

Risk management for an enlarged EU

In cooperation with Economist Corporate Network and Economist Intelligence Unit

Product liability

CONSUMER PROTECTION is an integral part of the EU’s single market legislation. Companies that operate in EU member states have to comply with 14 directives designed to protect consumer rights. In particular, product liability legislation aims to make manufacturers responsible for complying with product standards and holds them liable for all damages.

In most accession countries, EU product liability directives are already transposed into national law. Yet Enlargement is still going to have a significant impact. Legal requirements will be increased with the introduction of a new product safety directive. Consumer awareness of rights is



growing. Weak monitoring and enforcement capacity at the government level will lead to inconsistencies in implementation of the rules. These factors mean that companies need to reassess their product liability exposures.

Legal changes in the accession countries

ALTHOUGH MOST directives are already in effect in the accession countries, the crucial exception is a revised General Product Safety Directive, introduced in the EU-15 on 15 January 2004 and due to come into force in the new member states on 1 May 2004.

This directive broadens the scope of product liability to include all suppliers in the manufacturing and distribution chain, including importers, retailers, designers and component makers. Among other

things, the new laws will mean:

- The burden of proof will be reversed in the event of injury, loss or damage. Proving negligence will no longer be necessary by the claimant. Instead a system of strict liability will mean that suppliers and producers will have themselves to prove that they have done everything in their power to prevent or reduce the risk of injury, loss or damage

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Executive summary

- Product liability requirements are about to get tougher in the accession states. A new General Product Safety Directive comes into effect in new member states on 1 May 2004, broadening the scope of product liability to include suppliers and increasing the risk of product recall. Those suffering loss or damage will no longer need to prove that producers are negligent. Instead a system of strict liability will apply.
- Consumer organisations are gaining clout. Although the monitoring and enforcement capacity of governments in the accession states will remain weak at first, consumer groups are gaining influence. As awareness of consumer protection issues rises, companies that fail to maintain high product standards risk reputational damage.
- Many companies are ill-prepared for the eventuality of a product recall. The rising likelihood of product recalls will prove a major operational challenge for companies and policymakers in the accession countries, where there is little experience of such things.
- Smaller, local companies have the steepest learning-curve. Multinational companies generally have stringent internal control measures in place already, and most larger local companies are also well on the way to compliance. Smaller companies and non-exporters have only a brief window of opportunity to upgrade standards after accession.
- A recent survey showed that about 35% of companies in the East European candidate countries were not yet compliant with the acquis on consumer protection and product liability – over 40% in SMEs.¹
- A failure to identify, assess and manage product quality issues will result in real disadvantage in the marketplace. The bar is rising on product standards in Central and Eastern Europe. In home markets, consumers are increasingly aware of the protection to which they are entitled. And in the wider European firms marketplace, companies need to have proper processes in place across the supply chain if they are to qualify for product liability insurance, partner with EU firms and penetrate EU markets. The opportunities of the enlarged market are only open to those firms that manage product-related risks properly.
- Product liability insurance is likely to become more expensive. All the points above mean that the frequency and severity of claims will increase. As an inevitable result, within 2 to 3 years we are likely to see substantial changes in CEE insurance market conditions for product liability exposures.

¹ "Corporate Readiness for Enlargement in Central Europe. A company survey on the state of preparations for the single market 2003", Eurochambres and SBRA, May 2003.

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- More stringent reporting requirements for products that are already in the marketplace and pose serious risks. Hefty penalties will be levied on firms that do not report such products
- Enhanced information-sharing between member states and the European Commission
- Increased market surveillance, through systems such as the Rapid Alert System on Dangerous Products (RAPEX), which reports to the European Commission, in co-operation with national authorities, on products posing serious risks to consumer health.
- More intrusive product recall requirements, since regulators will be able to order a product recall from businesses in the supply chain and end-consumers if products are found to be dangerous.

Product recall

Product recall could prove especially challenging for regulators and local companies in accession countries since

there is no relevant experience in handling recall processes. The direct consequences of a product recall with its scandal, boycotts and media exposure can cost companies millions, influence share price and damage fatally the brand, potentially leading to bankruptcy. For instance, when in 1990 Perrier had to recall their contaminated mineral water, \$250 million were spent on the physical withdrawal of its bottles.

Business continuity plans outlining what must happen in the event of such a crisis are essential for all businesses facing this exposure. A PR-strategy, recall plan and targeted use of insurance will minimise company costs.

ONE TO WATCH FOR...

A new EU regulation on the Registration, Evaluation, Authorisation and Restriction of Chemicals (REACH) has been proposed. The draft requires manufacturers and importers of chemicals over one tonne per year to detail all properties, hazards and uses of the substance prior to authorisation by a new European Chemicals Agency. The proposal has three potential areas of impact :

- significant costs involved in registration
- potential restrictions in a chemical's usage
- increased liability and recall costs for chemicals registered inaccurately or deemed unsafe.

The food sector

One sector has more time to get its house in order – the EU has agreed to transition periods of three years after accession for certain, licensed food-processing establishments. Others that do not meet requirements will be closed down on accession. Those establishments that have been granted transition periods can only sell their products domestically; these products have to be clearly marked.

Monitoring in the food industry is particularly stringent, thanks in part to heightened West European sensitivities following health scares such as BSE and foot-and-mouth disease. Meat and

dairy exporters will fall under a comprehensive monitoring system known as the Hazard Analysis of Control and Critical Points System (HACCP), without which they will not get export certification. Food packaging and labelling is also heavily legislated in the EU and the regulatory regime will require many changes in the new member states. Compliance with these requirements is necessary but it is often not sufficient to satisfy the requirements of EU retailers: food suppliers from Central Europe must meet quality standards which go above the minimum EU legal requirements if they want to get on West European shelves.

Enforcement and monitoring capacity

INTRODUCING LAWS is the easy bit – monitoring and enforcing them is a very different matter. The EU’s central institutions can bring some market surveillance powers to bear. But throughout the region, monitoring and enforcement institutions are generally new and still relatively untested. “Nobody knows how to deal with enforcement at the level of public administration, consumer rights organisations or local small businesses,” says a spokesman for one pan-European consumer organisation.

Market surveillance, monitoring and enforcement capabilities are widely reckoned to be most effective in the Czech Republic and Slovenia. The Baltic countries would appear to have furthest to go.

Despite some EU aid programmes, the judicial system does not have the right enforcement procedures and trained people to enforce new consumer rights quickly and effectively. There is not enough money to build up administrative capacity rapidly. And there is a lack of co-ordination between the various administrative and judicial bodies.

Patchy and inconsistent enforcement of the rules constitutes a clear risk management challenge. There are two particular implications for organisations to consider. First, firms must be ready for the judicial landscape to change and for hitherto disregarded areas of activity suddenly to become the focus of attention. Second, there is a real opportunity for competitive advantage for those firms that aspire to go beyond mere compliance. Companies that match their product standards not to the enforcement capacity of governments but to the quality expectations of customers will perform better in the marketplace.

That’s particularly true given that it is not only governments who oversee product standards. Under EU law, independent consumer organisations have the competency to promote consumer protection through a wide range of measures. The activities of these non-governmental organisations (NGOs) include the promotion of consumer rights awareness, testing and evaluation of products, and monitoring product safety, depending on national laws and practice. They can also process claims and take action on behalf of consumers.

These NGOs are still weak in some accession countries. In Poland, for example, the government has been accused of interfering in the autonomy of consumer organisations, reducing their effectiveness and access to funding. For instance they are not allowed to sell their products and services, which is the main source of income of many consumer organisations across Europe, while in the Czech Republic consumer organisations are better funded and supported by the government.

Nevertheless, as in the EU-15, new policies on consumer rights have led to an increase in consumer awareness. In the Czech Republic, for example, high-profile consumer protection cases were brought against an Austrian bank and a local telecoms provider in 2003. Both cases were settled out of court. Both would have been unthinkable two or three years ago.

**CONSUMER PROTECTION:
ACCESSION COUNTRIES READINESS**



Source: ECN (Estimates based on research and interviews.)



Risk awareness in Central Europe

IN THIS changing environment, certain firms are far better placed than others. Multinationals appear to have less to do in the product liability arena than local firms. Many multinational companies have global or regional teams working on safety standards and most have product liability insurance.

For these companies, the harmonisation of product liability standards is a welcome development. Harmonisation removes the need to comply with individual country standards across the new member states. In the words of a manager at one multinational toolmaker, whose suppliers in Central Europe meet international

standards already: “We can hopefully forget local certification requirements in Poland and Slovenia and rely on EU certification.”

Many larger local companies, themselves suppliers to international companies, have also already implemented EU standards. “Product liability is not a new challenge to our company,” says an executive at a large Hungarian automotive supplier. The company was ISO-certified in 1997 thanks to the need to meet quality expectations from foreign customers. And it took out product liability insurance before the EU directive even became Hungarian law.

In the same vein, a leading Polish meat producer already has HACCP standards in place because it has been exporting to the EU for years. The company is now introducing changes to its product labels in order to comply with EU nutritional food labelling requirements but in the eyes of one company executive, the biggest impact



of EU accession will be the rapid consolidation that follows as meat processors close down.

Competitive advantage

That's not to say these companies can afford to stand still on product standards. Compliance is only a starting point for the best companies. Firms that strive to implement higher quality production standards and that put measures in place to safeguard their brand in the event of something going wrong may not be any more compliant, but they are at a competitive advantage.

Take the example of a large Czech pharmaceuticals company whose products have been developed, tested and registered according to standard EU rules for several years. The company has been implementing Good Manufacturing Practice (GMP) programmes for the past decade, has a product liability insurance policy in place and maintains a team focused on dealing with emergency issues. "Generally we do not wait to implement EU standards until it becomes an issue for law enforcement," says one executive at the company.

Not all large companies are up on EU law, of course. One of the companies we interviewed for this paper, a large local electricity producer operating in Central Europe, was not aware that, under the general product safety directive, producers

or suppliers of energy could be liable for another company's business losses caused by a power outage. As an example of the potential magnitude of these losses, Italy's retail trade association estimated that September 2003's blackout cost the food industry EU 120m in lost business and frozen food. The fact that the blackout began in the middle of the night and at a weekend helped reduce the overall impact, but the implications for the power sector are clear.

But it is the smaller companies, and particularly those that only cater to the local market, which will struggle most to meet new EU standards. There is a general lack of awareness regarding the changes to be implemented. Upgrading production infrastructure and hygiene and sanitary standards is very costly and time-consuming – even those plants which have been granted transition periods for upgrading are likely to request an extension to implement required changes. Small companies will have particular problems meeting product recall requirements.

Time will not run out for these firms on 1 May 2004. Government incompetence will give smaller local players a window of opportunity to introduce the required upgrading, says one executive at a multinational company in the region. But the clock will be ticking.

Learning lessons: Best practice in the EU-15

 **ADOPTING BEST** practice product safety controls will enable businesses in Central & Eastern Europe to:

- Build partnerships with other EU businesses more easily
- Generate external financing/investment more efficiently
- Develop a reputation for quality and reliability with customers
- Pick only the best suppliers to meet business goals

- Target investment in risk management measures, such as product liability insurance.

Every step in the business cycle must be evaluated, from product design to final consumption, when designing risk management solutions for product liability. It is critical to receive ongoing advice on relevant rules and legislation, including industry-specific European safety legislation.

CHECKLIST OF KEY RECOMMENDED ACTIONS

The list of actions below provides a useful framework against which to benchmark.

Management systems

- Appoint a senior/Board Director to chair an internal product safety committee
- Publish a product safety 'statement of intent' that explains internal safety goals for all parts of the business
- Use the safety committee to oversee compliance of all parts of the business with stated internal safety goals
- Monitor product liability decisions in courts to understand how regulations are being enforced
- Monitor future changes to regulations

Risk assessment process

- Implement a process for identifying all potential product safety exposures
- Quantify the potential impact of product liabilities using measures for impact and frequency that are meaningful to all functions within the business, e.g.
 - Multiple deaths
 - Loss of assets or revenues exceeding EU10m
 - National TV news headlines/ Government investigation
 - Total business cessation for 1 week
- Prioritise remedial action/risk management investments based on these measures

Record keeping

- In one, easily accessible internal library of information, maintain clear records of all product safety decisions, including:
 - Design and design modifications
 - Component and raw material specifications
 - Packaging and labelling
 - Marketing
 - Distribution
 - Dates of supply
 - Customer complaints
- This documentation will be critical evidence in the event of a product-related incident and will facilitate recall activity

Research & development

- Keep full records of product design specifications and modifications
- Conduct thorough safety assessments at the design stage, and keep records of said assessments
- Undertake rigorous documented product testing

Specification of components and raw materials

- Audit suppliers for quality assurance thoroughly, ensuring as a minimum that EU standards are complied with and including checks on financial status and insurance coverage
- Retain copies of suppliers' quality specifications
- Keep full records on stock management processes

Manufacturing

- Achieve ISO or similar certification for all processes
- Implement best-practice internal auditing procedures and records
- Pro-actively ask customers for their auditing procedures and surpass their requirements!

Packaging & labelling

- Mark all durable products being sold in the EU with the CE stamp, demonstrating that they meet EU standards
- For imported goods, implement correct assessment procedures to ensure EU compliance and apply the CE stamp
- Keep full records of assessments and audit results
- Regularly review product warnings, labels and notices for accuracy and user-friendliness

Sales & Marketing

- Ensure all promotional material and statements are aligned with product safety standards and internal goals
- Audit sales contracts regularly to ensure unquantified liabilities are not being assumed

Distribution

- Keep distribution records and maintain a retrieval system
- Maintain records of distribution control procedures
- Undertake due diligence of distributors and audit their insurance coverage

Product recall

- Design procedures that are practical, focusing on helping the business react quickly, reduce its exposure to consumer claims and minimise brand damage.
- Design and implement business contingency plans addressing national and cross-border regulatory issues
- Ensure traceability of product and its components
- Keep records of all product failures and responses from the authorities
- Train key personnel in media handling in the event of a crisis

Insurance implications

This report has made it clear that EU standards on consumer protection will increase product liability exposures. More companies will therefore seek appropriate risk management solutions and it will become more and more customary to transfer such risks to the insurance market. It is also clear, though, that an inevitable increase in claims frequency and liability is going over the next 2 to 3 years to have an upwards pull on insurance prices and deductibles and will lead insurers to review the terms of the policies they offer in the CEE region.

Coverage areas such as contractual liabilities and product recall are likely to be tightened, sub-limited or even excluded. The trigger for some types of liability coverage may be changed from a 'claims occurring' to a 'claims made' basis, for example medical malpractice. This means that products that have been manufactured for years and are subsequently found to be dangerous will not benefit from historic insurances in place at the time when manufacturing of the product – and therefore damage caused by the product – began. Instead, only insurance in place at the time of a claim becoming apparent and being declared will operate. This means insurers will be able to impose coverage restrictions once specific product dangers become apparent. Certainly very specific information will be asked by insurers who may have previously agreed to provide cover on a fairly non-specific basis. Insurers may also require certain risk management criteria to be met before cover is granted.

Industries with particular exposures that will focus insurers' attention include:

- Those with significant US exposures
- Component industries, e.g.
 - automotive
 - Construction materials
 - Consumer goods
 - Chemicals and pharmaceuticals
 - Food and beverage

There are a number of ways that businesses can manage these likely changes in the insurance market. Implementing the risk management frameworks suggested by this report is a start. Quantifying and prioritising product liability exposures will help companies assess the true value of investing in insurance.

Furthermore, good and demonstrable risk management will help control insurance costs and therefore limit negative impacts on a business's cost base – critical for the maintenance of cost advantages in the Central & Eastern European region.

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Mission of the Czech Republic to the EU in Brussels

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www.spcr.cz

Ministry of Industry and Trade

www.mpo.cz

Czech Agriculture and Food Inspection Authority

www.szpi.gov.cz/

National Institute of Public Health

www.szu.cz

Czech Trade Inspection

www.coi.cz/

Delegation of the European Commission to Estonia

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Estonian Employers' Confederation (ETTK)

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Ministry of Economic Affairs and Communications

Consumer Protection Board

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Confederation of Hungarian Employers' Organisations for International Co-operation (CEHIC)

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Ministry of Economy & Transport

www.gkm.hu

General Inspectorate for Consumer Protection

www.fvf.hu

LATVIA

Delegation of the European Commission to Latvia

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www.eiropainfo.lv

Mission of Latvia to the EU in Brussels

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Free Trade Union Federation of Latvia (LBAS)

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Consumer Rights Protection Centre

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European Commission Delegation to Lithuania

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Lithuanian Confederation of Industrialists (LPK)

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www.lpk.lt

National Council for Consumer Protection

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Fax: +(370) 5 279 1466
www.nvtat.lt

POLAND

Delegation of the European Commission to Poland

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Fax: (4822) 520 82 82
www.europa.delpol.pl

Mission of Poland to the EU in Brussels

Tel: (322) 777 7200
Fax: (322) 777 7297

Polish Confederation of Private Employers (PKPP)

Tel: (4822) 845 9550
Fax: (4822) 845 9551
www.prywatni.pl

Office for Competition and Consumer Protection

www.uokik.gov.pl
Tel: (4822) 826 9041
Fax: (4822) 826 5076

SLOVENIA

Delegation of the European Commission to Slovenia

www.evropska-unija.si

Mission of Slovenia to the EU in Brussels

Tel: (322) 512 4466
Fax: (322) 512 0997

Association of Employers of Slovenia (AES)

Tel: (3861) 563 4880
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Ministry of Economy

Institute for Consumer Protection
www.zrvod-zvp.si
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Delegation of the European Commission to the Slovak Republic

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Mission of the Slovak Republic to the EU in Brussels

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Federation of Employers' Associations of the Slovak Republic (AZZZ SR)

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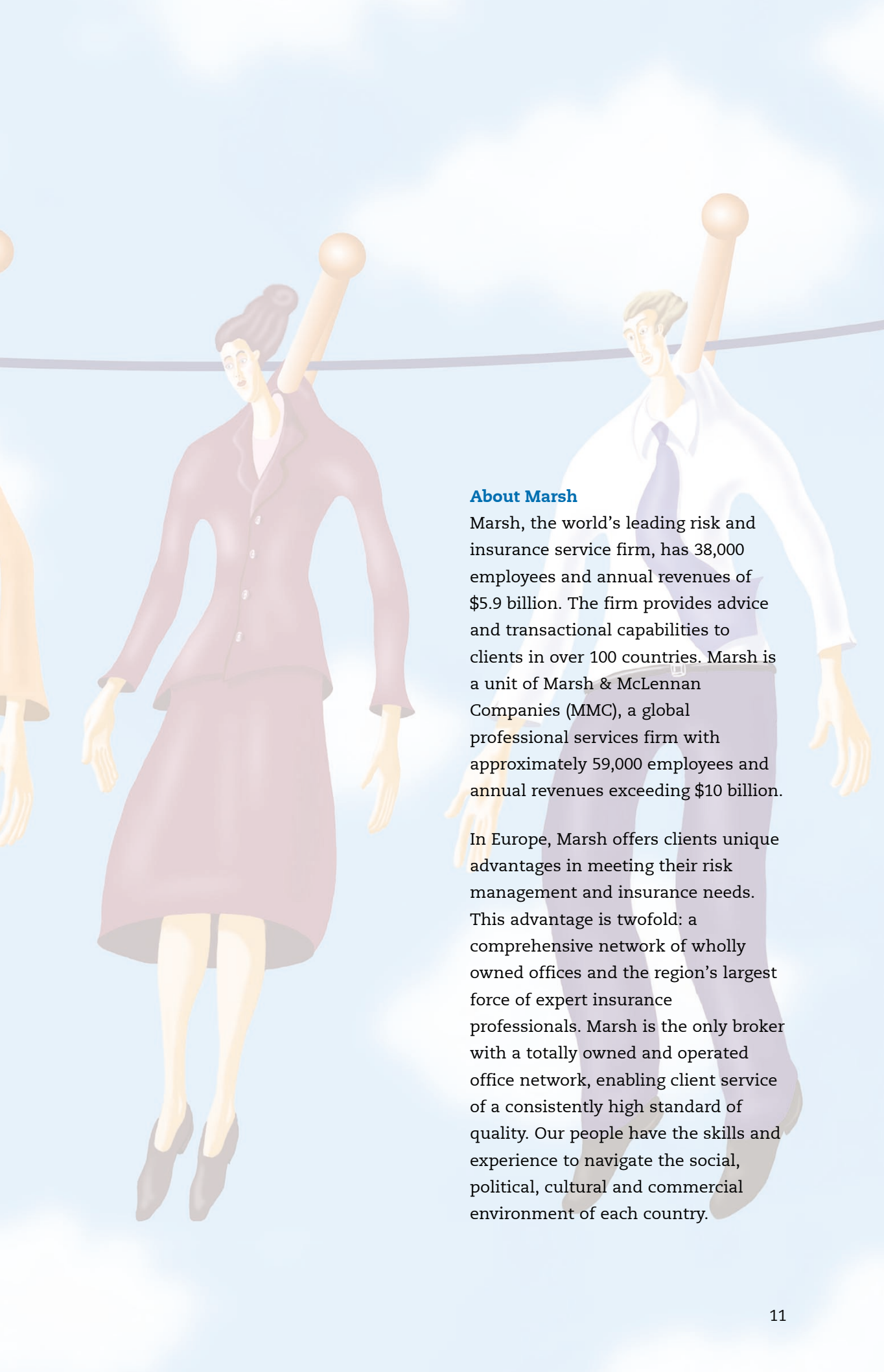
Ministry of Economy

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Consumer Protection

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This paper is the second in a series of five to be published by Marsh in co-operation with Economist Corporate Network and Economist Intelligence Unit. The papers address the risk management implications of EU enlargement for businesses operating in the accession countries. This second paper is focused on product liability. The first paper was an introduction to the series. Forthcoming papers will address the following topics:

- Health and Safety/Employee protection (available April 2004)
- Environmental liabilities (available June 2004)
- Directors' and officers' (D&O) liability (available September 2004)

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