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## The Pricing Effects of European Union Insurance

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**The Pricing Effects of European Union Insurance  
Liberalization on Italian Motor Insurance**

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**Abstract**

Shifting from a government-controlled system of motor insurance regulation to a market-based system has caused unexpected outcomes in Italy. Although there is more competition since deregulation occurred twelve years ago, the government has had mixed results attempting to continue to control the market. This paper will examine how pricing deregulation on the European Union level has caused significant changes in the Italian market. Furthermore, it will seek to develop a national solution for regulation of auto insurance pricing within the United States using Italian experience. Regulation in the insurance industry in the United States has been a subject of debate for quite some time, and although there has been consensus among researchers on the need to change current regulations, agreement on changes to make has not been quite as simple. The recommendation of this study is to implement a system of federal supervision in pricing regulation, while allowing states to conduct day-to-day oversight.

# **The Pricing Effects of European Union Insurance Liberalization on Italian Motor Insurance**

## **Introduction**

Regulation of the insurance industry has historically been a highly regulated area in the United States. When the McCarran-Ferguson Act was passed in 1945, the regulation of insurance, including auto, was determined to be in the public interest of the states (Cummins, 2002). Consequently, a variety of rate regulations has developed in different states. Although there has been consensus among researchers on the need to change current insurance regulation, agreement on changes to make has not been quite as simple. There have been several proposals, which have not passed, in the past few years about how to modernize the industry as a whole to achieve more efficient, market-based regulation of insurance. For example, the National Association of Insurance Commissioners (NAIC), has been working towards convincing state insurance commissioners to adopt “a common set of standards for a uniform market regulatory oversight program that will include all states” (NAIC, 2003). Another proposal is by the National Conference of Insurance Legislators (NCOIL) promoting a use and file system<sup>1</sup>. While, such systems do promote change, they do not address the entire regulatory problem.

The US auto insurance industry in its current state is a problem for both the insurance companies participating in the market and consumers who are legally obligated to purchase an auto insurance policy. Because insurers face dramatically varying regulations by state, costs are increased. A recent regulatory efficiency study about US insurance by Grace and Klein (1999) concludes that operating efficiencies can be gained by “eliminating non-essential market regulations and standardizing those regulations that are retained.” Accordingly, by allowing insurers to use one rate structure instead of developing rates for all states, the creation a more efficient regulatory system is possible.

A similar situation occurred just over a decade ago in the European Union (EU). However, while Cooper and Dorfman (2004) have written a plan for regulatory reform in the US using details from the EU, research trying to apply results from EU insurance liberalization to the US, is limited. Similar to Cooper and Dorfman (2004), this paper will seek to use regulations of the EU to provide suggestions for reform in the US. However, the focus will be on outlining a system of pricing regulation for the US that provides consumer protection by promoting competition and increasing access to insurance products<sup>2</sup>. Moreover, specifically this paper will look at the effect the EU third non-life directive had on Italian regulations for motor insurance pricing.

The organization of this paper is in the following manner: The second section will give a history of Italian Motor Insurance. The third will illustrate the changes that have occurred

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<sup>1</sup> A system of regulation where an insurer can use rates for a period of time before being required to file them with the state.

<sup>2</sup> Increasing access to insurance products refers to creating a wider range of prices for motor insurance products. Such a goal would be accomplished by going from a fixed price system to one in which companies set their own separate rates.

in Italy because of the implementation of the EU third non-life directive. The fourth will use experiences learned from Italy to apply to the US. Finally, section five proves concluding comments.

### **Italian Motor Insurance History**

Motor insurance<sup>3</sup> has been and continues to be a large part of the insurance market in Italy. As of 2005, the Italian National Association of Insurance Companies (ANIA) reported that motor insurance accounted for approximately 51% of non-life<sup>4</sup> premiums collected. Motor insurance has been compulsory in Italy since December of 1969. Since that time, there have also been strict regulations on tariffs, or premiums, that insurers charge. Until 1994, the rates were set by the Italian Inter-ministerial Prices Committee (CIP) based on recommendations from a commission of experts (Filippi Committee). To determine these rates, the Filippi Committee met annually to set a range of possible rates a company could charge for the next year. This range of rates used a set pure premium and a range of possible loadings. In addition, three variables helped to personalize an individual's rate: accident history, province of residence, and car power (Luperto and Porrini, 2005)<sup>5</sup>. Accordingly, there was a small, if any, pricing differentiation among insurers.

A number of issues have historically plagued the Italian motor insurance market. In its review of the Italian insurance industry in 2005, ANIA reports that prior to 1994, Italian motor insurance premiums did not respond to market conditions, as measured by the rate of inflation. A comparison of rate increases against inflation is shown in Table 1. Additionally, industry-wide combined ratios<sup>6</sup> are examined to determine the adequacy of rates. Starting in 1984, the growth of rates started to exceed the rate of inflation. Although rates were increasing, the industry-wide combined ratio was increasing to over 110 percent. As indicated by an increasing combined ratio, this meant that rates were becoming inadequate. By the end of the 1980's, a number of companies went bankrupt. The bankruptcies caused the rates to rise faster than inflation in the early 1990's, but adequacy was still not achieved (ANIA, 2005).

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<sup>3</sup> In Europe, vehicles are insured with motor insurance rather than with auto insurance, as in the US.

<sup>4</sup> Non-life insurance refers to property/casualty insurance in the US and includes both auto and homeowners insurance

<sup>5</sup> The inclusion of accident history was by using a Bonus-Malus system. This system rewards and penalizes drivers in the form of increased or reduced premiums based upon past accidents. Prior to 1991, the Bonus-Malus system in place had thirteen possible levels with a maximum of a 30% bonus and a maximum of a 100% malus. In 1991, a new system with eighteen classes was introduced. The maximum discount was 50%, while the maximum surcharge was 100% (Lemaire and Hongmin, 1994). The new system was not the result of deregulation; rather it occurred near the same time. Thus, the specific details need not be addressed in this paper. However, what is of importance is that the bonus or malus is included in the premium following other calculations and is the same for all insurers. For additional reading on Bonus-Malus systems, see Lemaire (1995). Car power refers to the power of an engine, or horsepower.

<sup>6</sup> The combined ratio is the sum of the loss ratio and the expense ratio. A ratio of less than 100 percent means that a company earned a profit on insurance operations.

As noted, prior to rate deregulation in 1994, premiums were increasing. To determine these increasing costs, frequency and severity are multiplied together. Table 2 shows the history of frequency and severity of claims in Italian motor insurance. Before 1994, two trends are of importance in the table. First, the frequency of claims was falling below historical levels. However, it was still above levels in marketplaces throughout the EU. Additionally, claims were costing more. Because frequency and severity are multiplied together to determine the basis for the premium, an overall increase in rates resulted. However, because of heavily regulated rates, premium increases did not follow higher costs proportionately. Accordingly, the Italian market was struggling at the time of implementation of the third EU non-life insurance directive.

### **The Third European Union Non-Life Insurance Directive**

The third non-life directive introduced the EU to a single insurance market in 1994. In planning the supranational reforms, the goals of the directive were to create a single insurance marketplace in the EU, promote competition, and increase the supply of insurance products.<sup>7</sup> Because of becoming a single marketplace, companies were able to operate in all member countries after receiving a license in only one. In addition, rating regulation changed how rates were determined in EU member countries. Throughout the entire EU, great changes were being made to allow for a unified marketplace. These changes were quite evident in Italy, as the Italian motor insurance industry changed dramatically in and after 1994. After deregulation, companies in Italy were responsible for setting their own rates. In effect, what the liberalization has done to Italy is free it to react to market forces, causing rates to reflect loss experience. Although many changes resulted from the directive, the focus here will be on the effect of pricing regulation on competition and supply.

Prior to the directive, EU members could set pricing regulations by country, as there was no supranational control. As shown in Italy, this could result in the government controlling rates. However, after the directive, the type of allowable regulation was much more limited. Countries could no longer use prior approval rating. According to Council Directive 92/49/EEC (1992), as “Member States shall not, however, adopt provisions requiring the prior approval or systematic notification of...scales of premiums...which an undertaking intends to use with policyholders.” In addition, the directive states that, “Member States may not retain or introduce prior notification or approval of proposed increases in premium rates except as part of general price-control systems.”

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<sup>7</sup> There have been a total of five directives non-life directives by the EU. Although the third directive is the directive dealing with pricing regulation, the others are important in creating a single EU marketplace. The first directive was adopted in 1973 and gave insurers the right to establish subsidiaries, branch offices, and agencies in each member country. However, insurers were required to be licensed in each country. The second directive, adopted in 1990 allowed insurers to do business in other member countries without having started a branch in each country (Cummins and Rubio-Misas, 2001). The fourth directive was introduced in 2003. It introduced procedures for out of country accidents and created a national registration system for vehicles and the amount of liability coverage on vehicles (ANIA, 2004). The fifth directive increases minimum liability amounts, refined a procedure for out of country claims, and ensures that countries cannot limit compensation caused by uninsured vehicles (ANIA, 2005).

While the directive does not entirely prohibit a price control system, it does make such a system difficult to implement or become legal. Court opinions from case C-59/01 (2003) have determined that a general price control system must be an economy wide price control system. Thus, the controls must not solely affect one sector, such as third-party liability motor insurance. Accordingly, it is not permissible to use a prior approval system that does not also control prices throughout an economy. The result of this regulation had a great effect on Italian motor insurance, as it allowed companies to determine their own rates.

Furthermore, it increased flexibility in rating by allowing for additional variables. Before the directive, only three variables were available for use in rating, as they were set by the CIP. The resulting freedoms caused the use of many new variables, allowing for more flexibility and hence competition. An example of the variables used, as of 1996, is shown in Table 3. When considering the variables in the table, it is important to note companies may or may not use all listed variables, thus it should be considered a guide and not a rule. Additionally, the comparison to the US illustrates a regulatory philosophy as to which variables are allowable by regulators in the EU and US. However, such a topic is beyond the scope of this paper<sup>8</sup>.

Moreover, the directive effectively increased the supply of motor insurance products to the Italian marketplace. Although, the number of companies present in the insurance marketplace traditionally measures supply, such a measure cannot be considered adequate in this situation given the uniform nature of previous tariffs. Accordingly, there would have been no benefit for a consumer to attempt to switch insurers to receive a different rate. However, now that the supply has increased as insurers now set their own rates, consumers are often able to find a less expensive price for the same insurance. ANIA (2005) reports that on average, when seeking the lowest price, a consumer can find a reduction of about ten percent. Consequently, the directive has increased the supply of motor insurance products in Italy.

However, the insurance market in Italy was not entirely positive after the implementation of the third directive. The belief was that the directive would result in a greater stability of premiums. However, the market was not in a good condition before the directive, thus leading to unexpected results. Instead of causing tariffs to become more stable, they have risen dramatically, as shown in Table 1. In fact, the average premium increase from 1980 to 1994 was just over four euros a year. In the period from 1994 to 2004 that increase has been about eleven euros per year. However, ANIA (2005) illustrates that these rate increases are not the direct result of the third directive. The increases are primarily from property damage and an increase in the cost of the cost of vehicle repairs. In fact, from 1996 to 2004, there has been an average increase in the cost of property damage per claim of 70%. This compares to a 20% overall increase in prices. Similarly, Turchetti and Daraio (2004) report that the increasing premiums are the result of combination of several factors: an increase in the number of vehicles, higher powered cars, higher insured value, increase in the average cost of compensations for damage, the rise in the cost of repairs, frequency of cervical spine lesions, and the frequency of fraud.

<sup>8</sup> For additional reading about the regulation of pricing variables, see Luperto and Porrini (2005) or Buzzacchi and Valletti (2002).

Because the determination of pure premium is not solely by the average cost of claims, it is also necessary to consider claim frequency, which has declined. Similarly, this should not be attributed to the implementation of the third directive. Rather, ANIA (2004, 2005) reports that vehicles are safer, cars are driven less, more fraud checks are occurring, less minor damage is being reported, and a driving record reflecting traffic violations.

To create an improved marketplace, the Italian government attempted two courses of action, both occurring in 2000: antitrust regulation and a price freeze. As reported by ANIA (2001), the Italian motor insurance market had antitrust violations by 39 of the 81 companies in the motor insurance market. It was found that these 39 companies were exchanging data and therefore creating similar rates. This cooperation by companies was found to have contributed to the significant price increases<sup>9</sup>. Accordingly, prices were not free to competition, causing a smaller supply of products.

Antitrust regulation was not the only way that the government attempted to retain control over escalating premiums. In response to increasing prices, the government took action to freeze tariffs in 2000, stating, "that insurance companies shall not apply any rate increase to policyholders that have not been the cause of claims during the last period of observation as regards third party motor liability policies renewed within one year from 29 March 2000..." (ANIA, 2000) This effectively prevented any further price increases. However, because the action violated the third directive, ANIA took the issue to the European Court of Justice.

The Court of Justice concluded that the price freeze was in violation of European regulations. Specifically, that the regulations were designed so that rates were to be freely established (ANIA, 2003). Consequently, the principles of the third directive caused the tariff freeze to be overturned. Accordingly, the third directive did in fact promote competition, and did not allow the government to restrict the competition.

### **US Regulatory Consequences**

Consequently, using the stated goals of providing consumer protection by promoting competition and increasing access insurance products, a model using regulations from the EU and Italy will be developed. To develop this model, it is first necessary to understand the condition of auto insurance rate regulation in the US. There is a great variability in regulations in the US because each state, instead of federal government, has been regulating the commerce of insurance. In Illinois, insurance companies are free to set their own rates, known as competitive rating, although they may be required to provide supporting documents to justify their rates. This is the most liberal form of all rating laws in the U.S. On the other extreme is the prior approval system of New Jersey until 2005. The strict regulatory system caused a number of insurers to refrain from conducting business in the state.

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<sup>9</sup> For additional information regarding the price increases and possible solutions for the price increases, see Buzzacchi (2001). This paper is in Italian.

These extremes show that regulation is by no means similar. It is for this reason, that a system of rate regulation making all states required to use the exact same regulations would not be a possible solution, at least politically. Adopting a system similar to the one that the European Union imposed does not mean that all states must act in the same manner. Instead, it means a national system customized by each state. An example of the use of variables to customize rates by country in the EU is included as part of Table 3. Although Italy, Belgium, France, Germany, Spain, and the United Kingdom are all part of the EU, national regulations cause different variables to be used depending on the country.

Although the Italian market did not produce results as expected, it has provided a number of important lessons that should be applied to the US. First and most important is that the indications of the market should not be ignored. As was the case in Italy, regulators imposed rates that caused the combined ratio to increase. The result was first insolvencies, and second, the use of large rate increases which were needed to adjust the tariffs to adequate levels. Although, it took the market eight years to reach the point where the combined ratio was less than 100%, rate increases in the past two years have been under 5% (ANIA, 2005). Accordingly, the implementation of this lesson for pricing is through allowing companies to set rates as they see fit. Further analysis of this topic would require examining solvency regulation<sup>10</sup>, but it is beyond the scope of this paper and should be the subject of future study.

As demonstrated by the ruling in case C-59/01, regarding Council Directive 92/49/EEC, the goal is to provide "the widest possible range of insurance products in the Community so that he can choose that which is best suited to his needs" (2003). Applied to the US, a similar conclusion should be drawn. More precisely, a national regulatory system that ensures pricing regulation allowing insurers to set their own rates is most suitable. This system, as in the EU, should act in a way that encourages responses to the market, rather than a system designed to control pricing systems. However, such a system that absolutely prohibits prior pricing controls would be difficult to pass politically. Therefore, the provision of "general price control systems" should be added. By requiring this provision, the auto insurance industry would not be singled out by regulators. Instead, many industries would have to be included within the controls.

Creating a system that encourages states to open the auto insurance marketplace to the free market will cause two events to happen: greater competition to exist among states and a greater quantity of products to be offered. These two points are illustrated from the recent example of market deregulation in South Carolina. Prior to deregulation in South Carolina, regulations limited insurers in their use of accident history, territories, and mandated a 20% safe driver discount. In addition, there were strict enforcements of price

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<sup>10</sup> The role of solvency regulation is to make sure insurers have enough money to pay claims, thus preventing insolvency. Current regulations require solvency regulation to be overseen by the member country in which the head office is located. There is an overall guideline, and each country can set control solvency how it sees fit. Accordingly, each country can determine categories for investments, valuation of assets, and calculation of technical reserves (The Council of European Communities, 1973). For additional reading about EU insurance solvency, see CEA (2006).



ceilings. These combinations led to a large residual market<sup>11</sup> where customers in the normal insurance market were heavily subsidizing the residual market. Initial reports by Cummins (2002) tell of the positive results of deregulation. First, a substantial reduction of the residual market, from 42% in 1992 to 28% and falling in 1998, has occurred. Additionally, an increase in the number of companies participating in the market occurred. In 1999, the year of deregulation the number of companies participating in the South Carolina market increased from 61 to 104. Therefore, deregulation of pricing regulations has been shown to provide both increased competition and an increase in products offered in Italy as well as South Carolina.

### **Conclusion**

The implementation of the third EU non-life directive has greatly changed the Italian motor insurance market. By creating more competition and a greater supply of products, the directive has helped to deregulate the marketplace. The deregulation, however, did not transfer all control from the Italian government, as antitrust solutions were successfully applied in 2000.

This model of motor insurance between the EU and Italy, should act as a guide for a US state and federal auto insurance system. Because research supports a uniform insurance regulatory structure, a federal governing body should be established. The federal body would set national regulations that must be used by states. Each state would then have the power to control operations within it, such as acceptable variables or antitrust violations. Accordingly, a federal oversight group should be created in order to oversee the regulation of the pricing of auto insurance in the United States.

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<sup>11</sup> A residual market occurs when insurers do not voluntarily insure consumers and are instead required to insure these individuals, who are considered higher risks.

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**Table 1**

**Rate Increases in Italy (1984-2004)**

Year	Premium (Base 1984)	Inflation (Base 1984)
1984	100.0	100.0
1985	106.9	108.3
1986	115.7	114.6
1987	121.4	119.7
1988	124.6	125.4
1989	134.2	133.3
1990	147.4	141.3
1991	165.2	150.8
1992	179.9	159.8
1993	184.2	166.8
1994	189.6	173.6
1995	199.8	183.4
1996	210.1	191.1
1997	226.8	195.7
1998	239.6	200.7
1999	264.2	207.7
2000	276.5	215.8
2001	286.7	224.0
2002	302.9	233.7
2003	312.3	242.1
2004	313.7	247.1

Source: Associazione Nazionale fra le Imprese Assicuratrici (2005)

**Table 2**

**Claims Frequency and Average Claims Cost in Italian Motor Insurance 1980-2004**

Year	Claims Frequency	Average Claims Cost <sup>12</sup>
1980	15.21%	1227
1981	14.33%	1272
1982	13.84%	1244
1983	13.40%	1359
1984	13.42%	1395
1985	13.46%	1432
1986	13.61%	1487
1987	14.04%	1519
1988	14.00%	1545
1989	14.69%	1505
1990	14.61%	1541
1991	14.02%	1634
1992	13.42%	1748
1993	11.83%	1947
1994	11.19%	2025
1995	11.71%	2153
1996	11.63%	2256
1997	11.54%	2395
1998	10.95%	2635
1999	11.05%	2815
2000	10.95%	3105
2001	9.55%	3427
2002	8.78%	3707
2003	8.63%	3889
2004	8.45%	3965

Source: Based on Associazione Nazionale fra le Imprese Assicuratrici (2005) and US Department of Labor (2005) data

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<sup>12</sup> Real cost in 2004 euros

**Table 3****Rating Variables in EU Member Countries and selected US states (1996 data)**

	Italy	CA	N J	PA	TX	Belgium	Canada	France	Germany	Spain	UK
Experience Rating	X	X				X	X	X	X	X	X
Gender	X		X	P*	X	X	X	X		X	X
Age	X		X	X	X	X	X	X	X	X	X
Place of Residence	X					X	X	X	X	X	X
Occupation	X						X	X	X		X
Marital Status	X		X	X	X		X	X			
Years of Driving License	X	X				X	X	X		X	
Coverage of Specified Driver							X	X	X		X
Parking							X				X
Car Type	X		X	X	X	X	X	X	X	X	X
Car Age									X		X
Mileage for year	X	X		X	X		X	X	X		X
Car Utilization	X		X	X	X	X		X		X	X
Car Power	X					X		X	X	X	X
Safety Device	X										X
Ownership of more than one car						X	X		X		

\* Prohibited

Source: Autorita Garante della Concorrenza e del Mercato (2003)