Assessment

In view of the frequent incidence of storms and flooding in recent years, the Commission's assumption that buildings will be at increased risk from natural disasters in the future, is understandable. Since many people in high-risk areas have insufficient, if any, insurance, it is appropriate to be working towards comprehensive insurance protection which includes cover against elemental damage resulting from flooding, storm and earthquake.

The Commission's idea of working towards comprehensive building insurance protection in the EU - which also covers elemental damage - is understandable. Differences in the propensity to take risks as well as meteorological and geographical differences can only partially explain the low level of insurance against flooding, storm and earthquake in some EU countries. The systematic underestimation of the existing risk also explains the low level of building insurance for elemental damage.

Government compensation for damage caused by disasters does not constitute a sustainable concept for tackling future disasters. They amount to an extreme subsidy for individual home-owners which will result in their failing to take out proper insurance cover ("moral hazard") and may financially overburden the states in the event of more frequent natural disasters. Furthermore, **they may provide false incentives** such as the incentive to acquire property in areas at high risk of natural disaster. They thereby exacerbate the problem rather than solving it.

Instead the liability principle should be brought to bear thereby placing the risk for elemental damage entirely with the home-owner. The latter generally have a financial incentive for concluding (partial) disaster insurance. It should no longer be possible to pass on responsibility for the damage to society at large.

State intervention is, at best, justified in areas with such a high disaster risk that buildings located there cannot be insured at all, or only at prohibitively high premiums. There may be social consensus that the habitation of such areas is worth maintaining. In this case, however, there should continue to be at least partial reliance on insurance as a solution which would ensure that the building owners retain responsibility. High excess payments by the insured and the obligation to take preventative measures to ward off damage are possible.

The Commission correctly emphasises the advantage of risk-based pricing for disaster insurance: such tariffs provide effective incentive to prevent damage and thus influence property prices. **Flat-rate insurance premiums should therefore be rejected.** That also applies to people on low incomes who cannot afford risk-based tariffs since this problem should be solved by way of social policy rather than shifting the burden onto those who have insurance.

Bundling storm, flood and earthquake insurance into one policy increases the distribution of insurance, as experience in Belgium, France and the UK has shown. It **should not be made compulsory**, however, **because it reduces the property owners' freedom of choice and often gives rise to cross-subsidisation.**

Compulsory insurance should be rejected. Although it may remove the problem of owners failing to take out insurance because they are insufficiently aware of the risks or they are counting on state aid in the event of an emergency, it nevertheless requires far-reaching state intervention. The intervention required will be an obligation on insurers to provide cover, state regulation of pricing and, in particular, rules on the extent to which various risk zones, and thus varying premiums, are permitted. As a result, compulsory insurance leads to cross-subsidisation at the expense of property owners in low-risk areas. **It therefore, in fact, fails to encourage personal responsibility.**

Regarding the amendment of the Environment Liability Directive, the aim should be to ensure that **industrial and off-shore companies** can finance the removal of environmental damage which they have caused. In view of the enormous potential damage, **liability insurance makes sense.** In order to prevent distortion of competition, further provisions – relating, for example, to the insurance amount - will be unavoidable.

The duty for companies to disclose the contractual conditions of their third-party liability insurance policies encourages abuse by third parties, for example by recording a higher level of damage than has actually been incurred. The right of an aggrieved party to claim damages against the party who caused the damage arises irrespective of whether the latter is insured or not.

Legal Assessment

Legislative competence

The legal basis for legislative follow-up measures depends on their form. Art. 53 (1) TFEU may apply. This empowers the EU to harmonise legislation and administrative provisions in the Member States which relate to the taking-up and pursuit of activities as self-employed persons. The internal market competence (Art. 114 TFEU) is a possible legal basis if the varying national legislation on obliging insurers to provide cover could result in distortions of competition.

Subsidiarity

Not currently foreseeable.

Proportionality

Not currently foreseeable.

Other Compatibility with EU law

The obligation to provide cover restricts freedom of contract which forms part of the freedom to conduct business (Art. 16 Charter of Fundamental Rights of the EU) so that the wording must be proportional.

Impact on German Law

Compulsory insurance and an obligation to provide cover must be defined proportionately because they interfere with contractual freedom which forms part of the general freedom to act (Art. 2 (1) Grundgesetz) or the freedom of occupation (Art. 12 GG). In particular, it is firstly necessary to ensure that all those obliged to take out compulsory insurance are actually subject to the insured risk (cf. BVerfGE 103, 197 (223 et seq.)) Compulsory insurance for a large group in the form of a bundling of various disaster risks would be legally justifiable even if it should be rejected on economic grounds (see above). Another possibility is compulsory insurance which only covers a single risk (such as flooding) and therefore only applies to a small group of affected individuals such as those living by rivers. However, this gives rise to problems of definition and equal treatment. Secondly, any pricing system should not unreasonably burden either the insured or the insurer.

Conclusion

Government compensation for damage to buildings caused by disasters does not constitute a sustainable concept for tackling future disasters. It amounts to an extreme subsidy for individual home-owners and will result in their failing to take out proper insurance cover ("moral hazard"). The Commission correctly emphasises the advantage of risk-based pricing for disaster insurance. Flat-rate insurance premiums should therefore be rejected. Compulsory insurance should also be rejected because it does not, in fact, encourage personal responsibility. The bundling of insurance should not be compulsory because it reduces the owners' freedom of choice and often gives rise to cross-subsidisation. Liability insurance for industrial and off-shore companies is appropriate.