

## INTRODUCTION

This submission is made on behalf of Lloyd's of London, 1 Lime Street, London, EC3M 7HA, UK. Our Interest Representative Register ID number is 07203323308-65. Lloyd's is a Society of members that operates as an insurance and reinsurance market in London. Lloyd's and the Lloyd's market are subject to supervision by the Prudential Regulation Authority and the Financial Conduct Authority in the UK, in accordance with EU regulatory provisions for insurance undertakings. In 2012, the Lloyd's market's aggregate premium income was EUR 31.4bn (£25.5bn).

We appreciate the opportunity to submit our views on the Green Paper and welcome the Commission's efforts to promote a debate on disaster risk prevention and mitigation. The Lloyd's market has many years' experience of providing insurance worldwide against the consequences of natural and man-made disasters. In 2011, based on this experience, Lloyd's published a report: [\*Managing the escalating risks of natural catastrophes in the United States\*](#). It included nine principles summarising Lloyd's views on this subject, which, although framed for the US, are of wider application. These are:

1. The first step in protecting property owners from natural catastrophe losses is ensuring there is a healthy, private insurance market.
2. Government intervention in private insurance markets should be kept to a minimum.
3. Risk-based pricing is the fairest and most sustainable solution.
4. Specialist international insurers and reinsurers add value to natural catastrophe markets through additional capacity and expertise.
5. Government and insurers must respond to changing trends in the frequency and severity of losses.
6. Government has an important role to play in helping develop risk mitigation measures and rewarding adaptation to reduce the overall costs to the economy.
7. The insurance industry has a key role to play in helping build more resilient communities.
8. Good quality data and hazard mapping is critical to robust underwriting.
9. We believe in encouraging a responsible approach to risk in society.

In relation to the wider issue of climate change, Lloyd's is a member of [ClimateWise](#), the global insurance industry's leadership group to drive action on climate change risk. Its international membership covers Europe, North America and Southern Africa and all members commit to action, individually and collectively, against the ClimateWise Principles:

1. **Lead in risk analysis**
2. **Inform public policy making**
3. **Support climate awareness amongst our customers**
4. **Incorporate climate change into our investment strategies**

5. **Reduce the environmental impact of our business**
6. **Report and be accountable**

Our detailed responses to the questions asked in the Green Paper are set out below.

## **MARKET PENETRATION OF NATURAL DISASTER INSURANCE**

1. **What is your view on the penetration rate of disaster insurance in the European Union? Please provide details and data to support your arguments. Is more research needed to understand any possible gaps in insurance supply and demand, insurance availability and coverage?**

The JRC's September 2012 report: *Natural Catastrophes: Risk relevance and Insurance Coverage in the EU*, investigates and analyses this issue in some depth. It concludes that, for flood, storm and earthquake, there are variations in penetration levels across the EU. This is in line with the conclusions of a Paper presented to the 2007 Amsterdam Conference on the role of insurance in adaptive flood management<sup>1</sup>, which assessed 19 European countries and concluded that market penetration was 50% or more in 7 of those countries. Variations depended on factors such as whether flood cover is sold as bundled, country surface area and average population density (large countries have a better chance of diversifying natural hazard risk across the country and within a larger population). We accept that penetration rates vary between member states and do not think that it is necessary to collect or assess additional data to support this contention.

However, we do challenge the assertion in the JRC Report Executive Summary that “...*there are cases where NatCat insurance markets do not seem to fully cope with existing risks*”, as this is not justified by the Report's formal conclusions. Varying penetration rates reflect a range of factors and are not necessarily problematic, for example if the relevant risk is immaterial or appropriate alternatives exist. Low penetration rates must therefore be put in context, for example noting the 2007 Amsterdam Paper conclusion that “*From our analysis it is clear that, contrary to what many believe, the availability of flood insurance is widespread in Europe*”.

## **PRODUCT BUNDLING**

2. **What further action could be envisaged in this area? Would mandatory product bundling be an appropriate way to increase insurance cover against disaster risks? Are there any less restrictive ways, other than mandatory product bundling, which could constitute an appropriate way to increase insurance coverage against disaster risks?**

The Green Paper describes as “product bundling” the practice of offering insurance against a range of perils in a single packaged policy. This is common in most Member States for policies offered to private individuals and small and medium-sized enterprises. It is adopted

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<sup>1</sup> *Adaptive flood management: the role of insurance and compensation in Europe*, Laurens M Bower, Dave Huitema and Jeroen CJH Aerts, Institute for Environmental Studies, Faculty of Earth and Life Sciences, Vrije Universiteit, Amsterdam Conference, 24 – 26 May, 2007.

by insurers more for the obvious conveniences it offers to insurers and policyholders than as a conscious strategy to underwrite disaster insurance. Contrary to what the Green Paper says, each peril is not independent from any other in the policy: perils such as storm and flood or fire and earthquake are connected.

One should not overstate the importance of product bundling as a technique for handling correlated risks. Other techniques, such as diversification of risk or the purchase of reinsurance, are more important and supervisory regimes for insurance, such as Solvency II, should make appropriate provision for these techniques.

Mandatory product bundling raises the following concerns:

- **It may act to the detriment of customers:** When “product bundling” is used to describe arrangements whereby insurers or intermediaries sell two products to a customer at the same time, regulators tend to view it with suspicion, as customers may get better deals by buying the products separately. Hence the discussion of restrictions under the proposed revision of the Insurance Mediation Directive. Bundling of perils within a policy raises similar concerns, as it can mean that some consumers are forced to purchase cover against risks that are minimal or non-existent and they would get better deals if the cover was optional.
- **It may be viewed as anti-competitive:** An obligation to include certain perils in a policy can hinder the launch of products in a non-standard form to compete with what is already on offer in a market. Compulsory inclusion of particular perils could be viewed as a form of standard policy condition, such as the Commission explicitly excluded from the insurance sector block exemption (Commission Regulation 267/2010) when it was renewed in 2010. We note that the Dutch Consumer and Markets Authority recently ruled that mandatory inclusion of flood insurance in the Netherlands would be anti-competitive.

Mandatory product bundling for the insurance of natural disasters is a feature of EU Member States such as France, Spain and Belgium. In the UK, the perils included in standard packaged policies are a matter of choice for the insurer, although the operation of the market means that perils covered by different insurers’ policies tend to be the same or similar, as a policy giving significantly lower levels of cover is unlikely to sell. Furthermore, many residential properties are purchased under mortgages and the lenders insist on properties being insured against common perils. So, without mandatory product bundling, bundled policies including natural catastrophe cover are widely available in the UK insurance market and market penetration is high, as set out in the JRC Report.

An exception to this is the Statement of Principles agreed between the ABI and Government. Under this agreement, ABI members agree to make flood insurance available for domestic properties and small businesses where the flood risk is not significant. To this extent, the inclusion of flood as a peril in packaged policies is mandatory, although with limitations. The Statement of Principles is due to be replaced by an alternative scheme (see below).

## COMPULSORY DISASTER INSURANCE

- 3. Which compulsory disaster insurance, if any, exists in Member States? Are these insurance products generally combined with compulsory product bundling or obligation for insurers to provide cover? Is compulsory disaster insurance generally accompanied by a right for the customer to opt out of some disaster risks? What are the advantages/possible drawbacks? Would EU action in this area be useful?**

“Compulsory disaster insurance” means that it is mandatory for property owners to insure their property against specified perils. Sanctions (such as fines or other penalties) are imposed on them if they do not do so.

Compulsory disaster insurance is unusual in the EU. In the Member States which require policies to include natural disaster coverage (see previous response), the purchase of insurance remains optional. We are aware that in Romania it is mandatory for the owners of residential properties to insure their buildings against earthquake, landslide and flood under the Law on Compulsory Home Insurance (260/2008), which came into force in 2011. Application of this Law has not been straightforward and that many properties in Romania remain uninsured against the specified perils. Outside the EU, but within the EEA, insurance of buildings against fire and specified perils is compulsory in Iceland. In Romania, insurers are not required to provide cover or to include it in their policies. In Iceland, insurance against natural disasters is provided by Iceland Catastrophe Insurance.

Disaster insurance is not legally compulsory in the UK. However, it is not possible to obtain a mortgage on a residential property without obtaining insurance to cover the property, so most residential properties are insured against damage, including from disasters.

Whatever the impact of compulsory disaster insurance on market penetration, a major drawback is its impact on low-income groups who have the greatest difficulty affording insurance. Compliance with the law requires them to divert money from other, possibly more important, purposes. Non-compliance is likely to be highest among such groups, who are therefore most likely to incur financial penalties. Compulsory disaster insurance, although well intentioned, can therefore operate to the detriment of the impecunious, whilst having little or no effect on the take-up of insurance by those who are wealthy.

EU action in this area is unlikely to be effective. Exposures to natural disaster are mostly local rather than continent-wide and there are significant variations in levels of prosperity and in attitudes towards insurance. Decisions on compulsory insurance should therefore be made at national level, with the informed consent of a country’s people or their elected representatives and in the light of national knowledge of and attitudes towards local risks of disaster. Attempts by the EU to impose “one-size-fits-all” solutions on Member States could arouse resentment, limiting their effectiveness.

## GOVERNMENTS AS REINSURERS OF LAST RESORT

### 4. How can state or state-mandated disaster (re-)insurance programmes be designed and financed to prevent the problem of moral hazard?

State or state-mandated disaster programmes should be implemented only as a last resort, where insurance is unavailable or unaffordable in the private market. Experience of such programmes worldwide suggests that they can have the following effects:

- **Undercutting the private insurance sector:** State programmes:
  - Are unlikely to charge rates that reflect the actual risks covered - they may be set up intentionally to do this.
  - Do not have to buy reinsurance or set rates to cover the costs of capital, taxes and contingent reserves.
  - Are not subject to risk-based regulation, requiring substantial regulatory capital requirements for catastrophe risk.

Consequently, state programmes often charge lower premiums than private industry, thereby inhibiting the development of healthy private insurance markets and concentrating the costs of disaster recovery in government hands.

- **Incurring substantial losses:** Because state programmes do not have to charge economic rates or demonstrate long-term solvency, they can incur losses considerably in excess of their available resources.

The US National Flood Insurance Program (NFIP) has been forced to borrow from the US Treasury following catastrophic losses in 2004, 2005, 2008 and 2011: by 2011 its cumulative debt reached \$17.75bn and in January 2013, its borrowing authority was increased to \$30.425bn (the costs of Hurricane Sandy, which struck in October 2012, threatened otherwise to exceed NFIP's existing borrowing limits). Although the Flood Insurance Reform Act 2012 is intended to strengthen the future financial solvency and administrative efficiency of the Program, doubts remain over whether it will ever have sufficient funds to cover future obligations for policyholder claims, operating expenses and interest on debt<sup>2</sup>.

- **Encouraging inappropriate and environmentally-damaging development:** Many vulnerable areas, such as coastal wetlands, are ecologically significant and sensitive and facilitate flood protection. State programmes shift insurance risks to taxpayers and reduce the long-term private costs of development in such areas, thereby encouraging such development, otherwise non-viable, to the detriment of the environment. Properties benefiting from state post-disaster relief can be rebuilt on the same site, despite their vulnerability to future disasters. In the US, it is estimated that 1% of the properties insured under the NFIP (known as "repetitive loss properties" – RLPs) account for over a third of the claims paid and that about 10% of RLPs have cumulative flood insurance claims that exceed their value as properties<sup>3</sup>.

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<sup>2</sup> *The National Flood Insurance Program: Status and Remaining Issues for Congress*, CRS Report for Congress, February 6, 2013

<sup>3</sup> *The National Flood Insurance Program*, *supra*

- **Providing subsidies disproportionately to the wealthy:** Properties at risk from natural disasters, such as those in beach front communities, may be desirable and expensive residences. This can mean that the financial benefits of a state programme are skewed towards high net worth individuals. In 2007, the US Congressional Budget Office found that over 40% of the coastal properties receiving a rate subsidy because they were grandfathered into the NFIP were worth over \$500,000 and 12% were worth more than \$1m (at the time, the median value of a single-family house nationwide was \$160,000). In fact, 23% of the subsidised properties were vacation homes<sup>4</sup>.
- **Providing state aid for some economic activities:** Cheap or free insurance for business in some locations and Member States can constitute a material economic advantage over rivals in other locations and Member States. The firms in receipt of it can also benefit in the event of a disaster, as their premises are refurbished and modernised at state expense.
- **Creating perceptions of unfairness:** State programmes require people at lower risk to contribute to the support of those at higher risk. This may appear unfair to those in the first category, particularly if they consider that the higher risk arises largely through the exercise of choice by the individuals concerned, i.e. they have chosen to live in areas at higher risk of natural disaster (which might be attractive areas in which to reside). The question of “fairness” is an important factor in the acceptability of any scheme for dealing with the consequences of natural disasters.

A state disaster programme should be established only on the basis of a full assessment of the need for such intervention, taking full account of the possibilities that it will have unfair or unwelcome consequences. It needs to be carefully targeted and regularly reassessed, to ensure that it achieves its objectives and that its benefits outweigh any harm that it causes. Governments have key roles to play in disaster risk management strategies and state programmes should form an integral part of such wider schemes.

It may well be preferable for governments to provide support to programmes run by private insurers. Private insurers can:

- Use existing facilities to administer the programme, reducing running costs;
- Draw on their professional underwriting experience, enhancing the pricing process;
- Meet some or all of the costs of a disaster, reducing state exposures;
- Arrange for the adjustment and settlement of claims through existing mechanisms, improving claimant outcomes.

In the UK, the ABI and the Government have recently agreed to explore the establishment of Flood Re, a not-for-profit reinsurer owned by the insurance industry, to provide insurance for households at high risk of flooding. It is envisaged that Flood Re will be funded by premiums, which would not be fully risk-based, and an annual levy on household insurers. This would be an industry initiative, with Government support. The Government consultation document on this proposal recognises that:

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<sup>4</sup> *Value of Properties in the National Flood Insurance Program 1 (2007)*, Congressional Budget Office

*“The insurance industry is better placed than Government to run what would be a reinsurance company in its own right operating in the high risk end of the market.”<sup>5</sup>*

## **PARAMETRIC INDEX-BASED WEATHER INSURANCE**

- 5. Do you see any difficulties, barriers or limitations in using information to generate parametric insurance? Which factors could scale-up the promotion and uptake of such innovative insurance solutions?**

This is a fast-developing method for undertaking insurance business, of particular value in less-developed countries.

There are obstacles to the successful across-the-board implementation of parametric insurance. As parametric insurance does not operate on an indemnity basis, policyholders may receive significantly less (or more) in claim payments than the full costs of damage they have sustained and unsophisticated buyers might find it difficult to understand the operation of their policy. This can be mitigated to some extent by appropriate sales processes and the supply of appropriate information to the policyholder. Nevertheless, it means that parametric insurance is probably not an entirely satisfactory means of providing individuals with protection against disasters.

An example of successful parametric insurance is the Caribbean Catastrophe Risk Insurance Facility (CCRIF), whose members include 16 governments. The CCRIF limits the financial impact of catastrophic events in the Caribbean region by providing short term liquidity to the participating governments whenever the insurance policy is triggered based on parametric considerations.

## **INSURANCE PRICING AS AN INSURANCE MARKET-BASED INCENTIVE TO PROMOTE RISK AWARENESS PREVENTION AND MITIGATION**

- 6. Could risk-based pricing motivate consumers and insurers to take risk reduction and management measures? Would the impact of risk-based pricing be different if disaster insurance was mandatory? Do insurers in general adequately adjust premiums following the implementation of risk prevention measures?**

Risk-based pricing is the fairest and most efficient way to rate insurance risks, as it allows insurers to set their premiums by reference to the actual risk insured, its history and potential for future losses. Risk-based pricing can also encourage risk mitigation by policyholders and allow insurers to provide incentives in this regard.

If disaster insurance is made mandatory, individuals are placed under a legal obligation to purchase insurance which, priced on a risk basis, could be unaffordable to them. If premiums are not risk-based, they may be more affordable for high-risk policyholders, but low-risk policyholders must pay higher premiums, which may appear unfair – particularly as they nevertheless must purchase cover for what might be an immaterial risk to them.

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<sup>5</sup> *Securing the future availability and affordability of home insurance in areas of flood risk*, DEFRA, June 2013

**7. Are there specific disasters for which flat-rate premiums should be suggested? Should flat-rate premiums be accompanied by caps on pay-outs?**

Insurance premiums should represent the risk that an insurance company accepts. Flat premiums should be avoided as they create cross-subsidisation, where low risk policyholders pay for policyholders who are more exposed to the catastrophe events. We support risk-based underwriting, which reflects risks more accurately and provides a fairer basis for pricing insurance coverage.

**8. What other solutions could be offered to low-income consumers who might otherwise be excluded from disaster insurance products?**

We believe that a healthy private insurance market is generally the best means of dealing with the consequences of natural disasters. Nevertheless, we accept that in some circumstances low-income consumers exposed to the risks of natural disasters are unable to afford the cover that a private insurance market is able to offer.

Providing insurance against disasters to low-income consumers requires Government intervention, as it entails one part of the community subsidising another. If this is considered necessary it should be done very carefully, in view of the negative consequences that can result from inappropriately-designed solutions. Schemes to address the problem should be effectively targeted: the mitigation of the impact of natural disasters on low-income groups should be an explicit objective of such schemes and this should not be mixed up with other aspirations, such as encouraging local development, however desirable policymakers may consider them to be.

As mentioned in response to Q.4, schemes that entail governments and insurers working together are preferable to state-owned programmes. Provision in these can be made for low-income consumers, increasing the affordability of disaster insurance. For example, the Flood Re proposal in the UK will see premiums for flood insurance capped. The maximum amount that can be charged will vary, depending on the Council Tax (a form of local property tax) band in which the property sits. It is proposed that the maximum premium for bands A and B (the least valuable homes) will be £210; at the other end of the scale, the maximum premium for band G will be £540. Houses in band H (the most expensive properties) will be excluded from the scheme altogether.

**LONG-TERM DISASTER INSURANCE CONTRACTS**

**9. Is there a case for promoting long-term disaster contracts? What would be the advantages/drawbacks for insurers and the insured persons respectively?**

We do not support the idea of long-term disaster contracts for the following reasons:

- **They restrict underwriters' ability to respond to developments:** The global environment and climate are continually changing and there is no certainty as to what risk profiles will be like in, for instance, 10 years. Under a long-term disaster contract, insurance premiums remain fixed for the duration of the contract and



cannot be re-negotiated to reflect the evolving nature of the insured risk. The ability to amend premium levels in response to events is a crucial element of sustainable underwriting.

- **They do not represent good value for customers:** Capital requirements for long-term contracts are higher than for annual contracts: probably by as much as 50% for a 10-year contract. This means that premiums for long-term contracts are higher.
- **They can threaten insurer solvency:** Long-term insurance contracts do not guarantee that all liabilities will be successfully fulfilled over the years. Mispricing of long-term contracts, based on flawed assumptions, could result in insurer insolvencies.
- **They can increase moral hazard:** As the contracts are secured for an extended period, insureds may consider that it is safe to reduce risk mitigation steps whilst their coverage is assured.
- **They can give rise to competition concerns:** Long-term contracts mean that policyholders are committed to policies for several years, making it difficult for them to switch to alternatives that might offer better terms. Long-term coverage can also act as a barrier to new market entrants, inflating premium costs within the market.

## PRE-CONTRACTUAL AND CONTRACTUAL INFORMATION REQUIREMENTS

**10. Do you think there is a need to harmonise pre-contractual and contractual information requirements at EU level? If so, should the approach be full or minimum harmonisation? What requirements concerning the commitment should be included, for instance:**

- **the nature of the insured risks,**
- **adaptation and prevention measures to minimise the insured risks,**
- **features and benefits (such as compensation of full replacement costs, or depreciated, time value of assets),**
- **exclusions or limitations,**
- **details for notifying a claim, for instance, if both the loss and its notification must fall within the contract period,**
- **who and to what extent bears the costs of investigating and establishing the loss,**
- **contractual effects of a failure to provide relevant information by the insurer,**
- **the remedies, costs and procedures of exercising the right of withdrawal,**
- **contract renewals,**
- **complaints handling?**

Contrary to what the Green Paper says, there are directive provisions for pre-contractual information for non-life policyholders. Article 31 of the 3<sup>rd</sup> Non-life Direct (Directive 92/49/EEC) and Article 183 of the Solvency II Directive (Directive 2009/138/EC) contain requirements on pre-contractual information for non-life policies.

Harmonisation of pre-contractual and contractual information will not address issues of disaster insurance adequacy and availability. This information helps only those who have

decided to take out insurance and does not reach consumers who do not purchase insurance. It cannot therefore affect market penetration rates. The Green Paper does not suggest that there is a widespread problem of consumers who think that they are covered against natural disasters, but, due to inadequate information, are not.

Attempts to enhance consumer interactions with financial products (such as disaster insurance) through the provision of information should take account of insights from behavioural economics. In the UK, the FCA published an Occasional Paper, [Applying behavioural economics at the Financial Conduct Authority](#) in April 2013. This builds on work at the FSA, including a July 2008 Paper<sup>6</sup> which said: “*Our survey of the literature on information overload shows that it is questionable whether people make better decisions when they have more or better information.*”

## INSURANCE TERMS AND CONDITIONS

### **11. Do deductibles, excesses co-insurance and other exclusions effectively prevent moral hazard? What alternative terms and conditions could be appropriate for disaster insurance, given that the insured party may be unable to take effective risk reduction measures against a disaster?**

The application of deductibles and exclusions assists underwriters in managing risk effectively. Underwriting should be based on comprehensive risk assessment so that insurance premium reflects the actual risk insured. Policyholders are thus encouraged to mitigate their risk potential to benefit from potentially lower insurance premiums or better coverage terms and conditions.

The Kyoto Statement of the Geneva Association (see response to Q.14) states that the insurance industry promotes mitigation efforts by developing products which incentivise offsetting or reducing greenhouse gas emission levels in relation to risks associated with climate change.

## DATA, RESEARCH AND INFORMATION

### **12. How could data on the impacts of past disasters be improved (e.g., by using standard formats; improved access to and comparability of data from insurers and other organisations)?**

The insurance industry needs access to reliable and qualitative data on past events to apply appropriate underwriting to future catastrophe risks. This process would be assisted if insurers had access to data held by national meteorological offices (e.g. Met Office in the UK). Wherever possible, data on natural hazards and vulnerability should be made publicly available.

Please see our answer to question 14 which discusses co-operation in information exchange between insurers and other organisations.

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<sup>6</sup> *Financial Capability: a Behavioural Economics Perspective*, FSA, July 2008

**13. How could the mapping of current and projected/future disaster risks be improved (e.g., through current EU approaches in flood risk mapping under the Floods Directive 2007/60/EC,<sup>29</sup> civil protection cooperation<sup>30</sup> and promotion of EU risk guidelines<sup>31</sup>)?**

The insurance industry requires better and more up-to-date mapping of natural hazards and improved data collection. Governments and insurers should work together to improve hazard mapping and the quality and availability of data.

**14. How could better sharing of data, risk analysis and risk modelling methods be encouraged? Should the available data be made public? Should the EU take action in this area? How can further dialogue between insurance industry and policymakers be encouraged in this area?**

Insurers rely on the availability of a wide range of data to assist them in sustainable underwriting. As a result, continuous research into evolving risks and exchange of information is crucial for the effective operation of the insurance industry.

### **ClimateWise**

ClimateWise's first principle '*lead in risk analysis*' is relevant here. In full it entails the following:

- *Support and undertake research on climate change to inform our business strategies and help to protect our customers' and other stakeholders' interests;*
- *Support more accurate national and regional forecasting of future weather and catastrophe patterns affected by changes in the earth's climate;*
- *Use research and improve data quality to inform levels of pricing, capital and reserves to match changing risks;*
- *Evaluate the risks associated with new technologies for tackling climate change so that new insurance products can be considered in parallel with technological developments;*
- *Share our research with scientists, society, business, governments and NGOs through an appropriate forum.*

This has proved to be a helpful initiative and policymakers may adopt similar steps to encourage co-operation and information exchange in the international market.

ClimateWise's Principle 2 encourages insurers to be actively involved in informing public policymaking. The Principle says that insurers should work with policymakers nationally and internationally to assist in developing and maintaining an economy that is resilient to climate risk and support government actions, including regulation, that enhance the resilience of infrastructure and communities.

## **Kyoto Statement of the Geneva Association**

The Kyoto Statement of the Geneva Association also commits the industry to enhance its research capabilities in order to provide a better evaluation and management of climate risk. The industry is prepared to help counter climate risks through active co-operation in implementing building codes or similar means, which encourage the use of sustainable practices.

The Statement offers close co-operation with policymakers on communicating to the customers their climate risk levels, possible strategies of mitigation and adaptation, and in quantifying the financial benefits of those strategies. The industry stands ready to offer assistance in reducing exposure to the risks associated with climate change and other calamities.

In turn, we encourage policymakers and relevant authorities to collect robust data and make it publicly available, to facilitate sustainable risk assessment and the development of effective solutions.

## **Oasis Loss Modelling Framework**

Lloyd's supports the Oasis Loss Modelling Framework (LMF). Under the auspices of the UK's Financial Services Knowledge Transfer Network and Climate-KIC, Oasis LMF has brought together leading players from the (re)insurance industry and technology and academic experts, to create a not-for-profit organisation. It aims to establish a proven framework for use of multiple catastrophe models. An open marketplace for models and data will lead to much wider access to understandable tools for catastrophe risk assessment and this will benefit governments, companies and eventually individuals.

### **15. How can the Union most effectively help developing countries to create solutions for financial protection against disasters and shocks and what should be the priority actions? What types of partnerships with the private sector and the international institutions should be pursued for this purpose?**

It is important to continue work in the area of building catastrophe models and EU support of further activities in this area would be welcome. For example, governments can contribute to risk model development by making data freely available to risk professionals. In addition, they can stimulate the academic sector to improve risk and engineering models and publish the outcomes of their work in open access environments. Continuous information exchange on the matter is also crucial to successful work in this area.

## ENVIRONMENTAL LIABILITY AND LOSSES FROM INDUSTRIAL ACCIDENTS

### **16. What are the most important aspects to look at when designing financial security and insurance under the Environmental Liability Directive 2004/35/EC?**

Lloyd's is not a major provider of on-shore Environmental Liability insurance, so we will not respond to this question.

### **17. Are there sufficient data and tools available to perform an integrated analysis of relevant and emerging industrial risks? How can data availability, sharing and tool transparency be ensured? How can co-operation between insurers, business and competent authorities be strengthened to improve the knowledge base of liabilities and losses from industrial accidents?**

Please see our earlier responses relating to data availability.

## OFFSHORE OIL AND GAS OPERATORS' LIABILITY INSURANCE

### **18. Considering the specificities of the offshore oil and gas industry, what kind of innovative insurance mechanisms could be appropriate? Are there ways for the insurance industry to reduce the uncertainty regarding the assessment of risks and calculation of premiums? What type of information should be publicly available to promote the development of insurance market products to cover major accidents?**

These questions assume that existing provision of insurance cover to the offshore oil and gas industry is unsatisfactory. We question whether this is a fair assumption.

Offshore oil and gas incidents can give rise to different losses: physical damage to the offshore platform and other infrastructure; liability for injury to workers and others; liability arising from the consequences of an oil spill for interests such as the tourist or fishing industries; expenses of dealing with a leak and re-drilling; clean-up costs and the costs of business interruption. A major accident can therefore cost billions of euros, so offshore operators therefore seek significant levels of cover for the exposures that they run. They obtain this cover from the commercial insurance sector as well as captive and mutual insurers. We therefore question the statement that:

*"It seems that insurance products in the European Union cannot provide coverage for the major multi-billion euro accidents."*

This is not correct: insurance products do cover multi-billion euro accidents. For example, in 2011, the Gryphon A platform in the North Sea was damaged in storms, leading to insurance claims of \$1,034m (property damage of \$500m; business interruption of \$534m)<sup>7</sup>. In 2011 there were 10 further insurance losses worldwide in excess of \$100m. So it must be considered whether there really is a gap between the cover that commercial insurance markets can provide and the cover that offshore operators should purchase.

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<sup>7</sup> Willis Energy Market Review 2013

At first sight, no such gap exists. There is little or no evidence of “unmet demand”: of operators seeking cover and being unable to find it. The insurance market therefore appears to meet the requirements of offshore operators for insurance cover.

The Green Paper is principally interested in clean-up costs and liability claims and the Commission may consider that, although operators are comfortable with the amount of cover that they purchase, wider societal interests require them to hold more (as the consequences of operators having insufficient cover are borne primarily by third parties). This requires the Commission to have a settled view of how much liability cover is “adequate”, which is a question of its “risk appetite”. This is a political issue, albeit one that should be informed by technical input.

A key factor – and one heavily dependent on technical evidence - is the financial magnitude of incident that operators should cover against. Most offshore energy extraction in EU waters is conducted in the North Sea by members of the Offshore Pollution Liability Association Ltd (OPOL). Members of OPOL undertake, in the event of a discharge of oil from offshore facilities, to reimburse the costs of remedial measures and to pay compensation for pollution damage up to a maximum of \$250m per incident<sup>8</sup>. An applicant for membership must provide evidence to OPOL that it has the financial capacity to fulfil its obligations under Clause IV of the Agreement<sup>9</sup> and may be required to provide further evidence of this financial responsibility subsequently<sup>10</sup>. Offshore operators in UK territorial waters are required to be OPOL members, effectively making OPOL’s financial responsibility provisions mandatory. Many operators meet these requirements through the purchase of insurance.

The *Oil Spill Cost Study – OPOL Financial Limits*, a joint study commissioned by OPOL and Oil & Gas UK, released in February 2012, examined whether OPOL’s requirements are adequate by computer modelling of well blowout scenarios for four representative locations around the UK, with a release duration of 30 days. It concluded that OPOL’s limit of \$250m per incident is adequate for the vast majority of UK well operations. For oil wells in the West of Scotland area the limit is calculated to be adequate in many cases, but the costs for higher production wells may exceed the current limit. It therefore recommended that additional financial responsibility should be considered for any well matching this scenario.

The Commission should therefore develop views on the adequacy of OPOL’s requirements and the joint study mentioned above. If it considers that the joint study is reasonable and OPOL’s arrangements are satisfactory then, as the commercial insurance market offers insurance that complies with OPOL’s requirements, the adequacy and availability of insurance for much of the EU’s offshore energy are probably acceptable. The Commission’s focus could then switch to cover for offshore activity in areas outside the North Sea. If the Commission disagrees with the joint study and OPOL’s requirements it should say so publicly, with reasons and engage in public debate with stakeholders on the subject.

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<sup>8</sup> Offshore Pollution Liability Agreement, Clause IV A

<sup>9</sup> Rules of OPOL (as at 1 January 2012), 2.2

<sup>10</sup> Rules of OPOL, 2.5

We believe that the joint study's approach, of modelling the consequences of possible scenarios in actual locations, is preferable to trying to use losses in other parts of the world as benchmarks. The explosion on the Deepwater Horizon rig in the Gulf of Mexico in April 2010 and the subsequent leakage of oil is a high-profile example: policymakers should be careful about viewing it as a "worst case" EU scenario, as:

- **The volume of oil released was unprecedented.** It totalled 4.9m barrels. The only other incident approaching this size is the 1979 Ixtoc 1 blowout in Mexican waters, which saw the release of 3.3m barrels. The next largest spill ever is Abkatun 91 (1986, Mexico, 247,000 barrels) and the largest release in European waters is Ekofisk Bravo (1977, Norway) of 202,381 barrels<sup>11</sup>. Proper preparation and access to appropriate emergency equipment such as capping devices reduces the period of oil leaks and therefore the volumes released.
- **The total cost of the incident was increased by specific factors.** Primary responsibility for the release of oil is viewed as resting with BP, operator of Deepwater Horizon. To date BP has incurred costs of \$42bn, including criminal settlement with the US Justice Department, although the final figure will not be known for some years. Factors that increased costs to this level included the US legal system, the influence of political considerations on BP's decisions and BP's obvious ability to meet substantial financial claims. It is unlikely that an offshore oil spill in European waters would lead to a similar level of settlement.

The Commission should consider "innovative insurance mechanisms" or other alternatives only if it believes – on the basis of technical assessment – that existing arrangements for insuring offshore incidents in EU waters are inadequate. As stated earlier, this means deciding what is "adequate".

When assessing "innovative insurance mechanisms" the Commission should bear in mind that innovation in financial markets has a mixed record in delivering desirable social and economic outcomes. We also question the footnote statement that "*In the Gulf of Mexico insurance coverage up to 10B\$ for sudden oil spills is now available*". If the "10B\$" refers to liability insurance only, we do not believe that coverage at this level is available, at any rate at prices that operators are prepared to pay. Under the US Oil Pollution Act 1990, liability for oil spills from offshore facilities is capped at \$75m, a figure that has not been changed since the Deepwater Horizon incident. Operators in the Gulf of Mexico may purchase liability cover above this figure, but this is not mandatory.

## **INFORMATION RIGHTS OF VICTIMS OF MAN-MADE DISASTERS**

### **19. Should contractual conditions of third-party liability insurance policies be disclosed to third parties in case of man-made disasters? If so, how?**

We do not agree with a general requirement to disclose details of liability insurance policies to third parties in the event of man-made disasters, for the following reasons:

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<sup>11</sup> Willis Energy Market Review, April 2011

- The Green Paper does not show that there is a problem for the proposal to resolve. For example, it does not say that, when man-made disasters occur, third parties have difficulties obtaining compensation because they are unaware that the responsible person is insured.
- If the purpose of disclosure is to enable a third party to pursue a claim directly against an insurer it is relevant only if the appropriate Member State's law gives third parties the right to make such a claim. The EU's 4<sup>th</sup> Motor Directive, Article 3, requires each Member State to ensure that injured parties enjoy a direct right of action against a motor liability insurer, but no similar EU measure covers insurance of other forms of liability.

In some Member States there are other legal provisions for the pursuit of claims directly against insurers by third parties. In the UK, for example, the Third Party (Rights against Insurers) Act 1930 gives a third party the right to make a claim against an insurer if the insured becomes bankrupt or insolvent. It is due to be updated by a 2010 Act, although that is not yet in force.

Introducing this right would be a significant change to the laws of many Member States. In the UK, the 1930 and 2010 Acts relate to the particular circumstances of an insured becoming insolvent. The legislation therefore addressed a real problem: payments under an insurance policy in these circumstances became part of the insured's general assets for distribution to creditors and, unless the law was changed, a third party, as an unsecured creditor, recovered at best a small dividend.

- It is not clear why this right would arise in the case of a man-made disaster only and not in other circumstances where parties pursue legal claims for compensation.
- The definition of "man-made disaster" to be met to trigger the right would be difficult to frame.
- Enactment of the proposal would look like a move away from the "polluter pays" principle. At present, injured parties can bring an action against a polluter and obtain a judgement against that person. An insurer may subsequently reimburse some or all of the settlement costs under an insurance policy, but there is no doubt that the legal liability rests with the polluter and the insurance claim is a separate issue. The proposal would allow the polluter to transfer entire responsibility for the legal action to their insurer, leaving the polluter essentially untouched by the legal proceedings and possibly able to avoid the public impression that they were at fault.

## **LOSS ADJUSTING**

### **20. Are there specific aspects of loss adjusting which would benefit from more harmonisation? If so, which? Are there practical difficulties for loss adjusters to operate cross-border?**

We do not consider that loss adjusting would benefit from greater harmonisation.



**21. This paper addresses specific aspects related to the prevention and insurance of natural and man-made disasters. Have any important issues been omitted or underrepresented? If so, which?**

We do not believe that any important issues have been omitted or under-represented. However, we question the wisdom of considering natural and man-made disasters in the same Paper. It is noteworthy that only a sub-set of possible man-made disasters is considered: there is no mention of the important issue of the insurance of terrorist incidents for example. However, we think that, rather than expanding the Paper to consider such issues, man-made disasters should be considered separately.