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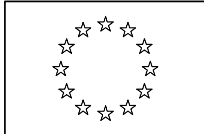

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**COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE COUNCIL, THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE AND THE COMMITTEE OF THE REGIONS**

**Sector Inquiry under Article 17 of Regulation (EC) No 1/2003 on business insurance (Final Report)**

{COM(2007) 556 final}

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# I. INTRODUCTION

## 1. BACKGROUND AND AIMS OF THE INQUIRY

The Commission decided on 13 June 2005 to initiate a sector inquiry into the provision of insurance products and services to businesses in the Community, based on its competences under the EC competition rules[1].

This decision was based on concerns that in certain areas of both the writing and distribution of business insurance, competition may be restricted or distorted within the common market. The sector inquiry aimed at better understanding the functioning of the sector with a view to ultimately identifying any concrete restrictive practices or distortions of competition that may fall within the scope of Articles 81 or 82 of the Treaty. This might further lead to follow-up enforcement action either by the Commission or by national competition authorities within the European Competition Network.

The purpose of this report is to present the findings of the Commission's sector inquiry and to allow all interested parties to submit their comments and observations and/or review their business practices. Bearing in mind that it inevitably also identifies market failures which are not, or do not appear to be, infringements of competition law, the report will also feed the ongoing debate at EU and national levels on the right regulatory environment for the insurance industry.

The scope of the report is limited to the EU-25 Member States, that is to say, that it does not include Bulgaria and Romania, which joined the EU only on 1 January 2007. Where necessary, a further subdivision was made between the ten members which joined on 1 May 2004 (EU-10)[2], and the remaining 15 Member States (EU-15).

Insurance is of vital importance as a risk management and transfer tool for businesses throughout the Community, big and small. The ability to insure given risks may make or break a particular business model, its ability to raise finance and the costs of doing so. Lenders and even providers of equity capital will often link financing decisions to the insurance of key assets, and all the more so when these assets are pledged as collateral or the cashflow from them is securitized for sale to investors. Many of the world's most important and iconic industries, from aviation and shipping to major real estate developments could not function without insurance, and when insurance markets lack the capacity to insure risks this has a knock-on effect on the whole economy. Accordingly, the operation of this industry is of vital importance. European insurers and reinsurers are also very active in international markets, and major investors in capital markets.

The insurance industry, however, has tended not to be examined outside the industry with the same degree of interest as other areas of financial services. This is likely gradually to change, with the Commission's work on Solvency II[3] and the Insurance Mediation Directive[4]

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1 Council Regulation (EC) No 1/2003 of 16 December 2002 on the implementation of the rules on competition laid down in Articles 81 and 82 of the Treaty and, in particular, Article 17(1) of said Regulation; Commission Decision of 13 June 2005 initiating an inquiry into the business insurance sector. See also Communication by Commissioner Kroes in agreement with Commissioner McCreevy, "Memorandum on sector inquiries in financial services (retail banking and business insurance)", both published on the European Commission's internet web-site at http://ec.europa.eu/comm/competition/antitrust/others/sector_inquiries/financial_services/.

2 Cyprus, Czech Republic, Estonia, Latvia, Lithuania, Hungary, Malta, Poland, Slovakia and Slovenia.

3 Proposal for a Directive of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance - Solvency II - COM(2007) 361, 10.7.2007.

4 See http://ec.europa.eu/internal_market/insurance/mediation_en.htm

particularly in the forefront of debate. Through this report, the Commission's intention is to contribute to an even more competitive, dynamic and profitable European insurance industry able to play its full role in the economy and fulfil its potential in the European Union of the twenty-first century.

## 2. ORGANIZATION OF INSURANCE MARKETS IN THE EU

The Interim Report contained an extensive account of how insurance markets are organized in the EU, including a good deal of original research by the Commission services during the inquiry, which will not be repeated here. However, it is useful to recall briefly some salient features.

Primary insurance markets for most risks tend to be national in scope, even when they are primarily served by consolidated multinational insurance groups. This is for a variety of reasons, of which the most important is probably the fact that insurance contracts are written under, and subject to, general national contract law as well as specific insurance law, and that liability issues similarly arise under national law which may substantially vary from one jurisdiction to another. In addition, there is a need for a local presence, often for distribution and always for claims settlement, and language issues may arise. It is natural thus to characterize the organization of the market as multi-domestic and to exclude, in many cases, the possibility of any competitive constraint from cross-border providers short of actual entry.

The mode of entry for insurers seeking to enter new markets has, to date, usually been through acquisition of a local company which becomes a subsidiary of the acquirer. Greenfield entry is uncommon. National markets tend as a consequence to be quite concentrated, especially in the major categories of risk.

Insurance is distributed through independent brokers, tied agents, banks (so-called bancassurance) and direct sales, including internet sales. The latter channel is in most cases still in its infancy, especially for business insurance. The report returns to the question of distribution in Chapter 4, however it is worth already noting that the need to build a distribution network may be a barrier to entry, especially in the absence of a strong independent brokerage network. However, this does not prejudge the efficiency of different distribution arrangements.

## 3. METHODOLOGY AND DATA

### 3.1 Phase One (leading up to the Interim Report)

The information contained in this report was obtained through desk research and through an analysis of responses to questionnaire-based surveys of some of the major participants in the EU insurance market. The surveys included EU insurance companies, insurance intermediaries, reinsurance companies as well as associations of insurers, intermediaries and risk managers. A full description of the primary methodology was included in the Interim Report previously published and is omitted here for brevity[5]. Certain recurrent themes relating to methodology and reliability of data, however, are worth mentioning and are accordingly presented in Annex 1.

A number of surveys were used to gather data for analysis. The information was mainly collected on a yearly basis for the period 2000-2005.

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[5] Interim Report on the Business Insurance Sector Inquiry of 24 January 2007, available on-line at the address cited in footnote 1 above.

An initial survey was conducted among 27 national insurance associations in the EU-25, 38 intermediaries associations in 22 Member States and 12 risk management associations (i.e. associations of purchasers of insurance, primarily within large corporations) in 10 Member States.

The survey of associations requested information on the structure of national markets, companies active in them and on distribution channels as well as on specific market-related issues. This survey was intended to narrow the scope of the inquiry and provide information to assist the sampling process for the major survey of insurance companies and insurance brokers that followed. There was considerable variation in the depth and detail of the information provided by the respondents in this survey.

A second survey of 28 national insurance associations was conducted in 2006. This survey aimed mainly at obtaining a selection of the information already requested, in a more structured and comprehensive format, allowing easier comparisons of data. The survey was focused on the horizontal cooperation at associations' level in the framework of the Block Exemption Regulation. It also covered claims settlement agreements.

First surveys of insurance companies in all Member States, and of intermediaries in a selection of Member States, provided major sources of data for the Sector Inquiry. Questionnaires were designed to elicit information on a wide range of matters, including the ownership and structure of the companies concerned, financial information on premiums, revenues etc, information on insurance products and prices, on distribution channels (or on relationships with insurers in the case of intermediaries), on reinsurance, international activities and a variety of other issues. The questionnaires were ‘road-tested’ by a selection of insurance firms and other experts before being circulated to the chosen addressees.

For the insurer survey the sample consisted of approximately 250 insurance firms from the 25 Member States. The sampling methodology and some of its possible limitations were described in the Interim Report[6]. The aim of the sample selection for each Member State was to ensure that both the major players and a selection of smaller firms were included in the sample while, as far as possible, preserving a degree of randomness.

The intermediary survey concerned 164 intermediaries, limited for practical reasons to 14 Member States which nonetheless represented between them a variety of situations and the major part of the market[7]. For reasons discussed in the Interim Report, the scope of the survey was limited to insurance brokers or intermediaries of a similar character to insurance brokers, such as independent agents having relationships with a significant number of insurance companies[8]. It therefore excluded tied agents and bank channels.

In addition to the surveys mentioned above, a survey of 11 reinsurers was carried out, based on a short questionnaire which mainly concerned the existence and prevalence in the market of the so-called “best terms and conditions” clause, contingent commissions paid to reinsurance brokers and the activity of reinsurers relative to the Block Exemption Regulation (possibly inside insurance associations).

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[6] Chapter II, Section 2.2.2.1.

[7] Belgium, Germany, Denmark, Spain, Estonia, Finland, France, Italy, Hungary, the Netherlands, Poland, Portugal, Sweden and the United Kingdom.

[8] Chapter II, Section 2.2.2.2.

## 3.2 Phase Two

The Interim Report was published on 24 January 2007 with a public invitation to comment on its findings, and notably on a number of key issues laid out in section X.3 of that report. These included, in the order they will be tackled in the current report, the discrepancies between the combined ratios achieved for business with Small and Medium-Sized Enterprises (SMEs) and with Large Corporate Clients (LCCs) respectively; "best terms and conditions" clauses; intermediaries' remuneration and commission rebating; horizontal cooperation between insurers; and long-term agreements.

The deadline for responses was originally set at 10 April 2007, but was extended to 15 May 2007 in the case of insurance customers in order to allow more time for considered responses.

A public hearing to discuss the findings of the Interim Report and the next steps was held in Brussels on 9 February 2007. It was attended by over 240 representatives of insurers, intermediaries, risk managers and SMEs and their associations, regulators and national competition authorities.

Although it was impractical to translate the Interim Report itself, the Commission made available translations in all official languages (except Bulgarian, Romanian, Irish and Maltese) of the executive summary and the issues for consultation, and invited submissions in a range of languages. Conscious of the need to involve customers more in the findings of the report, the Commission services attempted to contact them through relevant EU level associations, inviting these to contact their national member organizations and the latter to proactively solicit views from their members. The Commission services also invited customers to contact them directly with concerns. However, only a few reactions of this type were obtained. Finally, national competition authorities were asked to arrange consultations on the report at national level and communicate the findings to the Commission services, as well as to share their own experiences with the issues covered in the report. This led to some interesting discussions, although little further industry input was obtained in this way.

Excluding correspondence with national regulators, competition authorities and other public authorities, the Commission services obtained 44 replies from industry stakeholders, most of which have been published on the Commission's website (see footnote 1) with the exception of those labelled confidential in their entirety or for which no non-confidential version was provided.

During this second phase, the Commission services also sent a targeted series of questionnaires on the subject of "best terms and conditions" clauses, reported on in chapter 3. These questionnaires were sent, for reinsurance, to the twenty largest reinsurance companies established or with a subsidiary in the EU and the ten largest reinsurance brokers. The scope of the questions asked was all business written for clients incorporated in the EU. For coinsurance, questionnaires were sent to a selection of ten insurers and six brokers (three large and three medium-sized) in the four largest Member States, namely the UK, France, Germany and Italy. These questionnaires also included questions on insurers' experiences as customers of reinsurance, and (except for Germany where the practice is legally prohibited) on broker commission rebating, reported on further in Chapter 4.

In order to look further at the question of long-term agreements, the Commission services sent questionnaires to insurance supervisors, associations and national competition authorities in the four member states identified as potentially concerned in the Interim Report, namely Austria, Italy, the Netherlands and Slovenia. This issue is taken up in Chapter 6.

Lastly, questionnaires on profitability were sent to the same reinsurance companies as were asked to provide their comments on best terms and conditions. These questionnaires were based on a considerably more sophisticated methodology than that used for primary insurers in the first phase of the inquiry and attempted to cover a longer period of time (twelve years) as well as gather data relevant to computing investment returns and cost of capital. Although based on a documented approach in the public domain and developed by one reinsurer, Swiss Re, it proved very difficult for reinsurers to provide the data in the form requested, necessitating a customized approach to analyzing this data. For this reason, the findings of this exercise are not included in the present report.

## 4. NOTE ON THE ORGANIZATION AND SCOPE OF THE REPORT

The Final Report deals in a focused way with a number of key issues and concerns, as already alluded to above. A certain number of other issues were mentioned in the Interim Report without any definitive conclusions being drawn on this. In general, the issues omitted in the Final Report were not the subject of particular comment in the public consultation either. The omission of any issue in this Report does not imply that the Commission services have further studied the issue and concluded that it did not raise concerns.

Remaining within the scope of the inquiry, the Commission has not sought to include comments made during the public inquiry which related to issues other than the production and distribution of insurance to businesses. In certain instances, such comments may, of course, be further pursued by other means.

A certain number of concerns have been raised also in relation to the impact of agreements between insurers, including some agreements which may be block-exempted, on downstream markets affected by insurance. These markets, which include the markets for vehicle repairs and for security devices, have not been the subject of the sector inquiry and are, moreover, not exclusively related to commercial lines of business. For this reason, they are not commented on further. For the record, it should be recalled, however, that measures which distort competition on downstream markets and do not display countervailing efficiencies may violate Article 81 of the EC Treaty even in the absence of a direct economic interest in the downstream market on the part of the actors in the market in which the agreement occurs. As in the past, the Commission will assess any credible allegations of this kind carefully on a case-by-case basis if the condition of Community interest is met.

As is pointed out in the relevant chapter, no definitive conclusions in relation to the Insurance Block Exemption Regulation have been reached. The comments made in this regard should, therefore, be viewed as preliminary and as designed to offer the market some indications of the state of the Commission services thinking.

This Final Report is designed to be read without any need to refer to the Interim Report, although the latter is occasionally cross-referenced when it contained data of continuing interest but which it is not opportune to reproduce here. This is, in particular, the case as regards Chapters III through V of that Report, which described the organization of the EU insurance markets and the current degree of market integration. These chapters have not been reproduced here as the Final Report will primarily be of interest to persons already having sufficient industry background; however, they would still be of interest to a generalist reader.

# II. FINANCIAL ASPECTS OF THE INDUSTRY

## 1. INTRODUCTION

Ideally, an assessment of the degree of competition in the EU business insurance market would proceed by means of a comparison of insurance prices and associated costs for various lines of insurance in different Member States. Unfortunately, however, there are no adequate indices of insurance prices that would allow for such a comparison. Even if there were such price indices, any comparison of price alone in the insurance markets would be subject to a large number of caveats, since seemingly similar “insurance products” may be of a very different nature. For example, for relatively commoditized risks which do not need detailed individual assessments – such as third-party motor liability insurance – the scope of coverage and policy conditions will still often vary significantly from one country to another, and claims costs will also differ. Larger risks are usually written with individually tailored terms and are hence even less comparable.

An alternative approach is to rely on indirect measures, i.e. overall profitability. This type of measure may also yield important information for competition analysis. While the existence of significant profits may be the rewards for taking risks, innovating, superior efficiency or better management, it could also be the result of having and exerting market power. High and persistent profits in relatively mature markets together with possible barriers to competition may suggest the latter.

It is quite easy to measure and compare premium income at a portfolio level for different markets, insurers and lines of business and this approach lies behind much of the analysis in the present chapter. It should be acknowledged that this, however, may give an incomplete picture since it does not include any rents which might be captured in the independent distribution layer, and these are also paid by the final customer. The profitability of brokers was not surveyed for a variety of methodological reasons[9]. The consequences of this for the analysis is elaborated upon further below and in Annex 3.

This section therefore provides a descriptive comparison of profitability trends in the business insurance sector (exclusive of independent distribution) for all EU-25 Member States. The analysis covers the period 2000-2005. In order to investigate profitability, an economic measure was used which is simple and in widespread use in the industry: the so-called "combined ratio". It is calculated by dividing the sum of incurred losses net of reinsurance and expenses by earned premium net of reinsurance:

$$\frac{Claims \quad (net \quad of \quad reinsurance) + Expenses \quad incurred}{Earned \quad premiums \quad (net \quad of \quad reinsurance)}$$

This therefore measures the amount that an insurer must pay out to cover claims and expenses per euro of earned premium. A value of 100% means that the insurance company is breaking even on its underwriting: if it is over 100%, then the insurance company is making an

9 For small brokers, the task would have been difficult and disproportionate to the aims of this report. As regards the large brokers, it would have been necessary to isolate the profits of insurance placement, per line and geography, from remuneration for the large number of other activities carried out by brokers. This would have been very difficult and somewhat arbitrary. A firm-level profitability analysis for brokers would likely have been of limited significance for present purposes.

underwriting loss and, if less than 100%, it is making underwriting profits. A ratio significantly below 100% might therefore imply the existence of economic profits. Accordingly, a ratio of 95 % means the insurer has made five cents of underwriting profit for each euro received in premiums.

The combined ratio suffers, however, from a number of drawbacks. Firstly, when claims are more likely to arise and/or to be settled in the future, the matching principle of accounting is not satisfied for the combined ratio because clients "pre-pay" their insurance. Secondly, it makes no allowance for the investment income (returns) on the financial assets purchased with insurance premiums that are held until claims and related expenses are paid. This is an important source of insurance companies' revenues. In liability insurance, for instance, there is long time lag between receiving premiums and paying claims, and, consequently the accumulation of financial assets is large[10]. A recent publication from a leading institution reports that the annual net investment results of the non-life insurance industry over the period 1994-2004 were the equivalent of 16.2%, 16.8%, 15.4% and 13.4% of the annual premium income in the USA, UK, Germany, and France, respectively[11]. Finally, the risk covered by underwriting may be different in the different lines, and therefore the return on capital demanded may also vary.

Although the combined ratio suffers from all these drawbacks, it presents the advantage of being a simple and widespread economic measure used to measure the profitability of the industry. A more sophisticated economic measure would have required additional, complex data which it is believed that many market participants would have been unable to provide.

The profitability in the industry is usually analyzed as a combination of the combined ratio and net investment results. Companies were not required to provide the latter for the purpose of the inquiry. However, it is necessary to bear in mind that the investment return realized by a company is a function of its investment strategy and, in economic terms, needs to be corrected by its corresponding investment cost of capital. It is therefore only if an insurer realizes an investment return which exceeds its investment cost of capital that it achieves an economic profit on its investment activity. This implies that investment returns are unlikely significantly to impact the economic profit of insurers over the long term, and even if they did, it is unrelated to their performance in the underwriting part of the market.

However, the Commission services believe that there are more subtle problems in the reported values of the combined ratio which are likely to act, on average, to underestimate profits. These would be corrected at least to some degree if investment returns at the risk-free rate were added back in as an economic profit. These other issues are explored in Annex 3.

It should be noted once again that the combined ratio also, and by definition, does not consider any profits which may be captured by independent brokers. Thus it may understate total profits in the value chain.

The measurement of profitability of a specific activity within a firm is typically subject to problems related to the allocation of common costs or overheads. This could also be relevant in the present case because insurance companies are normally multi-product firms and, as such, some institutions may have difficulties in isolating the costs of some business lines from others. However, it is worth noting that the allocation of revenues and costs, based on accounting data, was made by the respondents. Moreover, the inquiry gave respondents the possibly to provide

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[10] According to industry publications, the primary source of investment earnings for insurers is interest from bonds. Other sources of investment earnings are dividends paid on stocks and capital gains. The sum of what insurers earn in interest from their bond portfolio, plus stock dividends and capital gains (less capital losses) is known as the industry's investment gain.

[11] See Swiss Re, 2006, "Measuring underwriting profitability of the non-life insurance industry", Sigma, N°3.

data at a higher level of aggregation, further decreasing the uncertainty on the allocation of revenues and costs. For instance, the inquiry contains a category that encompasses all commercial non-life activities. In this regard, it is worth noting that the same measure of profits is applicable to all respondents in order to compare results across countries. So, even if the measure of profitability may not be perfect, it is applied consistently across all Member States.

For the purpose of the inquiry, insurance companies were required to report their level of loss and expenses as well as the earned premiums associated with the relevant underwriting activities per line, country and year. Total losses are given by the sum of claims and claims adjustment expenses incurred by the insurance company. Total expenses are given by the sum of acquisition costs (that portion of an insurance premium which represents the cost of obtaining the insurance business) and other operating costs.

It should be noted that the data were submitted to statistical tests in order to identify possible outliers[12]. As a consequence of the data cleaning exercise and the size of some economies, some of the ratios are based on a limited number of observations, which means that results may not be entirely representative of combined ratios at the country level. In cases where the respondents in the sample were large and specialized insurance companies, the problem is less important. In contrast, in countries where only a limited number of non specialized insurance company provided figures - estimated figures, in some cases - the results need to be analysed with more caution. Whenever relevant, results are qualified in the text.

In this chapter, the following are therefore analysed:

- The combined ratio for individual lines of business insurance (for the entire EU 25 and per country).
- The loss and expense ratios for individual lines of business (for the entire EU 25 and per country).
- The combined ratio, loss ratio and expense ratio, broken down between Large Corporate Customers (LCCs) and SMEs

## 2. COMBINED RATIOS

It is worth noting that, when computed at the EU-25 or Member-State level, aggregate combined ratios have been calculated as weighted averages for all the insurance companies in the sample located in the EU or in a specific country, respectively, and active in a particular line (the weight is given by the company's total written premium in that line).

Reported figures showed that only 1 out of 12 lines of business insurance at the EU-25 level displayed a combined ratio higher than 100% (i.e. an underwriting loss) in 2005 (see Figure VI.1 of the interim report). Reported figures also showed a significant variation across lines. For instance, the combined ratio of Environmental Impairment Liability amounted to 36%, while the equivalent figure for Motor was 95%. In other words, the underwriting profit for each euro of premium is on average 64 cents for Environment Impairment Liability and 5 cents for Motor. This difference is less pronounced, but still significant, between Motor and other lines such as Property and Business Interruption (combined ratio of 85%).

It is worth noting that the aggregate item "Total commercial non-life business", which encompasses all commercial non-life activities, displayed a weighted combined ratio of 91% for 2005 and 99% over the entire period 2000-2005. If one were to generalize the average annual

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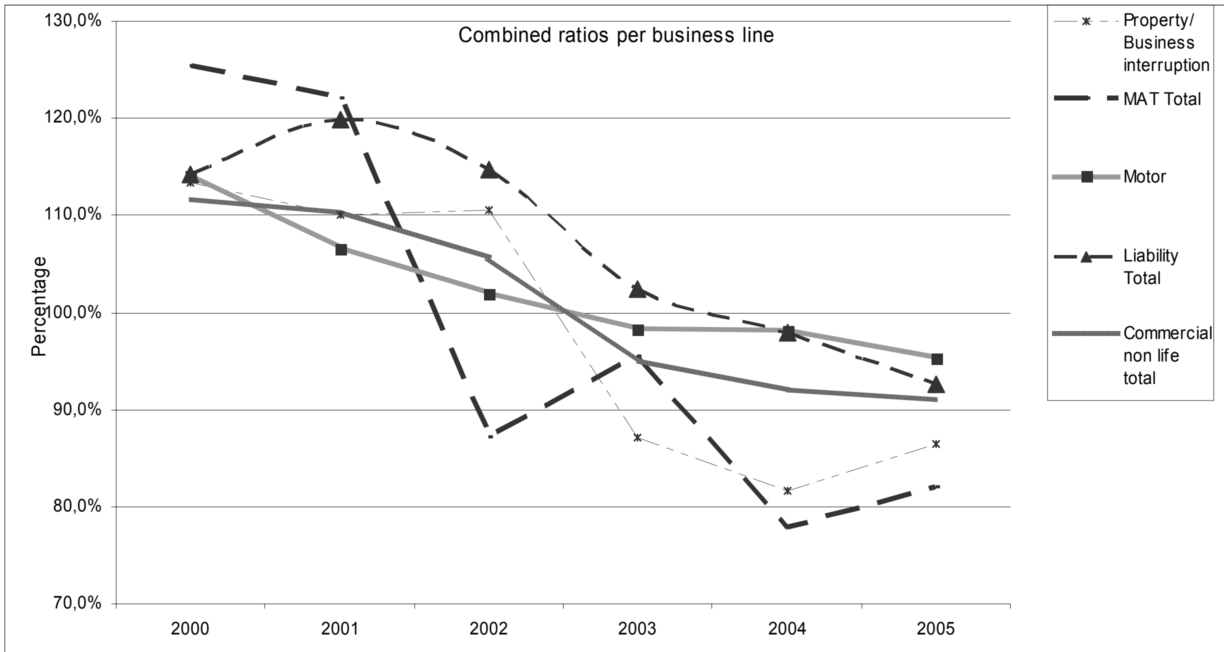
[12] An outlier is a value well outside the "typical" range of values associated with a given variable, and which therefore may be erroneous or otherwise distort the analysis.

net investment results of the non-life insurance industry as reported by Swiss Re (op. cit., 2006) in the UK, Germany, and France over the period 1994-2004 (16%) to all European economies, it could be concluded on this basis that business insurance is a profitable activity in the EU with a pre-tax average profit margin of 17% over the period 2000-2005. It should be noted, however, that this somewhat simplistic conclusion may be misleading in certain instances since there is a mismatch in the time periods considered for the combined ratios (2000-2005) and the average investment income (1994-2004). Moreover, this would still represent an accounting, and not economic, profit and need to be corrected by cost of capital. This point is returned to below.

For the sake of simplification, only the trends in the ratios for three aggregate items – "Marine, Aviation and Transport" ("MAT"), "Liability Total" and "Commercial non life Total" – plus that of two important individual insurance lines (Property/business interruption and Motor) are depicted in Figure II.1. These are the most important categories of lines of business insurance in terms of industry turnover.

Figure II.1 – Weighted combined ratios main lines, EU-25, 2000-2005




*Source: European Commission, Business Insurance Survey 2005-2006*

This figure shows that underwriting of all these lines has generally become more profitable over the period 2000-2005. Evidence confirms that nearly all of the 12 lines analyzed had falling combined ratios (increasing profits) over the period (see Table VI.1 of the Interim Report for details). Evidence appears therefore to indicate that the market has achieved lower combined ratios over recent years. This is probably related to the "hardening" of reinsurance markets in the wake of September 11, 2001

The need for catastrophe provisions in areas such as Marine and Aviation, the generally predictable nature of certain classes (such as Motor and Personal Accident/Medical Expenses), and the important role played by the investment income in Liability classes might partly explain the differences found in combined ratios.

The analysis of the underwriting profitability at an aggregate level may mask, however, substantial differences across Member States. Therefore, it was considered that analysis of the

underwriting profitability at a country level might provide further insight regarding the distribution of combined ratios across lines.

Results showed that the weighted combined ratios for 4 main lines in each of the 25 Member States for 2005 varied significantly. Property/business interruption displayed a weighted combined ratio of less than 100% (an underwriting profit) in 22 out of 25 countries, but these ratios varied significantly across countries – their values ranged from 50% in Slovakia to 107% in Denmark and Slovenia.

The category that includes Marine, Aviation and Transportation (MAT) had a weighted combined ratio of less than 100% (underwriting profit) in 24 out of 25 countries. It seems, therefore, that **MAT generates particularly low combined ratios in almost all European countries (as suggested by an overall combined ratio of 82%)**. Yet, there was again a sharp variation in the country weighted combined ratio, which varied from **56 % in Germany** to more than **140 % in Slovenia**. Motor tends to display higher weighted combined ratios: its overall EU-25 average amounted to 95 %. Again, combined ratios varied significantly across countries. Indeed, the lowest ratio amounted to **38% in Slovakia** while the highest ratio was **123 % in Portugal**. "Liability Total" also followed this pattern. For instance, Germany displayed a weighted combined ratio of 83% while the equivalent figure for Italy was 116%. When these four lines are compared, Motor displayed the lowest combined ratio in almost all EU-25 Member States. As regards Total Commercial non life, it should be noted that its computed weighted combined ratio was less than 100% in 22 out of 25 Member States. The country with the lowest ratio was again **Slovakia (57%)** while **Denmark** presented the highest ratio (**113%**).

When the analysis focuses on the difference across lines within countries, the picture is again one of great disparity. In Ireland, for instance, “Liability Total” generated a combined ratio of 98%, while the equivalent figure for “Property/Business Interruption” was only 68 %. In Slovenia, this difference was even greater: “Liability Total” had a ratio 40 points higher than that of “Property/Business Interruption”. This picture of great disparity across these lines within countries is common to almost all EU-25 Member States. While relatively lower combined ratios in Malta, Cyprus and Latvia need to be assessed carefully as they are based on a limited number of observations per line, the overall results show that there were significant differences across countries within the same lines. Results confirm that there are wide variations in insurers’ income for virtually all specific product lines within the same country (see Table VI.2 of the interim report). What explains these findings is not entirely clear: in the case of liability insurance, for instance, higher combined ratios may be tolerated because of offsetting investment income, but at the same time uncertainties as to the level of future claims are high. It may be that this latter factor is substantially reduced, however, by reinsurance coverage of excess losses.

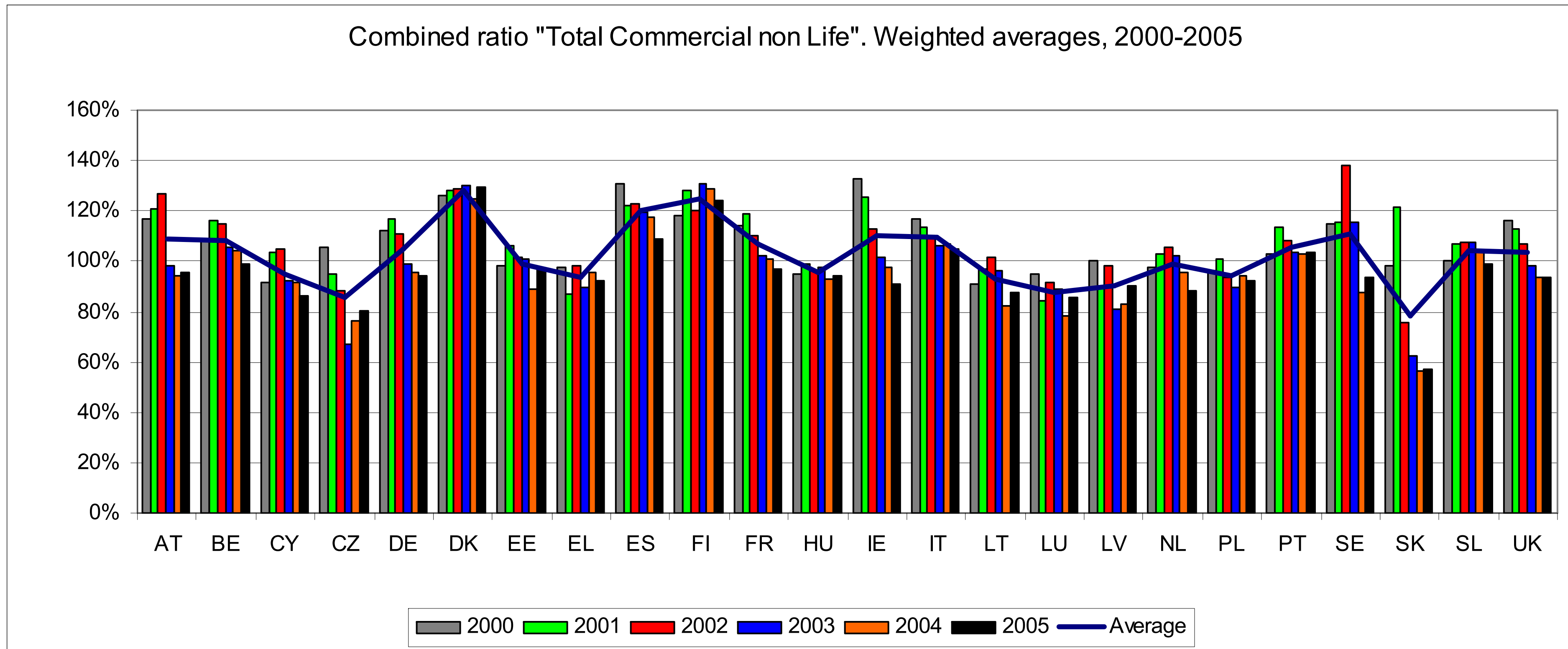
Another interesting finding relates to the comparison between the ten new Member States (EU-10) and the EU-15. All lines displayed consistently and significantly lower combined ratios (greater underwriting profitability) in the new Member States than in the EU-15. Indeed, the weighted combined ratio for the new Member States and the EU-15 was, respectively, 81% against 91% in Property/Business Interruption, 68% against 83% in MAT, 86% against 97% in Motor, 86% against 93% in "Liability Total" and 81% against 91% in "Total Commercial non life". However, as noted earlier, when claims are more likely to arise in the future (or their magnitude is likely to be greater in the future), it is normal to collect a higher level of premiums today, when the market is growing, and the current level of claims is a poor proxy for what will be the case in the future. Therefore, if claims adjustment fails fully to take this into account, it might be expected that lines which have this property would show a lower combined ratio when underwriting is growing. This might explain to a certain extent the difference in the ratios found for the EU-10 and the EU-15. On the other hand, acquisition costs

in those new countries may be higher and insurers may bear currency exchange risks, which would lead to a higher combined ratio. Lack of maturity of the market and of reliable historical claims information may lead to more prudent underwriting and/or a price-skimming strategy, i.e. initially writing only the most profitable business at higher prices than would pertain in a mature market.

It is important to acknowledge that a static analysis based on a single year may well neglect an important issue, namely the stage of the business insurance cycle in each market. Indeed, there may exist phases of more intense competition within the industry, with a consequent drop in premium rates, and phases where competition is less intense, underwriting standards become stricter, the supply of insurance is limited due to the capital constraints and, as a result, premiums rise. It is thus important to look at the way profit ratios have evolved over the period 2000-2005 in each country.

Figure II.2 reports the weighted profit ratios by country over the period 2000-2005. Malta was dropped due to data limitations.

Figure II.2 – Weighted combined ratios of main lines, country-level, 2000-2005




*Source: European Commission, Business Insurance Survey 2005-2006*

The analysis of this figure shows that "Total Commercial Non Life" showed a considerable decline in the combined ratio in most countries over the period considered, especially since 2002. There are **some exceptions to this trend, of which Denmark, Finland, Hungary, Portugal and Slovakia are the most notable**.

## 3. LOSS AND EXPENSE RATIOS

In order to obtain further insight into the sources of underwriting profitability, the combined ratio has been decomposed into the underlying loss and expense ratios, which represent the two categories of cost against which premium revenue must be offset.

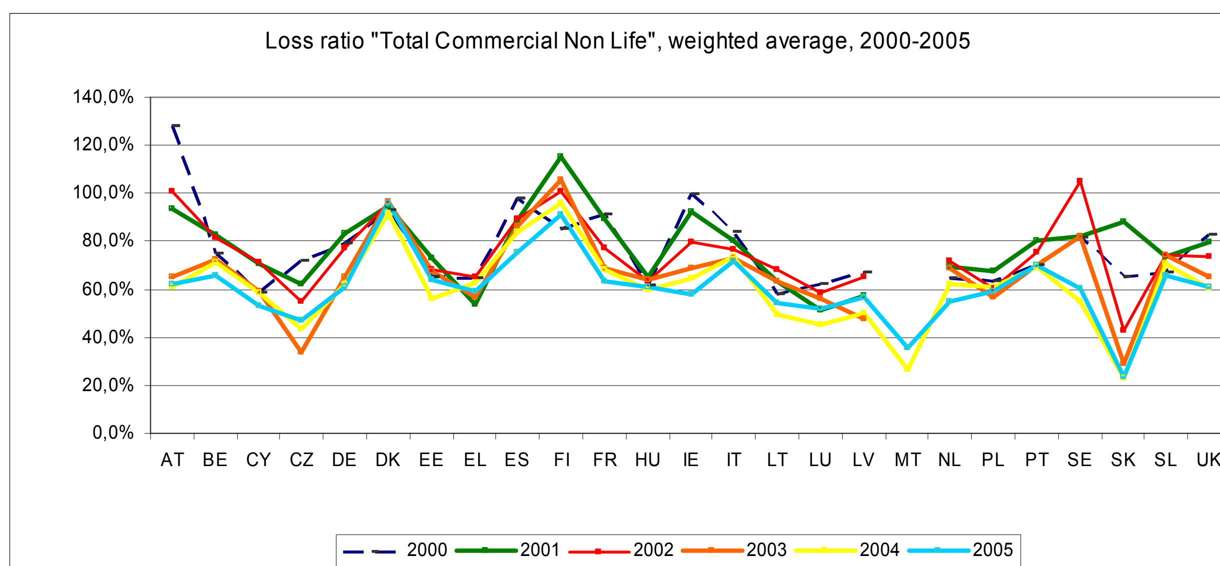
The loss ratio relates to what is typically the largest of the cost components of insurers – the amount of claims experienced – to the total net premiums earned. It is given by the formula (incurred losses plus loss adjustment expenses) / earned premiums .

The expense ratio relates the insurers' general expenses – such as general administration (e.g., salaries) and marketing costs – to the total net premiums earned. It is given by the formula ( expenses (excluding losses) / earned premiums ).

The breakdown of the combined ratio into loss and expense ratios for the aggregate "Commercial non life Total" for 2005 reveals that the cost bases of insurance companies vary considerably across the EU-25 (see figure VI.5 of the Interim Report). For instance, the total expenses incurred by Dutch, Lithuanian and Slovenian insurers amount to more than 35% of premiums earned, whilst the equivalent figure for Finnish, Danish and Spanish insurers is less than 18%. In the same vein, the percentage of total claims incurred by Finnish and Danish insurers amount to more than 95% of the premium earned while the equivalent figure for Dutch insurers is only 50%.

Figures II.3 and II.4 display the trend in, respectively, the loss and expense ratios over 2000-2005 for the EU-25.

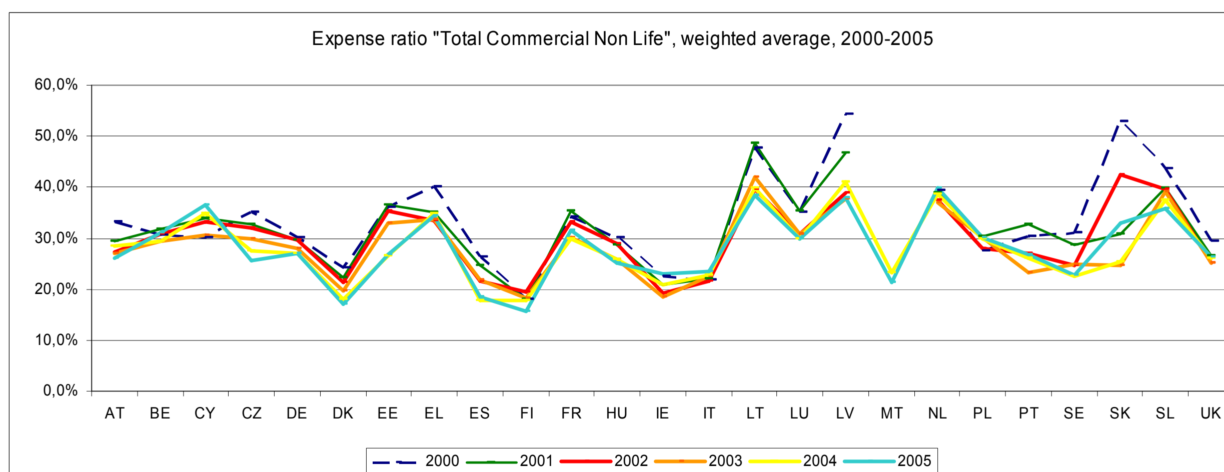
Figure II.3 – Loss ratio, country-level, 2005




*Source: European Commission, Business Insurance Survey 2005-2006*

As expected, the loss ratio (Figure II.3) presents a higher variation than the expense ratio (Figure II.4) over the period in virtually all Member States. The years 2004 and 2005 seem to display the lowest loss ratio in almost all Member States.

Figure II.4 – Expense ratio, country-level, 2005




*Source: European Commission, Business Insurance Survey 2005-2006*

Figure II.4 shows that the pattern of the expense ratio has been relatively consistent by geography over time. In other words, Member States tend to display relatively high or low expense ratios throughout the period. The differences across Member States might reflect structural factors (such as labor costs), which one would expect to be sticky. The slight decline in the expense ratio over time might reflect general efficiency gains and diminishing acquisition costs in the EU-10, or unexpectedly high commercial premiums, which could be the case in Denmark and Finland.

## 4. SMEs VERSUS LARGE CLIENTS

Respondents provided financial data broken down for two types of customers: SMEs and large clients. For the purpose of this enquiry, the definition of SME used was the Commission's standard one, according to which an SME is any company with fewer than 250 staff and the turnover of which is below 50 million euro[13]. It is therefore of interest to assess how the combined ratio varies across these two very different customer segments. It should be noted that, according to the Commission's survey, premiums from SMEs represent a significant part of the insurers' total premiums (60%).

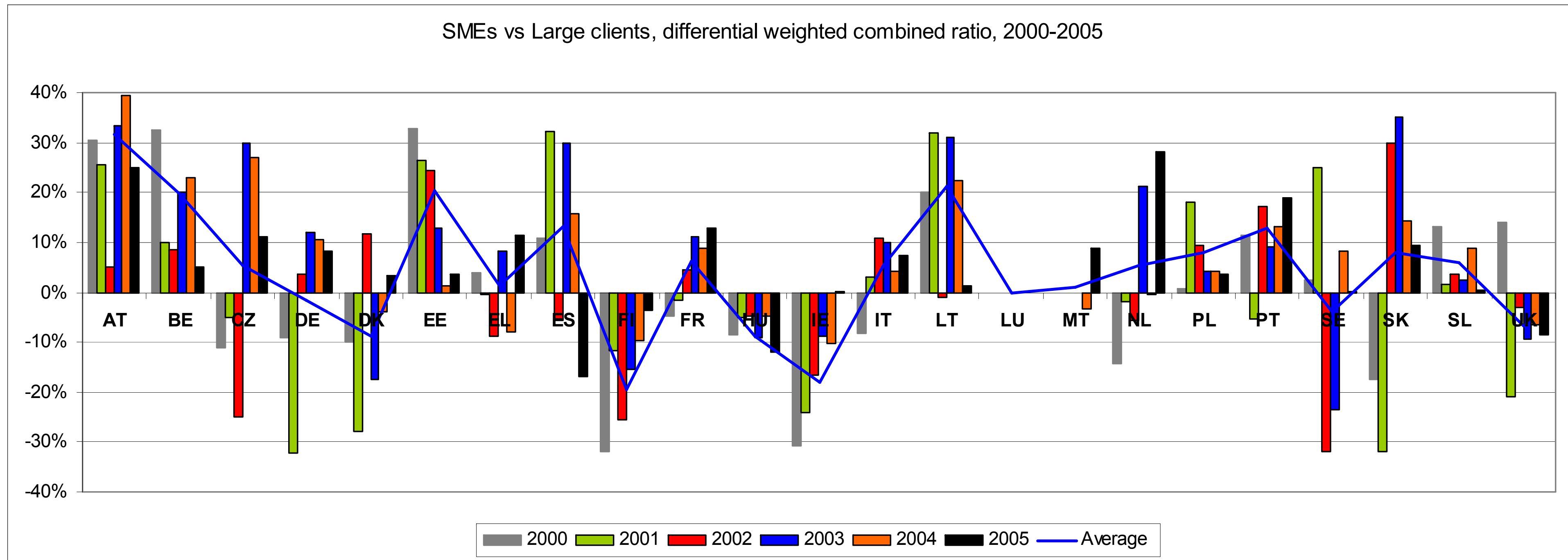
This analysis aims to assess whether small customers tend to get a less favourable deal in terms of combined ratio than larger clients. It should be acknowledged that the analysis may be subject to certain limitations, as it assesses solely the "size" parameter of a customer to the exclusion of other potentially significant factors specific both to the client and the class of customer in question, such as, for example, the more accurate risk rating alleged to apply to larger clients, the greater volatility of large risks and the diversification effect of a larger book of business with SMEs. These factors might distort the results to a certain extent, although the direction of any possible bias cannot be determined ex-ante.

Figure II.5 illustrates the difference between the weighted combined ratio for SMEs minus that for large clients. The period of analysis is 2000-2005 and it covers 23 Member States (Cyprus and Latvia were excluded from the sample due to data limitations). In the top part of the graph, the combined ratio for SMEs is greater than that for LCCs, implying that the SME

[13] Cf. Commission Recommendation of 6 May 2003 concerning the definition of micro, small and medium-sized enterprises (2003/361/EC).

segment is less profitable. In the lower part of the graph, SME business is more profitable than LCC business.

Figure II.5 – Weighted combined ratio for SMEs and large Clients, country-level, 2000-2005




*Source: European Commission, Business Insurance Survey 2005-2006*

It can be seen from this figure that the sign and magnitude of the difference in combined ratio between SMEs and large companies in about half of the Member States shows no consistent pattern. The combined ratio for SMEs has been consistently higher than that for large companies in Austria, Belgium, Estonia (until 2004), Spain (except 2002), Lithuania, Portugal and, since 2002, Slovakia. In Finland, Ireland, and the UK, on the other hand, the ratio for SMEs has been always lower than that for large companies.

In the latter case, the difference might be due to greater buyer power on the part of LCCs, or distribution mechanisms which result in SME business being subject to less risk of switching and hence fewer competitive constraints. It is worth noting that weighted combined ratios for large clients are often higher than 100% in this context. This might indicate a possible “discrimination” across client segments detrimental to small clients. As the data available is limited, however, it cannot be ruled out that the effects observed are not statistically significant.

## 5. INDUSTRY COMMENTS ON THE PROFITABILITY ANALYSIS

In their responses to the public consultation on the Interim Report, insurers and insurance associations criticised the methodology used to assess both profitability and, indirectly, prices in the insurance industry. The main criticisms can be summarised as follows.

1. *The measure used by the Commission – the combined ratio – is not suitable to assess profitability, since it does not properly take into account either the level of risk or the level of required capital, which it assumes are constant for all businesses.*

2. *A complete underwriting cycle in the business insurance industry is much longer than the six-year period considered in the report. As the part of the cycle used in the report coincided with the part of the underwriting cycle where combined ratios were below the average values for the entire cycle ("hard market"), the Commission's analysis allegedly overestimated the level of profitability of the industry.*

3. *The Commission's interpretation of the investment returns was inappropriate as it assumed that different lines of businesses and Member States had the same investment returns.*

Insurers and insurance associations have also commented on the discrepancy found in the combined ratios between small and large customers. They first argued that the definition provided of SMEs did not reflect the insurance sector's practice. The figures provided by the respondents concerning the individual customer segments would therefore be largely based on estimates rather than exact statistics, which would have considerably weakened the results. Insurers and their associations also considered that the differences in the combined ratios of small and large clients were fully justified by the level of risk of these two categories of clients. Larger clients would be more likely to structure their insurance so that they retain a significant amount of risk allowing for more flexibility in terms and price. Finally, insurers and insurers' associations claimed that the conclusion that in some Member States underwriting for SMEs may have been used to cross-subsidise low returns in the LCC segment is speculative as there is no consistent pattern between Member States.

The Commission's services have considered these comments in detail and reflected on their implications for the validity of the inquiry's findings.

Concerning the accuracy of the methodology on which the underwriting profitability analysis was based, it should firstly be noted that these calculations were based on figures provided by the respondents. Secondly, the report itself acknowledges that the combined ratio

suffers from a number of drawbacks. Nonetheless, it is an informative and widespread economic measure used in the industry. As mentioned, a more sophisticated economic measure would necessarily have required additional, complex data that some market participants might not even have been able to provide. With regard to the latter point, it is worth noting that the Commission's attempt to assess profitability in the reinsurance industry by using a sophisticated economic measure triggered a significant number of replies from reinsurers arguing that the data requirements were impossible for them to meet[14]. It should also be noted that the profitability analysis did not aim at providing data at such a level of accuracy (which clearly goes beyond the scope of a sector inquiry), nor did it endeavour to define reasonable or excessive profits. Any attempt at constructing a more sophisticated economic measure of profits might therefore have placed a disproportionate burden on market participants and very likely resulted in a less reliable dataset as both the number of respondents and the quality of the data provided might have been drastically reduced.

As regards the consistency of the methodology, it should firstly be noted that the same measure of underwriting profitability was consistently applied across all respondents in order to compare country variations. It is not clear that possible inaccuracies in the methodology should bias the profitability results of particular Member States and not others. Secondly, the extent of variation in profitability across the Member States is unmistakable.

Some market participants also argued that the report should have collected data for at least ten consecutive years in order to give an accurate picture of prices, losses, reserving and investment yields in the European insurance industry.

The report acknowledges the cyclical nature of business insurance and recognizes that a "complete" underwriting business cycle might be longer than the period of time considered (2000-2005)[15]. However, requesting financial data over a ten-year period of time, as suggested by some market participants, would have increased significantly the burden on the selected insurers in terms of data requirements. In their reply to the Commission's questionnaire, a significant portion of respondents reported that financial data for 2000 were already very difficult to provide due to, *inter alia*, changes in the accounting standards, companies' ownership, or new information systems (in particular related to the Y2K computer issue). Moreover, while it seems that there is no clear understanding in the industry on how long the duration of the underwriting business cycle is, market participants seem to agree that it may differ across Member States.

The period of time considered (2000-2005) in the report seems, therefore, to be sufficiently informative without increasing unnecessarily the burden on insurers in terms of data requirements.

As regards the definition of SMEs for the purpose of the questionnaire – i.e., any company with less than 250 staff and the turnover of which is below 50 million euro – it was already noted that it corresponds to a standard definition of SMEs promulgated by the Commission. Whilst well aware that company-internal practices may vary, this criterion was consistently applied across all respondents. It is therefore not clear that possible inaccuracies in the methodology should bias the profitability results of particular Member States and not others. Finally, it is worth noting that some replies have argued that the largest clients have

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[14] As mentioned in Chapter I, the Commission has gathered data with a view to measuring the profitability of the reinsurance industry by applying the "economic combined ratio" suggested by the Swiss Re Sigma publication (*Measuring underwriting profitability of the non-life insurance industry*, n° 3/2006). The analysis of this data is ongoing but fraught with difficulties.

[15] The origin of this cyclicality remains a matter of debate, however.

the ultimate bargaining power when it comes to price, namely that they often do not need to, and therefore will not, take out insurance unless they are offered the most competitive price possible. This is, of course, consistent with the inquiry's findings.

As regards the use of a single figure for the investment return, it should be acknowledged that it may not have been fully appropriate as it implicitly assumed that different lines of businesses and Member States had the same investment returns. It is not clear, however, that this would have led to substantially different conclusions.

## 6. Conclusion and Analysis

This chapter has gathered a range of data on insurers' financial performance, from the market survey across the EU and from public sources. The preliminary results suggest that profitability in business insurance at the EU-25 level has been sustained over time in the majority of Member States, albeit with significant variations.

Underwriting profitability varies significantly both in terms of business lines and Member States. Profit ratios vary by a factor of one to three across the EU-25 for the same insurance line and by up to double within the same country for different insurance lines. While it is acknowledged that the risk covered by underwriting may be different in the different lines, and therefore the return on capital demanded may be also different, the magnitude of these discrepancies is striking.

There are also wide variations in insurers' income for specific product lines within the same country. Taking Ireland as an example, results for 2005 show that insurance companies may be earning 50% more in absolute terms in the Liability Total than in Property/Business Interruption. The insurers' income in two product lines is even greater in Slovenia. It therefore cannot be ruled out that profit in some lines of insurance might be used to subsidise losses in other lines. Why this type of behaviour would arise, however, is not yet clear.

The cost bases of insurance companies vary considerably across the EU-25. For instance, the total expenses incurred by Dutch insurers amount to more that 40% of their premiums earned but the equivalent figure for Finnish and Danish insurers is only 15%. It cannot be excluded that this is due to the premiums themselves being higher in the latter case.

The pattern of the combined ratio applied to SMEs and large companies varies significantly across the EU-25. In a few cases, certain Member States seem to consistently display higher underwriting profitability in the SME segment than in dealing with large corporate customers. Whether this behaviour is statistically significant and why it arises remains, however, unclear. Referring to the UK market, one respondent suggested that the mode of remuneration of intermediaries by insurers – whether by contingent or just by classical commissions – may result in less ability to switch to find a better deal on the part of SMEs and thus less dynamic competition in this segment. This explanation presupposes that brokers have market power vis-à-vis their customers, since in the contrary case customers would be able to obtain the same cover more cheaply through other channels. It may appear reasonable in a limited number of cases but cannot be concluded with any certainty.

More generally, the Commission services would point out that the type of analysis carried out in this chapter can only serve to **screen the market for possible issues and would need to be corroborated by additional analysis before any firm conclusions could be drawn**. Indeed, even in the absence of significant profitability, it is not excluded that rents are captured by the firms' own factors of production or that rents arise in niche markets which have not been identified, and so the lack of findings of this type cannot be relied upon to indicate the lack of competition concerns either.

The analysis which the Commission services have carried out is probably most significant when it comes to underlining market fragmentation and the scope for savings from further integration. There are nonetheless many factors which fragment insurance markets and defy any simplistic analysis. Going forward, the Commission may wish to look further at these factors and propose additional measures to encourage greater market efficiency at the pan-EU level. Clearly, in the presence of market fragmentation, there is a correspondingly greater risk that collusive practices will arise because certain markets are sheltered from the threat of entry. The part of the findings which may point to the existence of such practices is, however, difficult to isolate.

# III. HARMONIZATION OF TERMS AND CONDITIONS IN COINSURANCE AND REINSURANCE

## 1. INTRODUCTION

In section VIII.9 of the Interim Report (pp. 93f.), the Commission services drew attention to a practice in the market for joint reinsurance, both treaty and facultative[16], of including a clause intended to guarantee that a given reinsurer obtained terms no less favourable (from its standpoint) than those offered to any other reinsurer participating in the contract, the so-called "Best terms and conditions" clause (BTC). The Commission services also noticed that this practice appeared to surface in a similar form in the coinsurance market (section X.8, p. 155), i.e. in primary insurance where risks were covered by an ad hoc consortium of insurers. Co-insurance puts insurers in a position to offer cover for risks which might be impossible for a single insurer to underwrite alone (because, for example, the risk is too large, is a new risk or an old risk which has become more complex) and, as such, serves to facilitate the ability of a wider range of insurers to be involved in the coverage of large and/or complex risks. It is also an alternative to taking out facultative reinsurance on a contract, offering the advantage of lower frictional costs and more rapid conclusion of the contract.

Since the nature of the legal issues raised by BTC clauses is in many ways similar in the reinsurance and coinsurance markets – although their economic impact may perhaps differ – most of the analysis in this chapter will apply, indistinctly, to both scenarios unless otherwise stated.

The view was expressed in the Interim Report that the practice of BTC was likely to be to the detriment of the respective customers and might, under certain conditions, amount to a restriction of competition within the sense of Article 81(1). The Commission services did not, at that time, advance a view as to the possible exemptability of the clause under Article 81(3). It undertook, however, in the second phase of the inquiry, to look in more detail at this type of practice and solicited views from the market on it. It was also not possible to give further indications as to the frequency with which this type of clause had been, or continued to be, encountered in the market.

The Commission services received a number of comments on this issue during the public consultation, and also launched a targeted series of questionnaires in relation to it, as explained in Chapter 1.

In this chapter, the Commission services presents the results of the market investigation in relation to this practice and their provisional views on it.

For the purpose of the second round of questionnaires, Best Terms and Conditions clauses were defined as:

*"Any stipulation, whether written or oral, introduced at any stage of the negotiation of a reinsurance contract, by means of which a (re)insurer A obtains, seeks to obtain or acquires the right, under certain circumstances, to obtain an alignment of its proposed or agreed terms and conditions, in particular the premium, to the terms and conditions ultimately obtained by*

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[16] Treaty reinsurance refers to standing arrangements between an insurer and a reinsurer, whereas facultative reinsurance is taken out on an ad hoc basis for risks which are not covered by treaty. For the distinction, see further at p. 27 of the Interim Report.

*any other (re)insurer B participating in (re)insuring the same (re)insured as A, in the event that the latter terms are more favourable to the (re)insurer, than the terms and conditions which A initially offered or subsequently agreed."*

The definition had to include the negotiation phase as it appeared during the first phase of the inquiry that **BTC clauses did not necessarily appear as such in the final (re)insurance contract** but could, for example, be **introduced at quote stage** and thereby relate exclusively to the process whereby co-(re)insurance arrangements were negotiated and drawn up.

As a result of its investigation, it soon became clear to the Commission services that widespread practice in both reinsurance and coinsurance markets results in a *de facto* alignment of premiums and other conditions of coverage in most cases and in all the markets which were examined, independently of the use or otherwise of BTC clauses. Accordingly, the scope of this chapter includes all mechanisms which lead to such an alignment. It should be emphasized, however, that this does not imply that the BTC clause does not have specific properties which require a differentiated analysis, or that the market outcome is necessarily identical regardless of the presence or absence of the clause. Whilst many participants affirmed that, even if included, in most cases the BTC clause had no effect on market outcomes, it appears that in other cases it may have an effect which makes it more detrimental to customers than the general practice which will be described below, even if it will be argued that the latter may be considered not to work to customers' full advantage either.

## 2. FINDINGS RELATING TO THE REINSURANCE MARKETS

In this section we are concerned with the arrangements through which several reinsurers cover a part of an insurer's portfolio ("co-reinsurance").

It is the Commission services' understanding that the coverage of reinsured risks by more than one reinsurer is the norm in most cases, and the use of a single reinsurer is rather the exception. Certain considerations of prudent risk management may mean that insurers typically prefer to use more than one reinsurer. With this in mind, the mechanisms by which multiple reinsurers become involved in a single contract assume a particular economic importance.

It should be noted that, when multiple reinsurers are used, the coverage may additionally be structured in **layers** (this phenomenon is also found in coinsurance). This means that one or more reinsurers will intervene up to a certain claims limit, above which another reinsurer or group of reinsurers would cover a further range of claims, and so on. Because the risk covered in each layer is not the same, the same premium is unlikely to apply to the various layers, although other contractual conditions may be common. In this section, the Commission services are concerned only with what happens within layers and not between them.

### 2.1 Description of the different procedures leading to the conclusion of a co-reinsurance arrangement

In order to assess the effect of BTC clauses and other arrangements on the reinsurance and insurance markets, as well as, potentially, their status under competition law, it is relevant to establish the different types of procedures leading to the conclusion of a co-reinsurance arrangement. The questionnaires accordingly invited market participants to identify the essential characteristics of all such procedures.

The first basic distinction relates to whether or not a broker is involved in the process of concluding co-reinsurance coverage.

If this is the case, two main sub-procedures can be distinguished:

- **Subscription procedure**: In this case, the broker first draws up a draft contract after discussion with the client and then approaches different reinsurers. We will call this the "**tender phase**". Each interested reinsurer will give a quote and indicate the share it wants to take. They usually request different conditions. On the basis of the quotes received, the broker, together with the client, will select **one set of terms and one reinsurer to act as lead reinsurer**. These terms, including the premium, are then put to other potential co-reinsurers and in almost all cases **negotiation takes place exclusively on the share which each reinsurer wishes to subscribe** (we call this the "**subscription phase**"). If a reinsurer accepts the share offered to him but requests additional conditions, such additional conditions are usually proposed to the other reinsurers by the broker in order to have a final set of uniform conditions.
- **Non-subscription procedure**: In this case, the reinsurers do not all obtain the same prices, terms and conditions. This might happen for example when the capacity is limited. The broker has to negotiate different terms or conditions or prices with individual reinsurers.

If no broker intervenes in the process, the business is directly negotiated by the client insurer (known as the "cedant") with the reinsurers through similar sub-procedures.

In the subscription sub-procedure, if no broker is involved it may sometimes fall to the lead reinsurer to seek out "followers", i.e. reinsurance companies accepting to take a part of the cover at the terms, conditions and prices negotiated with the leader(s).

It is important to note that, in the case of the subscription procedure, terms and conditions, including premiums, are typically made uniform, and this regardless of the use or otherwise of a BTC clause.

## 2.2 Introduction of BTC in the cover

The vast majority of respondents, both brokers and reinsurers, indicated that BTC clauses were introduced mainly by reinsurers. Some reinsurers indicated, however, that this clause was sometimes imposed by brokers or even, although exceptionally, by cedants. But the brokers in the sample informed the Commission services that they tried to resist the introduction of such clauses (a fact also confirmed by some reinsurers). No insurer accepted that they would solicit a BTC clause from a reinsurer.

According to most of our respondents, a BTC clause would very rarely appear in the final contract negotiated between co-reinsurers and cedant/broker, or in any case such a practice has decreased considerably in the EU over the last few years. Examples of such clauses have been observed in final contracts but it can be assumed that they are now very rare in this form. The clause would rather appear at quote stage, during the drafting and negotiation process, or in a stamp on the subscription slip, or by e-mail or fax from the reinsurer when it finally agrees to bind/contract. It usually takes in this case the form of a single sentence, for example:

"Same terms as most favoured reinsurers"

"Most favourable terms & conditions to apply"

"Warranted no better terms carried"

Although some reinsurers in our sample acknowledged that they made use of such a clause (typically in their stamp), most said they did not and among those who did in the past, many claimed that they had reviewed its use in 2006 and had decided to delete the provision on their stamp. Globally, the message received was that the use of this type of clause is decreasing in the European reinsurance market. It has to be noted, however, that some brokers claimed that they nevertheless were still regularly faced with the situation where such clauses were requested by reinsurers, even if they successfully resisted them in most cases. In at least one case, a reinsurer stated that they did not use the clause, whilst from another channel copies of contracts with this reinsurer carrying the clause were obtained.

Most of the insurers sampled also said that BTC clauses were rare in their reinsurance treaties though according to some they were still quite often requested.

Certain respondents suggested that the apparent decline in the frequency of the use of BTC clauses might be due to the cyclical nature of the insurance market: **when the market is at its hardest and capacity is limited (which is currently not the case), reinsurers may be more inclined to try to introduce such provisions**. It cannot be excluded that reinsurers have also changed their behaviour based partly on their awareness that the sector is currently the object of a competition sector inquiry, and that they are awaiting the conclusions which the Commission will draw. Accordingly, it is important to consider the subject independently of its current market prevalence and it would be premature to discount the possibility that this type of clause may regain popularity in the future, particularly if the arguments put forward for its use were to be implicitly accepted by the Commission.

### 2.3 Incidence of BTC clauses by geography and line of business

The use of BTC clauses seems to be a practice present in all lines of reinsurance, albeit to differing degrees.

Regarding the geographic prevalence, one relevant factor may be the domicile of the reinsurer rather than the jurisdiction of incorporation of the client, as it seems that certain reinsurers make greater use of such an endorsement than others, and this independently of where they are doing business. However, some respondents have suggested that the client geography may have a certain incidence on the prevalence of BTC, with business conducted in certain EU countries still considered to show widespread use of this clause.

The client geography certainly has some incidence on at least regulatory grounds, since in the London market the practice seems to have globally lost popularity (although some respondents argued that it might have originated from there). This is probably due to the UK's new regulatory and market requirements for full contract certainty at inception[17]. Regulatory disfavour appears principally to be due to the fact that the clause, if included in the contract, introduces an element of contractual uncertainty since it creates ambiguity on the exact terms and conditions which will apply in the event of a claim. It could, thereby, lead to what has been termed "underwriting after the event" where a reinsurer is free to pick and choose between any of the divergent conditions of its co-reinsurers in the event of a claim.

Regarding the domicile of reinsurers making use of the clause, some claimed that the clause was introduced mostly by reinsurers domiciled in specific European countries or in Asia or Bermuda.

[17] This reform in the London market seems to have outlawed the use of stamp conditions.

# 3. FINDINGS RELATING TO THE COINSURANCE MARKETS

As in reinsurance, a key observation, which derives from several replies to the questionnaires, is that "best terms and conditions" clauses, even where employed, have limited impact in practice due to the way the subscription market operates. This is because the market is already on "best terms" in the sense that, provided the cover can be completed, the same price, terms and conditions are offered to all insurers participating in the coinsurance process. One respondent even qualified the coinsurance process as making use of a "*de facto* best terms and conditions" clause. As in reinsurance, the actual use of a BTC clause would appear to have declined substantially in recent years (it may also never have been as prevalent in coinsurance as in reinsurance); however, **the market practice remains focused on a single set of terms and a single premium**.

As for reinsurance, the main procedures leading to the conclusion of a coinsurance agreement will now be described.

## 3.1 Description of the different procedures leading to the conclusion of a coinsurance agreement

The principal distinction is again the intervention or otherwise of an independent broker within the coinsurance process. The procedures used have much in common with those in use in the case of reinsurance.

### 3.1.1 Broker-led coinsurance (subscription procedure)

The replies to the questionnaire consistently mention one general type of procedure, involving intermediation by an independent broker, which, as in reinsurance, is often referred to as the subscription procedure. Below, an alternative broker-led procedure called "vertical underwriting" is described.

The subscription procedure proceeds according to several stages, which will be briefly summarized.

The broker provides potential coinsurers with underwriting information. Potential coinsurers are asked to indicate the share of the cover and the price they would be willing to accept. Whilst in the market as a whole coinsurance is the exception and single insurance the rule, in certain large markets the majority of risks are underwritten on a subscription basis.

The insurers reply with the share of the cover and the price at which they are willing to underwrite the risk. The broker discusses the offers with the client and advises him on which lead insurer to approach if the selected insurer is not covering the risk at 100%. Once a **lead insurer** has been determined, the broker will negotiate and agree terms and premium with this insurer.

The broker subsequently approaches the follow market to fill 100% of the slip and the offer agreed with the lead insurer is advised to a selection of insurers, which may or may not include some of the insurers who have quoted in response to the initial request but typically, according to certain information received, would include, if not concern predominantly, a number of insurers who are seeing the risk for the first time. The number of insurers available to act in this capacity is potentially greater given that it does not require the same degree of specialization.

Several scenarios are possible:

**a) The offer agreed with the lead insurer is accepted by all the other coinsurers, on the same terms and conditions (including premium).**

It is generally acknowledged on the part of market participants that the subscription procedure leads to a **single premium** but it is usually argued or implied that this procedure leads to the best terms and conditions for the client rather than the insurer, in the sense that the most advantageous offer is the one retained for the lead insurer, and the following insurers are required to match this price in order to subscribe a part of the risk, which in the case of those insurers who had already been approached in the tender phase would mean they had to lower their offers[18].

If a "best terms and conditions" clause were to be required by one of the following insurers, it would be unlikely to have any effects, as the cover is normally completed on a **"take it or leave it" basis**. The Commission services were advised that a BTC clause would rarely, if ever, be employed in such a context.

If a "best terms and conditions" clause is demanded by the lead insurer, this could lead to automatic premium alignment on the higher prices offered by at least one of the following insurers in the event that the coverage cannot be completed on the terms initially agreed. In this case, the insertion of a "best terms and conditions" clause would clearly lead to higher prices than those obtainable in its absence. Given that the lead insurer normally prepares one single policy wording, containing the same price level applying to all the coinsurers, it is probable that as a result all the following insurers would benefit from the premium level having thereby been obtained by the lead insurer.

Following insurers individually confirm to the broker or, on occasion, to the lead insurer their acceptance of the percentage of the line offered, each by completing a separate signing slip. The lead insurer prepares and issues policy documentation to the insurance client via the insurance intermediary.

**b) One or more coinsurers accept the share offered, but request additional conditions or introduce their own terms.**

This would be more likely to happen in a tight capacity market or for a specific risk and several scenarios are possible:

- The broker will **return to the lead insurer** either to renegotiate terms or to request that the lead insurer increases its proportion of the risk carried (in some cases, it will only do so on condition that the terms are changed).
- Following negotiations between the broker and the coinsurer which is requesting different terms and conditions, the client might decide to accept them. This is then communicated to all coinsurers. Negotiations between the broker and each coinsurer continue until **one set of terms and conditions is accepted by all coinsurers**. A new quotation which replaces the first one might be issued by the lead insurer.

Respondents state that a copy of the completed slip, signed/stamped by all subscribers is circulated by the broker to all subscribers and each subscriber's terms will be visible to all other subscribers. Then a final slip will be prepared with all these subjectivities agreed upon.

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[18] Whether such insurers would be willing to do this, and why, is not clear unless the lead insurer's terms were less favorable to the client than those on the basis of which the competing insurer had originally bid, and thus the risk premium was lower. This is because theory would suggest that in a competitive market insurers would already quote at or close to their reservation price in the first round.

**c) The cover cannot be completed at 100% at the proposed price and/or on the proposed terms and conditions**

There are several possibilities:

- The client may decide to self-insure the share of the placement for which no cover was obtained
- The client may decide to conclude individual agreements with insurers and accept different terms and conditions, including premium, for different portions of the cover (see below).

In this case, "best terms and conditions" may have the effect of the highest premium rate applying to the insurer with the benefit of this clause. That insurer would then benefit from the terms and conditions offered to any other insurer which is a party to the cover. Alternatively, the fact that the risk is covered by separate contracts may mean that BTC does not apply.

This scenario is understood, in any case, to be a very rare situation, in a tight capacity market or for certain very specific risks (e.g. aviation market).

### 3.1.2 Non-consensus procedure or "vertical underwriting"

This procedure is mentioned as a distinct case by only one large broker. In the case of that broker, it represents a minority but still significant proportion of business written, for marine, aviation and transportation lines only. It may, of course, be the case that some other brokers proceed on occasion on this basis, without having identified it as a distinct procedure, and for the large brokers this may even be a safe assumption; however, in the absence of any figures it is impossible for the Commission to know the type and proportion of business awarded by them in this way. Since this is evidently a distinct procedure, the failure of brokers who may use it to have identified it as such in their replies to the questionnaires should be viewed as unfortunate at best.

Risk managers consulted also failed to identify this procedure as applying in anything but very specific circumstances.

In the vertical underwriting scenario, **the price and possibly the deductible and/or reinstatement terms may differ amongst the various insurers subscribing the risk, while basic terms and conditions would tend to remain the same**. On other occasions, even basic terms and conditions may vary, or individual agreements with insurers may be concluded.

This procedure may involve **auctioning** the risk and is also described as an **auction procedure**.

### 3.1.3 The conclusion of a delegated underwriting authority

The specificity of this type of procedure is that an insurance intermediary accepts individual risks on behalf of coinsurers in accordance with the terms of a pre-agreed "delegated underwriting authority" (DUA), which gives authority to the insurance intermediary to accept certain risks on certain terms and within certain limits on behalf of the insurers.

The DUA is originally agreed between the coinsurers and the insurance intermediary. The lead insurer chosen by the insurance intermediary will provide to the latter underwriting criteria (including pricing) that it requires to be used under the DUA. The insurance intermediary will invite following insurers to participate and will provide to them the underwriting criteria, pricing and policy wording of the lead insurer. If acceptable to the

following insurers, they will indicate what percentage of the proposed DUA they are prepared to offer. The insurance intermediary will then inform each following insurer as to the percentage line that is being offered to them.

A DUA is signed by all the insurers and the insurance intermediary and includes the common terms (including pricing) upon which each insurer will underwrite and will specify what proportion of each risk each insurer will underwrite. The insurance client is not party to this agreement.

Some respondents indicated that there are slight variations within specific lines of business (e.g. Accident & Health): sometimes one coinsurer will have the authority to underwrite individual risks on behalf of all coinsurers, provided the risk falls within the pre-agreed parameters. In the event an individual risk falls outside these parameters, it is submitted to each coinsurer for acceptance on an individual basis.

The DUA acts, in principle, on the market as another insurer and may even compete with some of the insurers in its panel; whether or not it acts to reduce competition can therefore only be determined on a case by case basis.

#### 3.1.4 Coinsurance initiated by exclusive agents or the insurer itself

Besides the broker-led procedure, the respondents mention also a procedure initiated by exclusive agents or the insurer itself, with a distinction being made in the latter instance between cases where the insurer concerned is the one who initiates the procedure, especially when it has been approached with a request for single cover which it is not in a position to provide, and cases where it reacts to an approach from other insurers.

Within this procedure, insurers get the terms and conditions from the lead insurers and decide on whether to participate, and, if so, for what percentage. Respondents either state that the participation is at the premium and conditions of the lead insurer, and negotiation only concerns quota or that the other insurers perform their own premium calculation, but that in most cases the consortium is put together on the basis of a single premium regardless of internal arrangements on how the premium is distributed.

In exceptional cases, the procedure may be initiated directly by banks or by the customer.

### 3.2 Introduction of BTC in the cover

It appears from the replies to the questionnaires that best terms and conditions clauses are requested by insurers, never by the broker or the client. It seems that they are not, or only rarely, formally included in the policy wording and sometimes they are only used on a verbal basis with the broker.

When these stipulations do appear in writing, they are frequently in the form of an annotation to the original quote or introduced through an insurer's stamp on the slip. The term might also be raised in email or written correspondence, e.g. fax, in which the insurer states it will accept the proposed contract wording subject to best terms.

Some respondents emphasised that one of the biggest issues with "best terms" was defining exactly what they meant, because they were rarely spelt out in detail by the underwriter. Some examples of "best terms and conditions" succinct wordings confirm these observations:

- "Best terms available in the market";

- "Best terms to insurers"
- "Subject to warranted best terms and conditions"
- "Sub better terms"

Many brokers claim that they resist such clauses, in particular because they are aware that the clause may lead to dispute after an event or loss, which may involve considerable resource and expense in obtaining a commercial resolution for the insured, or could result in arbitration or legal action.

## 3.3 Incidence on the market

Most of the respondents acknowledged that "Best terms and conditions" stipulations have been frequently used in the past, but claimed that nowadays these stipulations are not widely employed.

When it comes to lines of business especially affected by "best terms and conditions", some respondents state that these stipulations have been used especially in the property line of business for large corporate clients. Apparently BTC has been used more recently in relation to projects in the field of space technology or within the liability and the construction lines of business, even if, allegedly, "very rarely".

Irrespective of the line of business, a general observation is that "best terms" tend to be more prevalent in a hard market where there is less capacity.

It seems that these clauses tend to be requested by insurers in certain geographical markets across various lines of business rather than within specific lines, or by insurers established in specific countries. Even so, a certain contradiction on a general level has been observed, since respondents established in the UK state that they tend to find these clauses emanating from German, Swiss, Spanish, French, US and Bermudian insurers, but that they are very infrequently used on the London market whereas respondents established in France for instance claim that "best terms" arise especially on the London market and very rarely on the French market.

It appears that the key factors influencing the diminishing and arguably by now infrequent use of "Best terms and conditions" stipulations are:

- The negotiation of the coinsurance process will usually mean that the risk is covered in its entirety at the terms offered by the broker (terms and conditions previously agreed upon with the lead insurer).
- The encouragement by the UK regulatory authority of the introduction of "contract certainty" principles to offer improved protection to the interests of the insured. The rationale behind the "contract certainty" is to ensure that insurance is provided subject to terms which are sufficiently clear so that the insured is able to ascertain from the outset the full extent of the cover provided. The view has been taken that "best terms" is not contract certain and therefore brokers have been vigilant in having it removed in instances where underwriters have sought to impose it.
- The legal opinion of the French *Conseil de la Concurrence*, which stated that this type of clause "**creates a practice which can restrict competition in the market**

**by favouring an artificial increase of prices to the detriment of their free setting by the market**"[19].

- Lack of capacity constraints in the market.
- As already stated, some of the brokers, especially the large ones, have adopted a policy not to accept "best terms and conditions" as they are aware that this clause operates to the detriments of the client's interests.

The Commission's own sector inquiry may arguably also have had an impact more recently on the prevalence of BTC although this is difficult to gauge.

## 4. EFFECT ON THE MARKET

### 4.1 ALIGNMENT OF TERMS TO THE POTENTIAL DETRIMENT OF THE (RE)INSURED

In addition to the concerns related to contract uncertainty, as discussed above, and which, whilst serious, are not properly a concern of competition law, BTC clauses have the principal effect of aligning terms, conditions of cover and premiums at levels which are, to a varying degree, detrimental to the (re)insured and which are correspondingly more favourable to the (re)insurers. In the coinsurance market, despite the lack of precision as to their interpretation, BTC clauses may also be considered more specifically as a tool used by a potential lead insurer to benefit from the typically higher price that may have to be offered to the reluctant insurer to complete the cover. It is less evident whether this is still a relevant dimension of the clause in the reinsurance markets.

Although it appears that the "best terms and conditions" clause appears very rarely as a distinct clause in the contract, it could be used to apply pressure in order to obtain premium harmonisation at the highest level possible and/or the most restrictive terms of cover, to the detriment of the customer.

In the view of the Commission services, to the extent that it does not result from a concerted practice, the stipulation by a potential (re)insurer, acting independently, of a BTC conditionality in its offer of coverage at the tender stage may not be best market practice, but can hardly raise concerns under Article 81 since the client or his broker is free to refuse this condition.

It must be reiterated that the outcome of harmonized terms and conditions appears to be achieved in the vast majority of cases without the explicit use of a BTC clause, even at the quote stage. Indeed, this may be why the clause itself appears to be falling into relative disuse. The precise mechanisms which lie behind the general market practice of premium alignment even in the absence of BTC clauses are not, however, yet clear.

The restriction enacted in the context of pursuing the subscription procedure can be viewed as containing at least four distinct elements :

a. Alignment on the contractual terms offered by the lead (re)insurer;

b. Revealing the price offered by the lead insurer to the follow market;

c. Potentially, guaranteeing to the lead insurer that the price and conditions, and the share of the risk, that were agreed with it at the end of the first round, will not be changed to its detriment if participants in the follow market were to offer a lower price[20];

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[19] Legal opinion n° 03-A-19 of 17 November 2003, p. 8.

d. Alignment on the premium.

Although it is the broker's responsibility to ensure that the client's interests are respected, the Commission services are not aware of the extent to which it is general practice that brokers inform clients about the possible existence of different best terms and conditions requests from different insurers and their potential impact on the terms of coverage. It would be hard to view this, however, as anything but good practice. The services also consider that, whilst there may be clear benefits from having a single set of terms and conditions, clients should not necessarily be precluded from having different agreements with different insurers where this is not prejudicial to their interests, since such different agreements may be in part more favourable than those available on a harmonized basis. Therefore, it would be desirable that brokers systematically discuss with their clients all available options rather than exclude certain options in advance merely on the grounds that such options are contrary to established market practice.

The harmonization of premiums at the highest level would also lead to higher brokerage fees for brokers in cases where the brokerage fee is calculated as a proportion of the premium (and possibly also when the broker is remunerated on a fee basis, if in addition he receives contingent commissions based on the profitability of the business placed). In this case, brokers might not have an incentive to challenge the prevailing market practice beyond their insistence that a BTC clause not be incorporated in the contract as such because of the effect of contract uncertainty which it would engender. However, the Commission services understand that, for the classes of risk concerned, clients normally remunerate brokers on a fee rather than commission basis so that this incentive problem for the broker would not arise unless linked to any additional contingent commission arrangements they may have with insurers.

When reinsurance is bought directly by the cedant, or coinsurance by a customer, one might expect that incentives would be properly aligned. It is not presently clear to the Commission services whether or not this is in fact the case and, if not, whether for example principal-agent problems might lead to misalignment also in this latter case[21].

## 4.2 Alleged efficiencies

Some market participants have put forward a certain number of justifications for the use of the BTC clause. However, all or almost all participants have acknowledged that alignment of premium and the terms of cover occurs anyway in co-(re)insurance and have not explicitly sought to justify this outcome, apparently on the grounds that it was largely unquestioned market practice.

Since the inquiry's questions regarding the BTC clause may not have been understood by respondents to refer also to the general situation of aligning terms, it cannot be excluded that further justifications might have been put forward by the industry if the latter scenario had been more clearly within the scope of the questionnaires. Nonetheless, the justifications put forward in defence of the market practices observed, while valid in part, do not go to the heart of the issue of premium alignment under the subscription procedure and whether this

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[20] It was not established to what extent this was standard practice; however, it is implied by the practice of aligning premiums since, in this case, follow insurers are not invited to quote a lower price and so the conditions are unlikely to arise under which the broker might have an incentive to renegotiate with the leader.

[21] The suggestion in this case being that although the customer firm has an incentive to pursue the insurance option which is economically most advantageous to it, purchasers of (re)insurance within those firms may have incentives which are not precisely aligned with those of the firm as a whole.

may generate market efficiencies. Accordingly, it is worthwhile summarizing and analyzing these potential efficiency arguments.

#### 4.2.1 Effect on capacity and risk diversification

The principal argument put forward in support of BTC, which would apply to the subscription procedure generally, is that smaller or less experienced (re)insurers benefit in this way from the conditions negotiated by the larger, more experienced (re)insurers. In consequence, more (re)insurers will tend to participate in the cover and so capacity on the market will be increased and possible risks linked to default of a single (re)insurer also diminished, as each party of the agreement is independently liable for its share. A consequence of the spreading of risk could also be the reduction in price of (re)insurance (though it is not clear under what circumstances this would be material). (Re)insurers are also interested in maintaining an acceptable spread of risk and exposure to reduce the volatility associated with large losses which could threaten their solvency. Increased capacity could also lead to lower prices if capacity is initially constrained and therefore rationed through price signals.

It seems doubtful whether the stipulation of a BTC condition in the offer which is then retained as the basis for the constitution of the co-(re)insurance syndicate could be justified on the grounds of increasing capacity. This is because it seems unlikely that a client or following reinsurers would accept the lead from an inexperienced or financially less robust reinsurer, and therefore this (re)insurer does not need to apply such terms in order to supply its capacity to the market.

A more sophisticated version of this argument implies that a (re)insurer may have an interest in attaching BTC conditionality to its offer in order to avoid the "winner's curse". This is the phenomenon whereby, in an auction, the party bidding highest has, by definition, valued the good being purchased above the consensus level of the market and (assuming private and public value are aligned) is therefore more likely to be wrong, but does not know this ex-ante.

This may indeed be a reason why some reinsurers who are particularly hesitant about their ability to determine the value of a particular risk may wish to accompany their offer with such a conditionality, but hardly justifies a market-wide practice, at least on any grounds that the Commission services are presently able to envisage. It should also be noted that an auction process is also designed by the seller to capture part of the value premium which some buyers attach to a particular good and thus inevitably increases consumer welfare (where consumers are sellers, in this case of risk), even if it subjects buyers to the winner's curse. If all participants to an auction were to attach conditionalities to their bids based on general market evaluation, this benefit would be lost. A concerted practice to that effect can, therefore, hardly be considered to qualify on *prima facie* grounds for exemption under Article 81(3), and might, therefore, contravene competition law if it was found to fall under the prohibition of Article 81(1). This latter point is discussed further below.

In a variant of the capacity argument which is employed in defence of BTC *per se*, it has been suggested that, under the subscription procedure, the broker must reveal the actual terms and conditions agreed with the lead (re)insurer at the stage of completing the cover in order to give following (re)insurers who may have less experience with the class of risk concerned confidence in the pricing of that risk. It has also been pointed out that the process of assessing a given risk may be quite costly, that (re)insurers will be unwilling to assume this cost without a reasonable prospect of getting the business on the terms they desire, and that it would anyway be inefficient for following (re)insurers who have not assessed the risk at the tender stage to be obliged to do so subsequently, at a cost which would have to be passed on

to the client (divided by the probability of in fact obtaining a part of the business). Some market participants have even suggested that concealing this price might amount to fraud on the part of the broker and be so viewed by regulators, although it is not clear that this would apply in cases other than wilful misrepresentation.

The efficiency argument to justify revealing the leader's price cannot be rejected ex-ante although it is not necessarily self-evident either. In any case, its relevance does not extend to aligning the premium agreed with the followers on the price revealed, and such alignment therefore presents the character of an additional constraint which is not indispensable to achieving the efficiency.

It would appear that a number of factors might justify variation in price amongst insurers in a co/reinsurance syndicate, including most notably the distinct role and costs assumed by the lead insurer (on which the followers, to a certain extent, free-ride) as well as the fact that, if premium alignment is imposed ex-ante, there may be pressure on the broker or client to work on the basis of a higher proposed premium than would otherwise be attainable from the lead (re)insurer in order to achieve greater certainty of full coverage at the subscription stage. It is not clear whether this would lead to a tendency to prefer higher bids at the initial tender stage or to encourage candidate lead (re)insurers not to bid "too low". Whilst in some instances the lead (re)insurer receives a separate administration fee, this appears not to be usual practice. The Commission services also note that when the syndicate is constituted by the (re)insurer itself, the division of premiums amongst the participants is an internal matter likely to be invisible to any involved broker and, as such, it does not raise similar observations.

It also seems that the mechanism in question gives limited incentive to (re)insurers who both bid in the tender phase and would wish to participate in the subscription phase, to offer the best possible price in the tender phase. This is because by bidding low in the first phase, they potentially impose a negative externality on themselves in the second. This would increase the rewards from collusion and therefore the incentive to find means to collude during the tender phase. Moreover, since price transparency is achieved ex-post (at least as concerns the offer of the entity chosen as lead reinsurer, which is the key price needing to be controlled for collusive purposes), it would be easy to effectively monitor the degree of ex-post compliance with any ex-ante collusive agreements. If it is accepted that such price transparency is needed to achieve efficiencies, as described above, then there is all the more reason to be vigilant in respect of accompanying market practices which have the potential to increase the incentive for collusion.

Although the Commission services would emphasize that they have not found evidence of actual collusion, it is nonetheless of concern that the subscription practice in the way that it currently works may act, at least in theory, to underpin collusion.

Since the Commission services do not see evidence that the practice of premium alignment is indispensable to achieve an increase in capacity, it is evident, *a fortiori*, that actual BTC clauses are not indispensable to that goal. Therefore the argument of increasing capacity would not seem to amount to grounds for exemption under Article 81(3) either for BTC or for imposed premium alignment within the subscription procedure.

#### 4.2.2 Effect on the service offered to the customer

Some market participants have asserted that this type of practice helps to achieve administrative efficiencies, such as more quickly establishing cover and facilitating the handling of claims.

The majority of the replies to the coinsurance questionnaires stressed the importance of having the same terms and conditions for all the coinsurers participating in the negotiation process, citing the following considerations :

- For the customer: the ability to find 100% cover quickly for a particular risk, the existence of only one policy wording, the reduced risk of gaps in coverage for different portions of the risk, the avoidance of the need for multiple risk surveys to be undertaken, simplified claims settlement system and reduction in claims disputes.
- For the insurers and intermediaries: the ease of premium distribution, streamlined claims settlement, quick resolution of disputes over interpretation and coverage, reduced time taken for a broker to negotiate the full cover for its client – leading to cost efficiencies.

Whilst these considerations are certainly not without value, respondents did not specifically address the question of efficiencies which would be brought about specifically by having one single premium level for all the (re)insurers participating in the process instead of individually established prices.

Respondents implied, in some cases, that premium and contract terms were inevitably linked in the sense that the same terms and conditions would inevitably imply the same premium, or that "equitable premiums" are being offered for the same risk exposure. While there is unarguably a link between terms and premium, it should normally be possible for the risk to be priced individually by each of the participants, as it depends not only on the terms and assessment of the risk, but also on a number of other elements which are specific to every insurer. These include the costs incurred to assess and price the risk and in the event of a claim, the diversification value of the risk to the insurer, its cost of capital and so on.

It may also be questioned whether certain of the cited efficiencies actually benefit the consumer at all, much less would meet the "fair share" criterion of Article 81(3). This is in particular the case for the administrative efficiencies achieved in the tender process when broker fees are anyway established on a default *ad valorem* basis, since in this case the benefit is fully internalized by the broker. To the extent that the time saved in looking for a lower price results in a higher one, customers are clearly disadvantaged to an extent which even saved brokerage fees may not offset.

It therefore cannot be entirely excluded that administrative efficiencies might justify the practice of offering a single premium level to all following reinsurers in certain circumstances. However, no evidence was produced of such an efficiency, which would need to be assessed on a case-by-case basis.

The practice of aligning other terms whilst allowing premiums to vary appears to the Commission services to have a much more plausible efficiency defence, although also this cannot be concluded with certainty without examining the specifics of an individual case..

## 5. LEGAL ANALYSIS

Within the context of this final report on the sector inquiry into business insurance, the Commission services limit themselves to expressing a *prima facie* assessment of the legal qualification of the "best terms and conditions" clause and of the negotiation process on the coinsurance and co-reinsurance markets.

A definitive assessment can only be achieved on the basis of detailed examination of specific agreements and will obviously depend on the factual circumstances of each case. This

is in particular the case given that certain of the practices observed might fall within the scope of Article 81(1) and thus the assessment of them will depend on considerations of efficiencies as already outlined above.

### 5.1 Exchange of Information on Prices

From the description of the coinsurance and co-reinsurance subscription processes it results that insurers or reinsurers expect to, and do in fact, become aware of prices offered and agreed with the customer by certain of their competitors. This happens either through the intermediary agency of a broker or directly through the lead insurer's mediation.

The Court has confirmed, in a case that involved a highly concentrated market on which competition was already greatly reduced, that exchanges of precise information on individual sales at short intervals between the main competitors, to the exclusion of other suppliers and of consumers, were likely to impair substantially the competition that exists between traders. In such circumstances, the sharing, on a regular and frequent basis, of information concerning the operation of the market had the effect of periodically revealing to all competitors the market positions and strategies of the various individual competitors[22]. On appeal, the ECJ confirmed that this type of exchange was liable to have an adverse influence on competition[23]. The Court of Justice has also found that an information exchange system may constitute a breach of the competition rules even when the market is not highly concentrated but there is a reduction of the undertakings' decision making autonomy resulting from pressure during subsequent discussions with competitors[24].

As regards more specifically business insurance, the fact that insurers and reinsurers become aware of the prices quoted by their competitors may, depending on the circumstances of the case reduce the autonomy of competitors in determining their own market behaviour and thus lead to higher prices, or mean that fewer (re)insurers actually engage in pricing any particular risk coverage on a realistic basis in order to avoid overheads for business they do not expect to win. For example, a (re)insurer can make a tender which it knows will not be accepted (because, from the experience gained, based on the information gathered over time, it might know that one of his competitors will quote at a lower price), without losing the opportunity to participate in the contract. This type of behaviour may, depending again on the circumstances of the case, lead to higher prices.

Whilst exchanges of information thus might, in a range of circumstances, fall under the prohibition laid down by article 81(1), the question remains open, at this stage, whether they meet the criteria for exemption of Article 81(3), as already discussed above, either as a general matter (which is less likely) or in individual cases or a defined range of circumstances. The Commission Guidelines on the Application of Article 81(3) provide guidance as to the methodology to apply these conditions[25].

In order to meet those criteria, it would, in particular, be necessary that the arrangements used do not go beyond what is indispensable to achieve the efficiency cited, and that customers receive a fair share of the benefit.

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22 Judgment of the Court of First Instance in Case T-35/92 *John Deere Ltd* v *Commission*, [1994] ECR II-957, paragraph 51. More recently, the Judgment of 23 November 2006 in *Asnef-Equifax* v *Ausbanc,* Case C-238/05, § 73.

23 *John Deere Ltd* v *Commission*, Case C-7/95 P, paragraph 90.

24 Judgment of the Court of First Instance in Case T-141/94 *Thyssen Stahl AG* v *Commission* [1999] ECR II-347, paragraphs 402 and 403.

25 OJ C 101, 27.4.2004, p. 97.

The question may arise whether an analogy could be drawn with the insurance Block Exemption Regulation[26], in order to argue that individual coinsurance agreements fall below the relevant thresholds for market share and thus may meet one of the requirements needed to benefit from the block exemption. However, the BER exempts only a defined subset of standing arrangements set up ex-ante to cover a specific *category* of risks. Moreover, the BER expressly recalls that the standardisation of premiums, amongst other practices, involves a restriction of competition and that it is appropriate to lay down, in this context, what is implicitly a limited set of circumstances in which such groups can benefit from exemption[27]. Furthermore, this exemption is conditional on sufficient competition remaining in the market. In the present context these criteria are not met.

Some market players may also point to the conclusion of the French Competition Council[28] according to which the BTC clause, and by analogy also the generic subscription procedure, would be without effect in the event that customers were not deprived of the possibility of returning to the market to obtain other terms.

Whether or not such a possibility exists in practice can obviously not be determined ex-ante, but in many cases such a choice is likely not to be available bearing in mind that most of the market operates *de facto* only in this manner. However, better awareness ex-ante on the part of customers might enable them to insist that brokers pursue alternatives from the outset and, in this case, it is possible that the behaviour of insurers would in turn change to accommodate more flexibility in the procedure.

## 5.2 Possible existence of other concerted practices or agreements on price fixing within the scope of Article 81(1)

As discussed above, the Commission's investigations showed that premium harmonisation remains, in the vast majority of cases, a consequence of the way that coinsurance and co-reinsurance markets usually function, even in the absence of a "best terms and conditions" clause as such. As already mentioned, the broker proposes to the following (re)insurers to fill the cover at the same terms and conditions, including premiums, as those agreed upon with the lead (re)insurer.

This practice seems to exclude the possibility of obtaining more advantageous terms from the follow market by stimulating competition between participants in that market, and imposes on that market a price taken from the lead market, notwithstanding the more limited role played by and costs incurred by potential follow insurers, which might be expected to justify a lower price in that market. Since this way of proceeding leads to convergence amongst a number of independent undertakings on a single price, it might be considered potentially to fall within the scope of Article 81(1), again provided the other conditions of that article are satisfied. Additional analysis would be required to confirm this.

Many brokers have stated that they do not accept the best terms and conditions clause and some of them have an in-house policy against it. However, even in the absence of a BTC clause or explicit conditionality, the question arises of whether, by failing to stimulate possible competition on price in the follow market, brokers are not, in certain instances, parties to arrangements which fall within the scope of Article 81(1).

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[26] Commission Regulation (EC) No 358/2003 of 27 February 2003 on the application of Article 81(3) of the Treaty to certain categories of agreements, decisions and concerted practices in the insurance sector (OJ L 53, 28.2.2003, p. 8).

[27] Recital n° 18 of the Block Exemption Regulation.

[28] Legal opinion n° 03-A-19 of 17 November 2003, page 8.

As already indicated in section 4.2 above, the question as to whether there are efficiencies which meet the criteria of article 81(3) EC is a matter of factual circumstances which can only be fully determined on a case-by-case basis.

### 5.3 Status of brokers under the competition rules

It has sometimes been suggested that, under the competition rules, brokers should be viewed as pure agents of the customer and that, accordingly, any agreement to which they are party is an agreement directly with the customer and, as such, unobjectionable.

In the view of the Commission services, the agency nature of any agreement between broker and customer does not have the effect of removing the broker, in its capacity as an independent undertaking, from the obligation of respecting the rules on competition.

It is relevant in this respect to note that a broker (with the exception of an in-house broker) is not a pure agent of any single customer but provides services to multiple customers and potentially to any customer; that he is remunerated on terms which normally relate exclusively to specific insurance business to be passed, i.e. not retained by the client on a standing basis; and that the broker faces incentives which are not narrowly aligned with those of the customers. As such, it appears that the broker constitutes an independent undertaking from the customer whose behaviour is dictated by its own commercial considerations, albeit subject to certain regulatory constraints. In this capacity, the broker is capable of, and does, enter into agreements and conduct business which goes beyond a pure representational role. Such agreements have the potential to have an impact on customer interests and must therefore be subject to the competition rules of the Treaty.

Secondly, the fact that the final customers of business insurance are undertakings would anyway bring the relationship between them and insurers within the scope of Article 81 even if brokers were acting as their pure agent. This is clear from §24 first indent of the Commission's Guidelines on Vertical Restraints which reads that "Vertical agreements with final consumers **not operating as an undertaking** are not covered; More generally, agreements with final consumers do not fall under Article 81(1), as that article applies only to agreements between undertakings, decisions by associations of undertakings and concerted practices."

Accordingly, the Commission services are of the view that the relationship between insurer and broker cannot be exempted from the scope of Article 81 *per se*.

It remains possible, of course, that in the context of a given procedure all decisions as to the award of the business are made in full autonomy by the customer, having been advised of all relevant possibilities by the broker and that, in this context, the broker merely advises and carries out the instructions of the client and plays no role in influencing the choice of procedure. Indeed, it is evident that this is a description of what should be good, and standard, broker practice. In the event that the customer is fully informed in this way and given every opportunity to make use of alternative ways of awarding the market, and that the panoply of options available to the customer has not been reduced by any prior agreement between insurer(s) and broker having general effect, it might then be argued that the broker could not be considered a party to any possible infringement of Article 81.

Whilst it remains, under normal circumstances, the right of individual insurers to decide the way in which they do or do not wish to do business, collective arrangements which narrow the scope for individual insurers to do business in other ways than the subscription procedure would likely fall within the scope of Article 81(1) and need to be assessed for their compatibility with Article 81(3). In the view of the Commission services, an important

consideration would be whether the arrangements in question are transparently disclosed to the client.

The Commission services cannot presently exclude that the current market situation may be an equilibrium without explicit collusive intent, underpinned by certain market failures and possibly by incentive incompatibility on the part of the broker, albeit that an individual insurer would appear to be free to quote a lower price for a given risk, even if not invited to do so, in order to win the business. It must be noted, however, that such an independent quotation is in fact very rare. It is not clear whether this may in part be due to the possibility that some insurers have other inducements available to influence the broker's choice, a matter which, however, is speculative and falls in any case within the matters considered in the next chapter. In case the market is indeed in such a situation of weak equilibrium, activism by customers, brokers and/or insurers, supported by their associations, might be sufficient to reform procedures to the benefit of customers and of those market participants who best serve their needs.

Finally, and in passing, the Commission services would also note that insurers have also on occasion made the contrary – and evidently incompatible – claim that brokers are agents of insurers and thus that the relationship between insurers and brokers falls under the agency exception of the Commission Notice on Vertical Restraints[29].

## 5.4 Customers

As indicated above, the vertical relationship between insurers and final business customers may also be considered to fall under Article 81 of the Treaty. This is particularly so when this relationship results in outcomes which are prejudicial to final consumers. In the present instance, increased costs of insurance may in the end be borne by the customers of the businesses which pay these costs. If market practices impede the discovery of lower input prices for all producers of competing goods or services in a given market, then market efficiency suffers in downstream markets too. As undertakings themselves, it is not excluded that customers of business insurance may be a party to arrangements the cumulative effect of which is to raise downstream industry prices. These agreements may certainly in most cases be *de minimis* in the markets concerned, but it is not excluded that in certain cases the collective failure of participants in an oligopolistic or monopolistic market to discover ways to reduce costs in input markets may derive from anticompetitive agreements and thus have to be reviewed under the competition rules.

More generally, it has been put to the Commission services that the relationship between customers and providers of business insurance suffers from a principal-agent problem on the demand side. This type of problem occurs, of course, in a variety of B2B settings. In this instance, the hypothesized problem specifically concerns a failure on the part of senior management of insured companies to correctly assess the performance of company risk managers. Risk managers' principal incentive is to put insurance cover in place, whilst they do not bear the cost of it. This might, of course, be mitigated by the professional duty of the broker to discover the best terms of cover, and indeed risk managers may feel they are justified in relying on this. However, if there is a market failure along the chain, then also risk managers may not exert the optimum level of effort in control of the actions of brokers. This may help to explain why there is insufficient customer activism to destabilize suboptimal market practices.

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[29] Commission Notice, Guidelines on Vertical Restraints, § 13.

## 6. CONCLUSIONS

Both co-reinsurance and coinsurance are important mechanisms underpinning the EU insurance industry and the insurability of large risks. The existence of mechanisms allowing multiple (re)insurers each to take a part of a given risk plausibly allows for greater capacity and risk diversification and results in lower prices and better terms for clients. However, whilst acknowledging these benefits, the Commission services have found, in this chapter, evidence that market practices exist, and are even widespread, which may fall within the scope of Article 81(1) of the Treaty and which may not satisfy all of the criteria for exemption of Article 81(3). Reform of these practices might well result in a better deal for clients.

In view of this conclusion, the industry is invited to consider the matters raised in this chapter and either to reform its practices or to ensure that they meet the conditions required for compatibility with EC competition law.

In following up the findings in this chapter, the Commission services will take into consideration the widespread nature of the practices found, the long period during which they have existed in the marketplace and the extent to which they may have been considered normal market practice. In the case of coinsurance, the services are also aware of the potential efficiency created by the reduced need to have recourse to facultative reinsurance; however, it needs to be recalled that restrictions of competition are only justified under Article 81(3) *inter alia* if they do not "impose on the undertakings concerned restrictions which are not indispensable to the attainment of these objectives". Certain characteristics of the subscription process, and notably the alignment of premiums, do not appear, at this stage, to have this quality of indispensability. Should this process be underpinned by agreements or concerted practices between undertakings, and should this have a negative effect on competition on the relevant market, such agreements or concerted practices may thus run afoul of Article 81 of the Treaty.

Finally, the Commission services also invite the customers of business insurance and reinsurance which is typically awarded on a subscription basis to be aware of the possibility of awarding such business on terms which do not imply harmonized premiums and to ensure that wherever this is appropriate, this option is fully explored by risk managers and brokers.

# IV. DISTRIBUTION OF BUSINESS INSURANCE

The Interim Report on the business insurance sector inquiry provided a detailed overview of the main aspects relating to the distribution of business insurance products and services in the European Union. The analysis was based on both extensive desk research and a vast array of empirical data derived from questionnaire-based surveys among a large number of market participants and industry associations (see section I.2.1 for details).

Responses received within the framework of the public consultation showed very limited controversy or doubt in relation to the inquiry's factual findings. A significant number of respondents, including important market players and industry associations, also agreed with the gist of the preliminary conclusions set out in the Interim Report. Some market participants or their representative bodies, however, did not, or not entirely, share the report's interpretation of the facts or tried otherwise to justify some of the practices called into question.

Below, some of the most competition-relevant facts established in the Interim Report in their respective context are briefly reproduced and discussed in the light of the observations received in the framework of the public consultation procedure and of additional fact-finding carried out subsequent to the publication of the Interim Report, where applicable. In all cases reference is made to the Interim Report for full details on the facts established in the market surveys.

This Chapter is divided into three parts dealing, respectively, with a description of how insurance distribution is organized and some competition issues that this organization may raise; conflicts of interest to which intermediaries may be subject; and the specific issue of commission rebating. Parts 1 and 2 are based on the surveys carried out in phase one of the inquiry, whereas Part 3 presents new information from the more targeted surveys realized in phase two. For a glossary of terms used in this section, please see Annex 2.

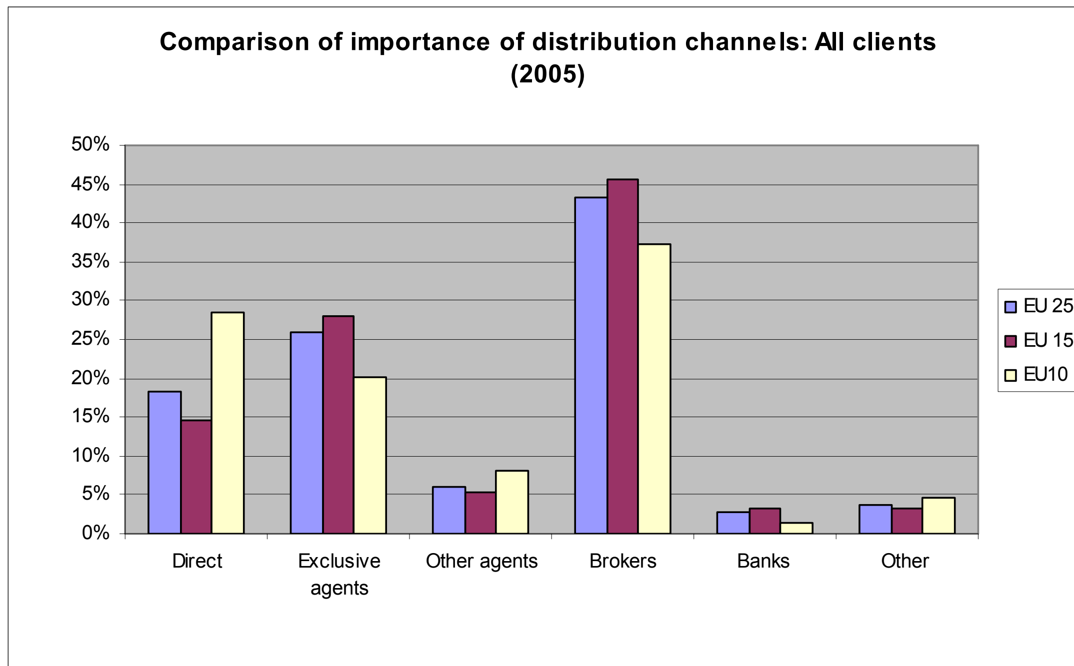
## 1. DISTRIBUTION CHANNELS

### 1.1 Importance of the various distribution channels in the total non-life business insurance sector per country and at EU level

The business insurance market in the EU is predominantly served through brokers and multiple agents, although many insurance companies operate through more than one system. Exclusive agents constitute the second most used channel of distribution in most lines of commercial insurance products.

As described extensively in sections IX.2.1 through 2.5 of the Interim Report, the role of brokers has changed a lot in recent years to encompass a range of new services provided both to clients and to insurers, and continues to evolve.

Graph IV.1




*Source: European Commission, Business Insurance Survey 2005-2006*

There are nevertheless distinct variations at Member States level across the EU in the structure of distribution channels[30].

Traditionally, the broker channel is predominant in the Anglo-Saxon countries such as the UK and Ireland, but also in Belgium and the Netherlands. In the UK, for example, the brokers' share measured as a percentage of premiums generated by commercial lines is very high (70%-80%), while direct marketing or tied agents both represent less than 10% each. In Belgium, the brokers' share for all commercial lines together exceeds 80% while the rest of the market is mostly served by exclusive agents. Direct sales appear relatively insignificant; they are limited to a few lines of insurance such as 'accident'. By comparison, in the rest of Europe the share of business conducted by brokers is also significant, but smaller.

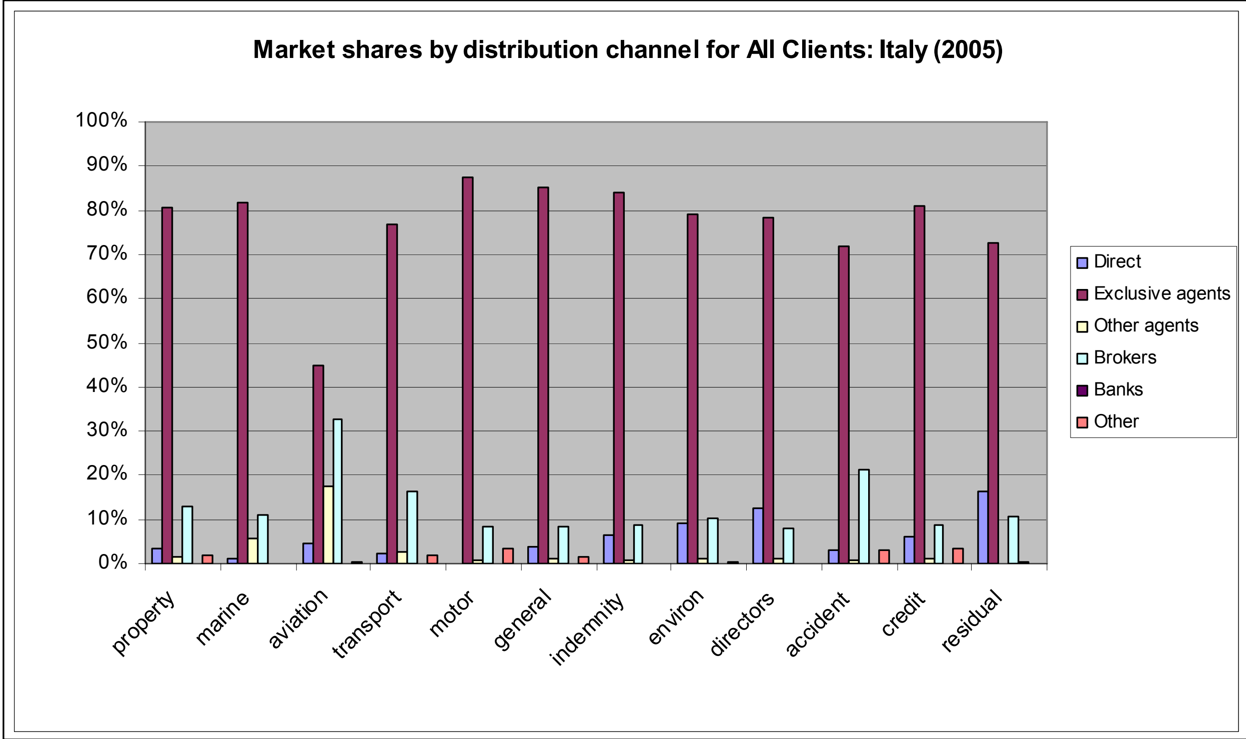
At the opposite end of the spectrum, tied agents constitute by far the most important distribution channel in Italy, not showing any sign of decline over time. Here, the Interim Report found that exclusive agents hold a market share of close to 75% on average and over 80% in some business lines such as general liability, indemnity or motor insurance[31]. Germany, which is reputed to be a tied agent market as far as the placement of insurance in general (i.e. life and non-life insurance including personal lines) is concerned, does not

[30] The figures presented are based on the responses to the Commission's survey of insurers.

[31] The importance of the brokerage channel is more significant in respect of the Energy, Marine and Aviation product lines. It appears that the importance of the tied agent channel is reinforced in Italy by the fact that brokers themselves place insurance through tied agents. The Swiss Re Sigma report No 2/2004, notes in this context (p. 33): "The small broker share in the Italian market is apparently understated: 7% of business goes directly to insurance companies, whereas a considerably larger share is channeled through tied agents. The tied-agent system in Italy is often based on bilateral exclusivity rules – according to which all business within defined geographical areas must go through the agent." See on this further below.

present the same pattern in respect of commercial insurance where brokers are represented to a much higher extent.

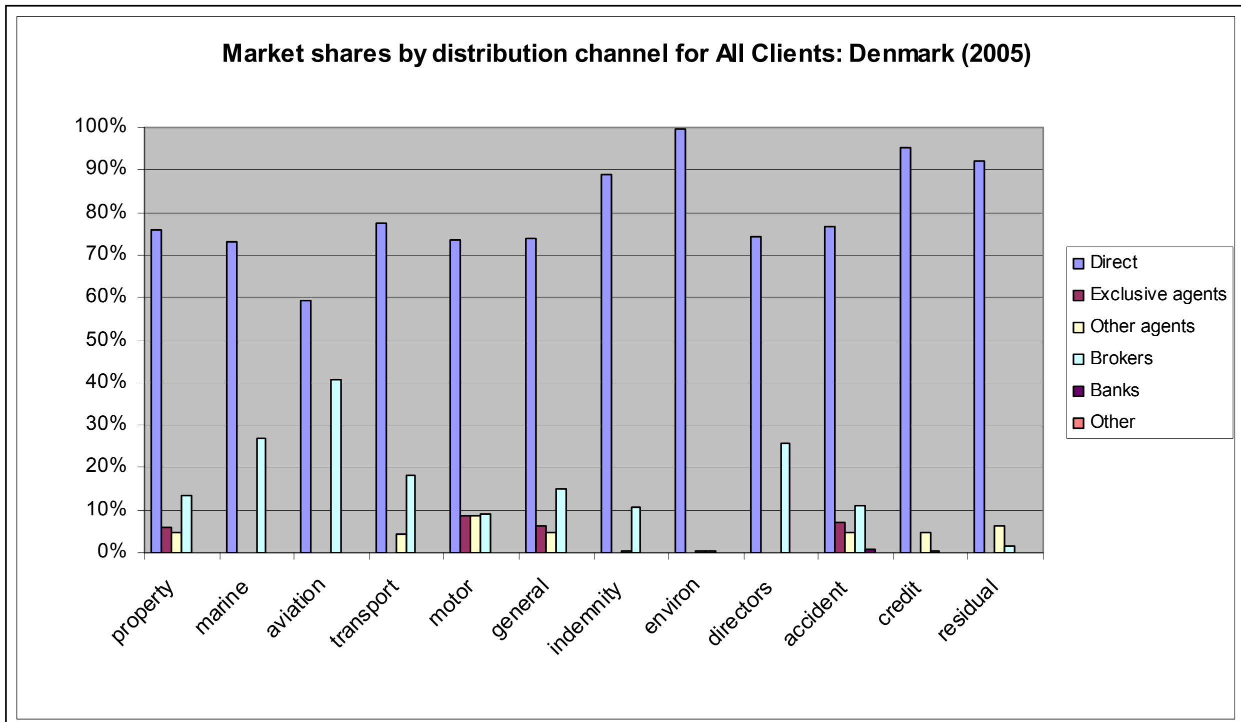
Graph IV.2




*Source: European Commission, Business Insurance Survey 2005-2006*

Direct writing is traditionally favoured in the Nordic countries, Denmark, Sweden and Finland. The Baltic countries, Estonia, Latvia and Lithuania, have followed the same pattern. Insurers have sometimes considered direct sales to be a particularly interesting distribution channel, because it may appear less costly and could also allow for more stringent controls of the quality of business accepted. In Denmark, the share of direct writing measured as a percentage of premiums generated by commercial lines ranges from 60% up to 100% for each of the lines of insurance, while brokers and agents represent less than 10% each.

Graph IV.3




*Source: European Commission, Business Insurance Survey 2005-2006*

Overall, banks and other financial institutions constitute only a minor channel of distribution of business insurance products in Europe, notwithstanding their major role in the distribution of life insurance in countries such as France, Spain, Italy, Portugal or Belgium. This may be explained by the complementarities of some kinds of life-insurance products with certain banking products and by the banks' possibilities to exploit existing customer relationships for cross-selling[32].

The lower market shares in the distribution of non-life business insurance products may among other things reflect the level of competition experienced by banks from other established channels, the higher degree of complexity of risk and, as a consequence, of special expertise required, the higher resource demands servicing insurance clients etc.

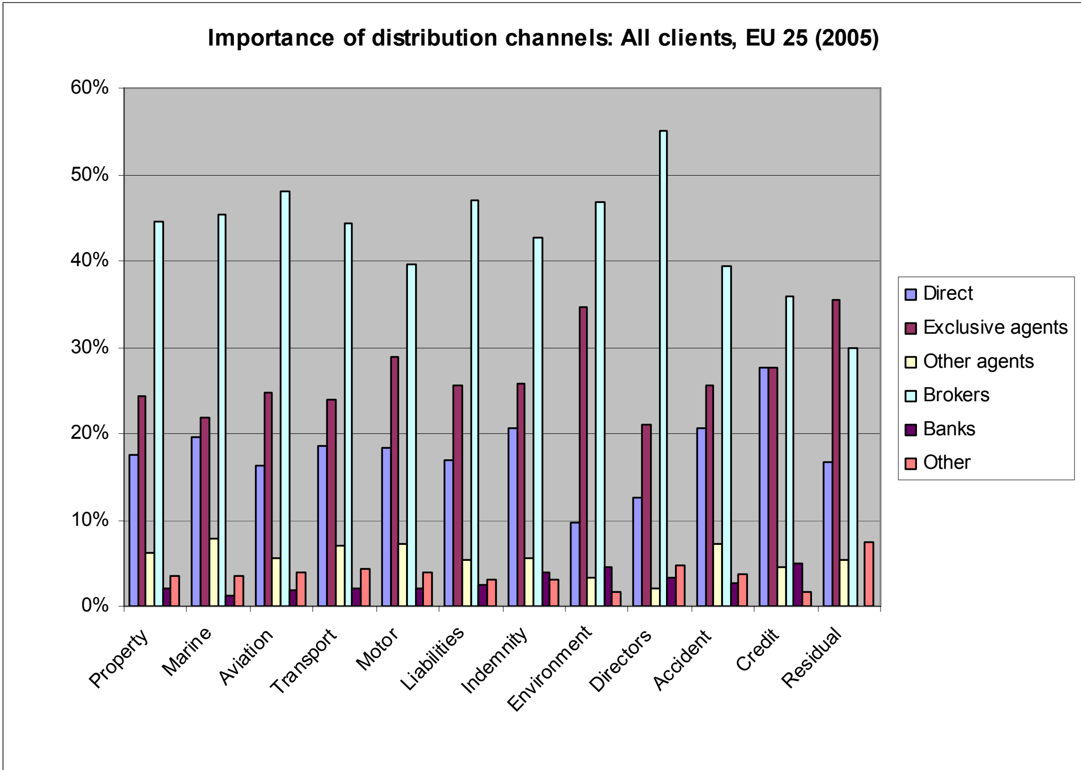
The sector inquiry nevertheless shows a significant presence of banks in the distribution of certain lines of business insurance in some countries such as the Netherlands or Spain. However, this appears mainly to be confined to the distribution of certain standardised insurance policies to small businesses responding to straightforward insurance needs. In one case reported to the Commission (see section 1.2.3 below), the bank distribution channel may be dominant for certain customers and products, built on the ability to leverage banking relationships with a subset of smaller SMEs.

[32] For a discussion of banks' practices relating to the cross-selling of banking products, please refer to the European Commission's recent Report on Current Accounts and Related Services.

### 1.1.1 Differences in the importance of the different distribution channels according to products lines

The high importance of brokers and multiple agents in certain lines of business insurance is explained by the complexity of the related products or the risk presented in these lines. Therefore, these intermediaries have a greater role to play both in analyzing the potential risk exposure, securing adequate coverage and possibly in providing additional value-added services. On the other hand, exclusive agents and direct writing play a more important role in less complex products such as motor insurance. This is a sector where banks are, in general, also comparatively more active.

Graph IV.4




*Source: European Commission, Business Insurance Survey 2005-2006*

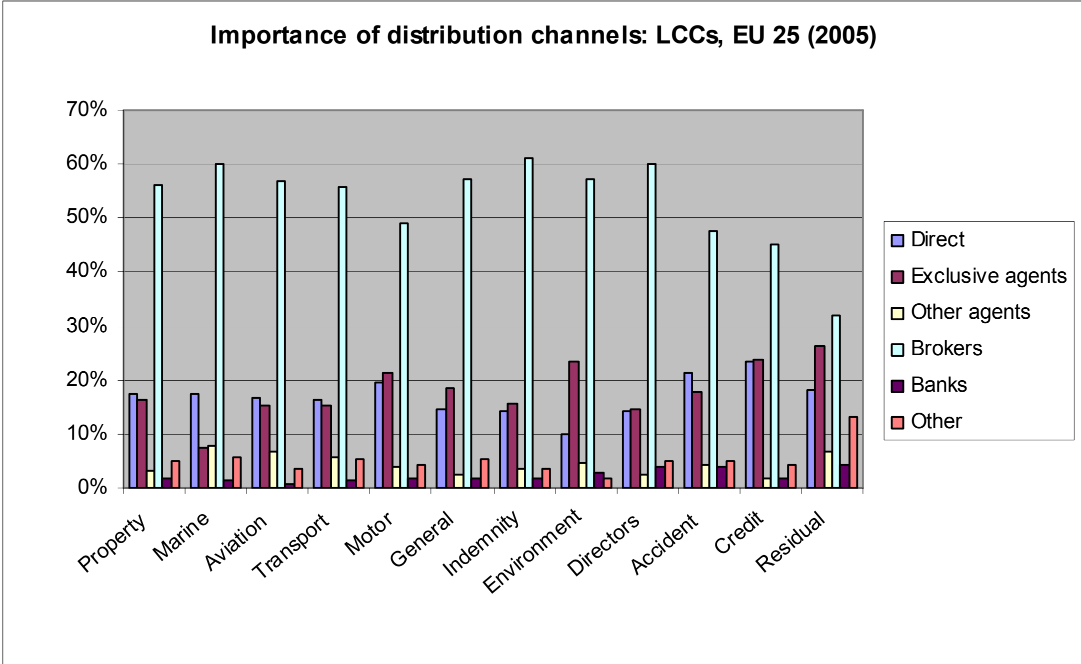
### 1.1.2 Differences in the importance of the various channels according to client profiles

The most noticeable differences in the structure of distribution channels for business insurance are related to the client segment served. The inquiry confirms the predominance of the broker channel for large corporate clients and, correspondingly, a lesser importance of direct sales or sales through tied agents. Furthermore, it is to be noted that only a limited number of intermediaries serve this segment, whereas a very large number of small intermediaries serve the very small end of the business. LCCs and multinational companies tend to deal with brokers because it gives them access to a wider choice of insurers (including foreign insurers, depending on the type of risk concerned), which may enable them to place large insurance programs on more favourable terms and conditions; certain brokers may also have an advantage when it comes to servicing clients abroad (e.g. servicing the clients'

foreign subsidiaries) through international networks[33]; last, but not least, some brokers offer highly sophisticated risk management and other services. Agents or in-house sales staff of insurance companies may not be able to provide these services to the same extent and therefore cannot completely substitute for brokers. Even if some LCCs use their own captive brokerage department ("in-house broker") to place business directly with insurers, they often use independent brokers at the same time because of the different services that these offer.

By comparison, and as shown by the two graphs below, exclusive agents achieve a greater market share of SME business.

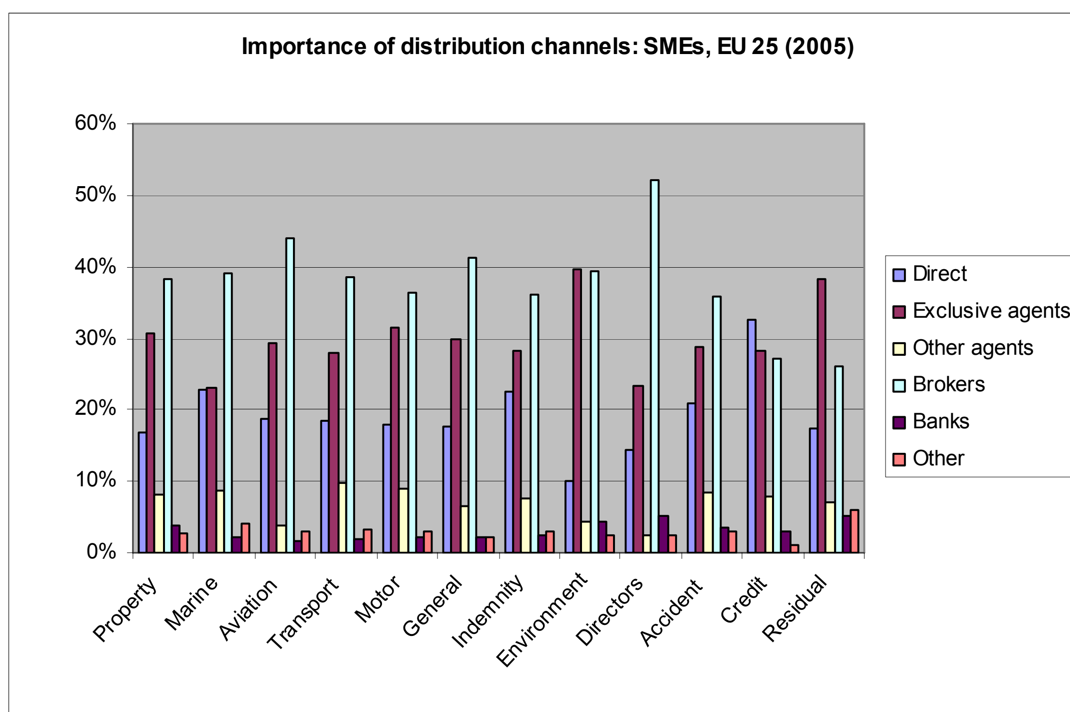
Graph IV.5




[33] Note that besides the global brokers that are represented in many foreign markets through group companies, there are also networks in which medium-sized brokers co-operate in order to be able to service their clients internationally.

*Source: European Commission, Business Insurance Survey 2005-2006*

Graph IV.6




*Source: European Commission, Business Insurance Survey 2005-2006*

## 1.2 Competition considerations

### 1.2.1 Networks of tied agents

The Interim Report set out possible competition considerations in relation to **tied agent networks**, explaining that under certain circumstances, the existence of networks of exclusive agents tied by non-compete obligations could lead to cumulative foreclosure of specific insurance product markets. The existence of any such foreclosure would be characterised by insufficient inter-brand competition on the relevant markets resulting from a cumulative effect of the network and an excessively long duration of the exclusivity or non-compete obligations imposed upon the tied agent. The mere existence of a network of tied agents is, however, not sufficient to characterise a finding of foreclosure - it would have to be appreciated in the light of market structure and other circumstances.

In this context the Interim Report pointed out that the **German retail insurance** market had been examined by the Commission in the past. Sales through tied agent networks represented at that time approximately 65% of retail insurance products. However, the Commission had concluded that this particular market showed sufficient inter brand competition due to the existence of a large number of competitors, the absence of market power of individual insurers and a resulting low concentration, an increasing variety of products and an increased readiness to switch insurers. The sector inquiry confirmed a trend towards increasing competition in the German market between the different distribution channels for the various lines of **business insurance** products (through brokers, direct selling, multiple agents, establishment of branches, take-over, new and foreign entrants), evidenced

by a decreasing proportion of contracts sold through tied agents. Respondents to the public consultation agreed with these findings and stated that according to the German insurance association's (*Gesamtverband der Deutschen Versicherungswirtschaft*) data, the market share of tied agent networks had decreased in retail insurance to approximately 50% at present, and that tied agents did not play an important role in the distribution of business insurance altogether, with a somewhat higher importance, however, in relation to smaller commercial clients. This corresponds to the findings of the Commission's market survey as to the differences in the importance of the various channels according to client profiles.

As far as **Italy** - the Member State with the highest market share of tied agent networks in the distribution of business insurance - is concerned, the Italian insurance association ("ANIA") submitted a number of comments and observations. ANIA considers that the Interim Report understates the role of brokers in the Italian business insurance market. According to this claim, the figures provided by Italian insurers to the Commission as well as the official statistics compiled by the Italian insurance supervisory authority and the data compiled by ANIA itself do not reflect the reality in the market. The reason given for this is that Italian insurance companies allegedly do not know who originated business placed with them. In this context, the Interim Report made reference to brokers' channelling business through tied agents and pointed to rules granting agents geographical exclusivity. According to ANIA, the channelling of broker originated business through tied agents reflects brokers' and clients' preferences, whereas the bilateral exclusivity rules allegedly do no longer have particular practical importance. Recent legislation in Italy addresses the issue of tied agent networks in the field of non-life insurance[34]. The Italian insurance association has criticised this legislation, claiming that it could cause an increase in costs for consumers, could reduce the value of insurance companies operating in Italy and that it interferes with the principle of freedom of contract.

### 1.2.2 Net-quoting in the Nordic countries

Based on a recommendation of the Federation of **Finnish** Insurance Companies that was allegedly motivated by tax considerations, a significant number of Finnish non-life insurers changed their business practice from 2003 to providing quotes to brokers exclusively on a net basis, i.e. without any element of commission payable to the broker. The new Finnish Insurance Mediation Act (570/2005), which became effective on 1 September 2005, introduced a legal prohibition for brokers to accept commission payments from insurers. The prohibition will take effect from 1 September 2008 after the expiry of a three-year transition period.

The **Danish** Intermediary Act, amended as from 1 July 2006, grants a transition period until July 2011 after which Danish insurance companies are prohibited from paying commissions to brokers. However, as in Finland, Danish insurers have also meanwhile largely changed their practice to net quoting. Commission payments from foreign insurers that are not established in Denmark to Danish brokers will continue to be legally allowed in the future, but the brokers are obliged to pass any commissions received on to the insured.

The **Swedish** Insurance Federation issued a non-binding recommendation on compensation to insurance brokers offering non-life insurance in April 2003, according to which insurance companies should neither offer nor sign agreements with a client or an

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[34] The corresponding laws prohibit exclusivity arrangements between insurance companies and their agents; cf. Article 8 of Law 248/2006 (ratifying Decree Law 223/2006) and Article 5.1 of Decree Law 7/2007.

insurance broker which contain provisions relating to the amount of the broker's compensation.

The Interim Report highlighted that the introduction of mandatory net quoting in the Nordic countries had led to sharp criticism from members of the broker community. In the framework of the public consultation a number of observations were received in relation to the issue of net quoting from insurance associations, from brokers and from some of their representative bodies.

The arguments in favour of mandatory net quoting presented by insurance industry associations from the Nordic countries can be summed up as follows: (1) The provision of insurance cover and the provision of insurance broking services concern separate markets. If brokers are remunerated for insurance placement exclusively by clients this will enhance price transparency in relation to the broking services, thus stimulating competition in the market. (2) In contrast to agents, insurance brokers are supposed to represent the client and to scan the market in order to find the best deal for the client. If brokers do not receive any compensation for placing insurance policies from the insurer concerned, there is no potential for conflicts of interest, and brokers are more likely to provide a truly independent and impartial service to their clients[35].

Furthermore, the insurance industry associations in question have stated that the introduction of mandatory net quoting is not motivated by any desire on the part of the insurance industry to limit the activities of the broker or the role of the brokerage channel in distribution. It was also stated that insurers could still pay brokers for the provision of certain other services not related to insurance placement. Last but not least, one association stated that in the change-over to the new system the net quoted premiums were lowered by an amount that equalled the amount of the commission previously paid to the broker.

Brokers and their representatives disagree with these assertions. Against the background that direct writing has traditionally been favoured in the Nordic countries and that incumbent insurers avail of well-developed own distribution networks, brokers consider that mandatory net quoting is a mechanism that may allow for the control of distribution by insurers within the relevant domestic market and restrict competition from international insurers. They emphasize that the issue of potential conflicts of interest could have been resolved on a commission basis by less restrictive means, for instance through the introduction of disclosure requirements[36]. Brokers maintain that the choice of the remuneration basis should be a matter to be determined between the broker and his client, while mandatory net quoting has removed this type of freedom of contract. Furthermore, they are of the opinion that the imposition of a fee basis for broking activities may reduce efficiency of the placement process, in particular in relation to smaller risks, as the negotiation of fee and service agreements and the processing of separate invoices add to the administration costs of the broker.

Brokers have also indicated that insurers have not always reduced the net quoted premium by the full amount of the commission previously paid to the broker. This could be an

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[35] The arguments presented allude to some of the issues previously highlighted in section IX.3 of the Commission's Interim Report. These issues will be discussed in the corresponding sections of the Final Report further below.

[36] Brokers would like to see transparency requirements extended to insurance companies and their agents, considering that this would increase competition concerning both the provision of insurance and of mediation services, as clients would exactly know the cost of competing insurances, of brokers' work and of the cost of distribution.

economic disincentive for clients to use independent brokers, adversely affecting the development of the broker distribution channel. Brokers fear that this may lead to consolidation in the industry and that the obligation of net-quoting will have an impact on insurers, in particular foreign insurers, who rely on brokers as their distribution channel. Foreign insurers that may consider entering the markets could eventually be confronted with the need to establish their own local distribution infrastructure (i.e. appointing their own agents or recruiting in-house sales staff). This could amount to an effective barrier to entry for foreign insurers, as the costs of establishing and maintaining such a distribution infrastructure may be considered prohibitive, in particular since the achievement of market shares that would justify these costs is only possible over an extended period of time. The brokers' argument appears to be supported by the finding of our market survey, that access to distribution infrastructure is one of the most important factors influencing insurers' decision whether or not to enter a foreign market[37]. Moreover, given the relatively small size of the markets, the question arises how many full-fledged parallel distribution networks are sustainable.

On the basis of the findings of our survey, which covered the period from 2000 to 2005, definitive conclusions as to the economic effect of the introduction of net quoting in the Nordic countries cannot be drawn.

## 2. CONFLICTS OF INTEREST

### 2.1 Background

The Interim Report provided a detailed analysis of the intermediary sector in the EU, highlighting the important role that insurance intermediaries play in the business insurance market and examining in detail aspects that could affect their competitive behaviour.

The business insurance market in the EU is predominantly served by brokers; exclusive agents constitute the second most used channel of distribution across the EU in most insurance lines. Typically, brokers have a particular importance in servicing corporate clients with complex and large exposure. Small commercial risks are to a higher extent placed through agents or underwritten directly by the insurer.

Insurance brokers analyse the risk situation and needs of their clients in terms of, for instance, risk to be retained, risk cover and level of services to be provided by the insurer. Brokers scan the market and match buyers with insurers who have the skill, capacity and financial strength to underwrite the risk, help clients selecting from all competing offers and assist their clients with claims settlement.

Through their activities, which allow access to a wider choice of potential insurers (including the international insurance markets for the placements of larger or specialty risks) and which reduce asymmetries in bargaining power of the parties, intermediaries that are not constrained by agreement to refer business to one insurer, especially insurance brokers, may be able to stimulate competition in the insurance marketplace.

In this section, conflicts of interest to which insurance intermediaries may be exposed are considered. Conflicts of interest deserve particular attention because they could compromise the objectivity of the advice provided by an intermediary to his clients and thus adversely affect the competitive dynamics in the insurance market. The Interim Report

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[37] Cf, section V.3 of the Interim Report.

highlighted factors that could constitute incentives for brokers to recommend particular insurance carriers to their clients, even where those may not be the most suitable ones to meet the clients' needs[38].

The Interim Report concluded that tensions between the objectivity of the advice given to clients and brokers' own commercial considerations can emanate, in particular, from the services provided to insurers or from remuneration obtained from insurers.

## 2.2 Services provided to insurers

The function that brokers fulfil for insurers is twofold: besides giving insurers access to potential clients, brokers offer a number of specific services to insurers.

Giving insurers access to potential clients includes the provision of information about the risk to the insurers, which will allow insurers to quote a premium for the risk cover sought. In order to quote competitively, insurers will depend on accurate information about the risk in question. As brokers rely on long-term relationships with both insurers and clients, they should have an interest to provide a fair representation of the client's risk, in order to obtain a number of competitive quotes for the client.

Risk analysis can be expensive; depending on the risk to be insured, it may require expertise in engineering, actuarial science, law, finance etc. The quality of the information, the familiarity of the insurer with the type of risk in question, the modeling/actuarial capacity of the insurer to measure the risk and its underwriting policy will be decisive to submit a competitive bid. Some brokers have acquired the capability to provide highly sophisticated services, such as risk modelling or risk surveying that are offered to interested insurers for a fee.

For the purpose of the inquiry, the services provided to insurers were defined as follows:

- **Reinsurance broking**: arranging reinsurance on behalf of an insurer, including advice before and after the placement related to that reinsurance.
- **Insurance underwriting**: underwriting risks on behalf of an insurer or a panel of insurers, including all or any of the setting of terms and premiums, binding of cover and agreement of claims[39].
- **Loss adjusting**: independent advice to insurers and their clients in the establishment of the cause of a loss, the validity of any claim and the quantum of that claim.
- **Claims management**: advice or administrative services relating to the management of claims to reinsurance clients, where these are separately charged for that service.

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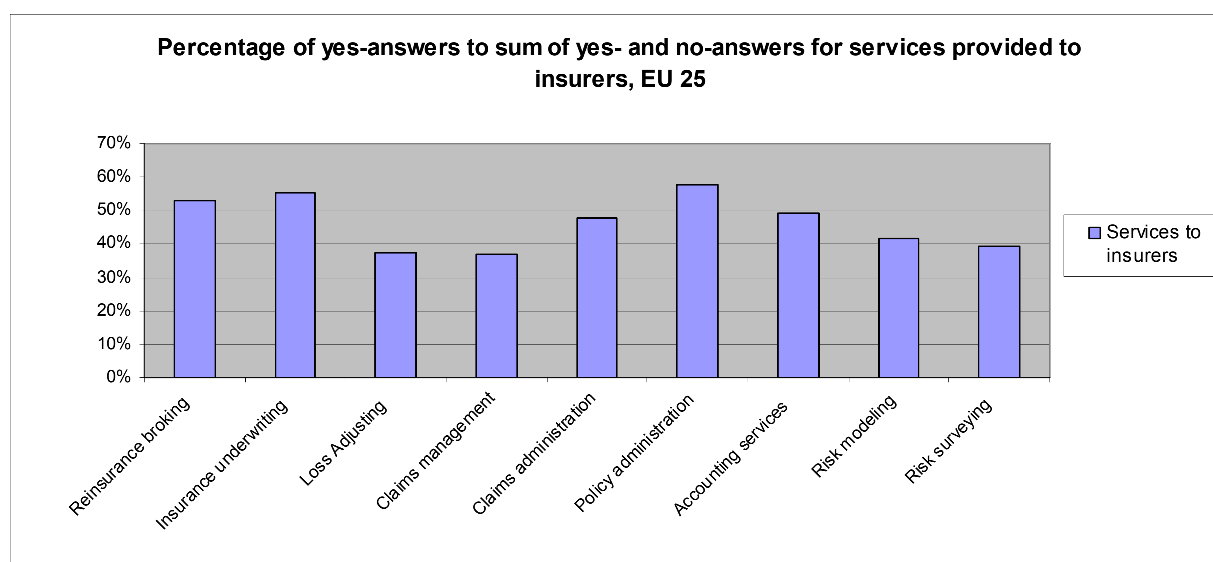
[38] This type of conflict of interest is also known as "provider bias". Note that clients can also be harmed where intermediaries recommend particular products that are not the most suitable ones for the clients' needs. This latter phenomenon is also known as "product bias" and could concern any insurance intermediary, including exclusive agents. There is not much academic research in this field relating to non-life insurance, but see, for example, Malcolm *et al* 'The effect of commission-based remuneration on financial advice', Journal of Insurance Research and Practice vol. 17 part 2 for a study of commission bias in life insurance and savings products.

[39] Revenue from this was supposed to be reported including profit commissions paid by insurers on client portfolios or segments thereof.

- **Claims administration**: services related to the handling of claims made against insurance companies by their direct clients, whether mutual clients (of the broker and of the insurer) or not.
- **Policy administration**: services related to the issuing of policies, endorsements and other documentation, including cover notes and certificates, to the insurers' direct clients, whether mutual clients or not.
- **Accounting services**: services related to the collection of premiums and the settlement of claims to insurers' direct clients, whether mutual clients or not.
- **Risk modelling**: assessing and reporting to insurers on probable risk outcomes for specific risks or risk portfolios.
- **Risk surveying**: assessing and reporting to insurers on risks, including client and third party risks, where a fee is paid by insurers for the service.

The following figure shows the percentage of cases in which the various intermediaries included in the survey answered that the group to which they belonged did provide the service in question to one or more insurers in 2005.

Graph IV.7




*Source: European Commission, Business Insurance Survey 2005-2006*

The figure shows that a high percentage of intermediaries surveyed (or the groups they belong to) do indeed provide a wide range of services to insurers. The services most commonly provided by intermediaries to insurers are, in order of importance, policy administration, insurance underwriting and reinsurance broking. The Interim Report considered that the dual role brokers assume as a distribution channel for insurers and as an advisor to their clients is a potential source of conflicts of interest. As far as the provision of services to insurers is concerned, the potential for such conflicts may be greatest where intermediaries act under a delegated authority for an insurer vis-à-vis their own insurance broking clients. Some data on the scope of such delegated authorities was included in section IX.2.5 of the Interim Report.

### 2.3 Remuneration of intermediaries

In phase one of the inquiry, detailed information was requested from insurance companies – on remuneration they provide to intermediaries – as well as from insurance intermediaries, mostly brokers and a small number of multiple agents, on their sources of revenue.

Questions to EU-25 insurance companies concerned, in particular, commissions and other direct payments made to the various types of intermediaries, and included information on contingent commission agreements and profit commissions, as well as on the percentage of policies written subject to a particular type of commission arrangement.

Intermediaries in the 14 Member States selected for the intermediaries survey were asked to provide information on their revenue from insurance placement, from other services to clients and from services to insurers, as well as on specific details of revenue from fees, commissions, contingent/profit commissions and other charges[40].

#### 2.3.1 Forms of remuneration

Besides straightforward commissions in the form of a percentage of the premium for the policy placed, intermediaries' revenues can originate from contingent commissions including profit commissions, client fees related to insurance placement and/or to other payable services offered to clients as well as from payable services provided to insurers or re-insurers. However, there is considerable variation in the patterns of remuneration for intermediaries across the EU and considerable debate about the most appropriate form it should take. Contingent commissions, discussed in more detail at section 2.3.4, have perhaps been the most contentious issue in the recent past.

**Commissions**

The traditional form of remuneration for intermediaries has been commissions, not only in the case of insurance agents, but also for other insurance intermediaries. Commissions are payments made by insurers (or reinsurers) to intermediaries[41] where the amount payable is fixed as a percentage of the premium for the policy placed, also including any subsequent additional revenues from the adjustment of premiums subsequent to original placement. The insurance premium paid by the insured consists in this case of the actual price for obtaining coverage of the risk as well as of the price of the mediation services, as both are bundled together.

**Contingent commissions**

For the purposes of the inquiry, contingent commissions were defined as any kind of payment (excluding client fees and straightforward commissions as defined above) paid by insurers to intermediaries that are not exclusive agents of the insurer, where the amount

[40] As far as the presentation of results in the following sections is concerned, graphs do not include Member States where the number of reliable observations relating to a particular question was deemed to be insufficient for appropriate statistical analysis or where the limited number of observations (particularly in the Member States where the sample size was smaller) relating to a particular question may allow conclusions about individual parties' confidential responses. However, such Member States may be included in the textual discussion of the issues concerned. For some additional clarifications on methodology, readers are referred to the Interim Report.

[41] Including the case where intermediaries collect premiums on behalf of the insurer and deduct their commission from the gross premium paid prior to remitting the premium net of brokerage commission to the insurer.

payable is based on the achievement of agreed targets relating to the business placed by the intermediary with that insurer[42].

**Profit commissions**

By profit commissions was meant commissions or fees paid by insurers to intermediaries for the achievement of profitability targets or otherwise related to the profitability of the insurer's book of business with the intermediary. To the extent that they are not paid to exclusive agents, profit commissions are a sub-category of contingent commissions, exclusively related to profitability.

**Client fees**

Client fees are remuneration paid to intermediaries by clients either in addition to, or instead of, commissions paid by the insurer. They relate to insurance placement, i.e. the intermediaries' arranging insurance on behalf of a client, including advice before and after the placement related to that insurance, and to separately charged services provided to clients. The intermediaries questionnaires solicited information on the following classes of separately billed client services, which were deemed to be the most common and financially most significant ones: claims management services, loss assessment, legal services, captive management, risk management, risk control, instalment premium/premium credit, financial planning, and asset management[43].

It should be noted that in the more recent past there has been a trend towards greater use of fee-based remuneration, especially in respect of large corporate accounts. According to Swiss Re[44] some brokers generate as much as one-quarter to one third of their revenues from fees, but on average the share is still low. In a competitive environment, brokers who receive commissions from insurers by default may be asked to rebate some or all of these commissions to the client in exchange for an agreed fee.

**Revenue from services to insurers**

The intermediaries questionnaires solicited information on revenue originating from the following services to insurers: reinsurance broking, insurance underwriting, loss adjusting, claims management, claims administration, policy administration, accounting services, risk modelling, risk surveying[45].

### 2.3.2 Relative importance of the different types of remuneration

The following graph depicts the composition of intermediaries' client-related revenue by type of remuneration, for all lines of business insurance placed, as given by the intermediaries surveyed. Data is presented separately for 11 Member States, together with what is referred to as the "EU total", which reflects the responses received from all 14 Member States surveyed. Revenue from services to insurers has been omitted. It should be emphasized that "client fees" in this graph includes fees for services provided to clients that are not limited to insurance placement.

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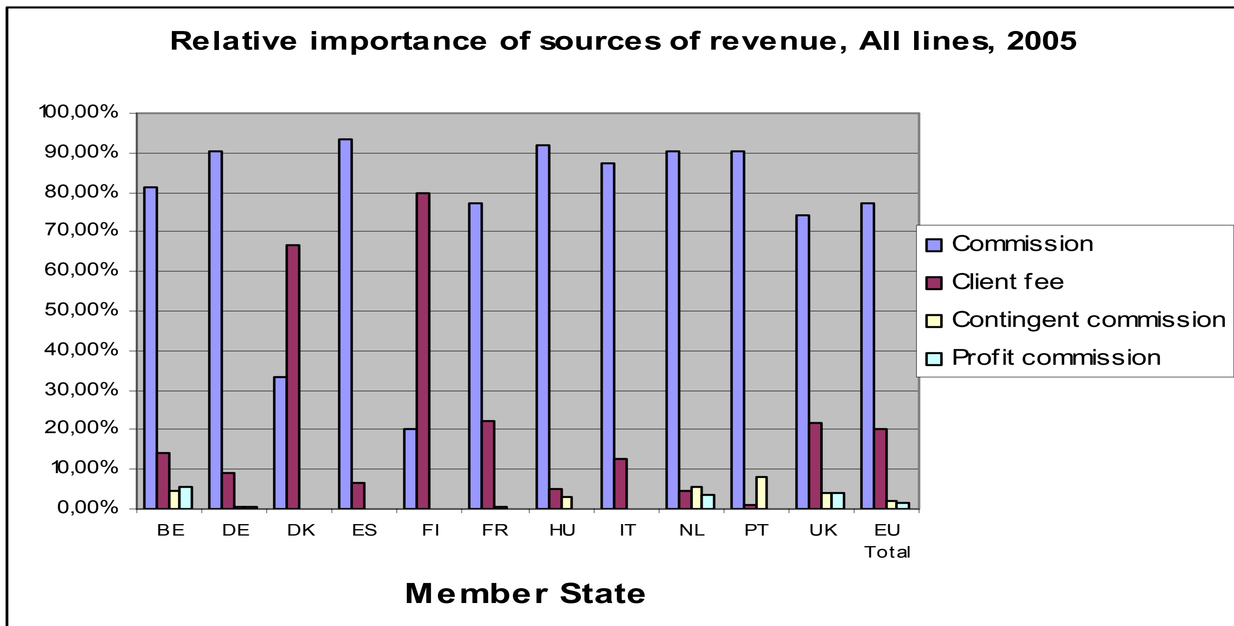
[42] Please note that contingent commission agreements exist not only between primary insurers and intermediaries, but also between re-insurers and intermediaries. Contingent commission agreements are sometimes known as "Broker Contingent Agreements", "Market Service Agreements" or "Placement Service Agreements", but have also been termed differently.

[43] Please refer to the definition of these services in the glossary at the annex.

[44] Swiss Re, sigma No. 2/2004, page 26.

[45] Please refer to the definition of these services in the glossary at the annex.

Graph IV.8



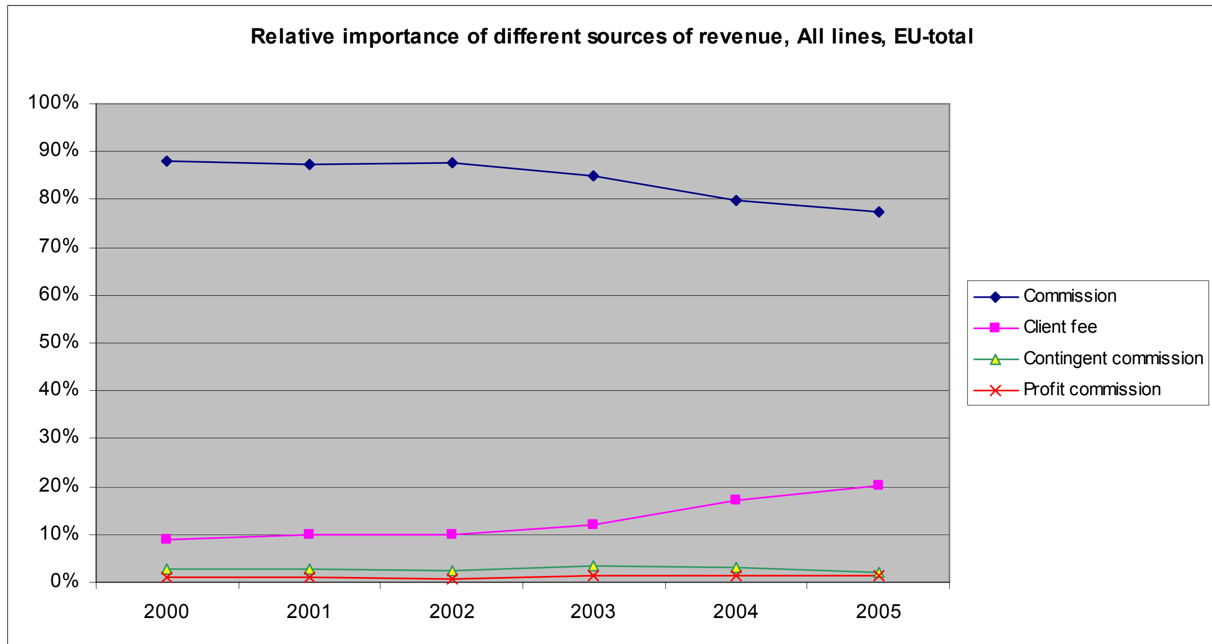

*Source: European Commission, Business Insurance Survey 2005-2006*

The graph shows for the total sample as well as for the vast majority of individual Member States surveyed, classical commissions were said to be the main source of intermediaries' revenues, representing in some cases more than 90% of the combined revenue from insurance placement and client services. Client fees are particularly important in Denmark and Finland, explained by the developments in these countries concerning net-quoting (see below). Among the remaining Member States, France and the UK stand out with client fees accounting on average for more than 20% of intermediaries' revenue. However, as evidenced by the analysis of individual responses, client fees and contingent commissions[46] typically account for a higher percentage of the larger intermediaries' revenue. However, the data on the level of contingent commissions including profit commissions, which will be examined in more detail in section 2.3.4, is considered not to be entirely reliable, for reasons set out in the Interim Report (IX.3.2), and therefore it is likely that the figures given understate their significance.

The following graph provides an overview of the relative importance of the various types of remuneration from 2000 to 2005 at the aggregate level of the 14 Member States considered . It displays a decrease in the relative importance of commissions and the rise in significance of client fees over time. It also highlights that the proportion of contingent commissions and profit commissions was higher in all years from 2000 to 2004 than was stated by respondents for 2005, albeit from a small starting base.

[46] Details of contingent commissions are discussed in section 3.4. It should be noted that some of the large brokers have discontinued or modified their business practice in relation to contingent commissions since 2005.

Graph IV.9 – Relative importance of sources of revenue, All lines, EU Total[47]




*Source: European Commission, Business Insurance Survey 2005-2006*

As stated, in addition to insurance placement, where the intermediary may return the commission to the client or place the client's business on a net quote basis in exchange for a fee, client fees may relate to the provision of **separately charged client services** by the intermediary.

The inquiry showed that separately charged services to clients are more common in some markets, and nearly absent in others. Similarly, the provision of such services is generally much more common among the larger intermediaries, for which separately charged services are an important source of revenue. Respondents in our survey have also pointed out that depending on the national legislation there may be legal restrictions for the provision by insurance intermediaries of some of the services listed[48]. Moreover, when arranging insurance placement, the provision of certain services may, according to jurisprudence, be part of a broker's fiduciary duties, thereby limiting the possibilities for separate charging of the services concerned[49].

Looking at only those intermediaries that did provide separately charged services to clients, the following graph provides a breakdown of the revenue from different categories of client services in 2005 for selected Member States and the aggregate for all 14 considered ("EU"), excluding insurance placement.

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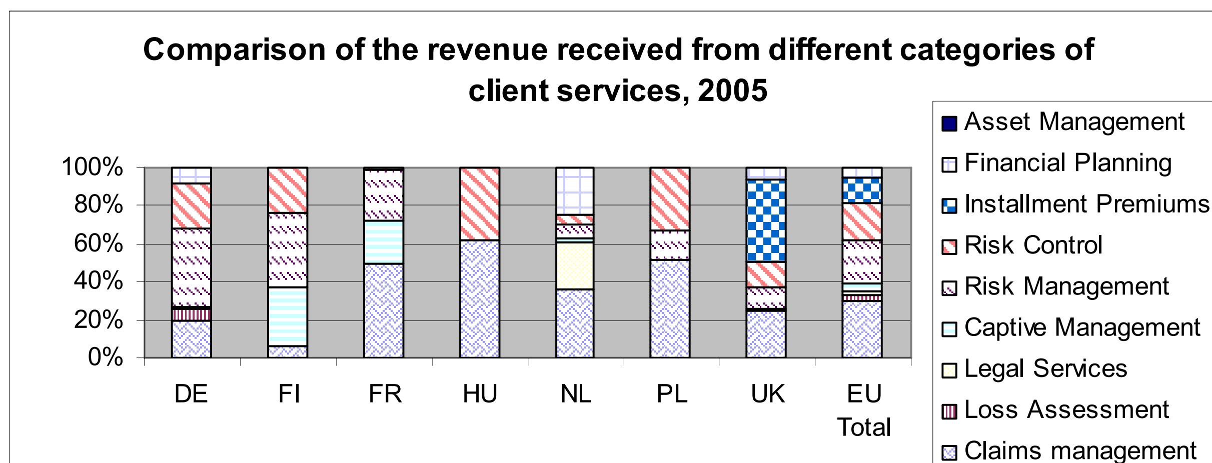
[47] As explained above, the total sample consisting of 14 Member States is referred to as EU Total.

[48] E.g. in Germany the Legal Advice Act ("*Rechtsberatungsgesetz*") limited the provision of legal advice to certain professions. One respondent in the public consultation on the Interim Report pointed out that with the implementation of the IMD in Germany, insurance intermediaries will be allowed to give legal advice to business clients independently of any broking activity.

[49] Judgement of the Bundesgerichtshof of 22 May 1985 (IV a ZR 190/83, Düsseldorf).

Graph IV.10 – Comparison of the revenue received from different categories of client services, 2005




*Source: European Commission, Business Insurance Survey 2005-2006*

Overall, claims management services to clients, risk management and risk control are the most significant services to clients across our sample of Member States. In the UK, instalment premiums/premium credits also have a prominent position, whereas in the other Member States no revenue at all was reported from this service.

A considerable number of intermediaries surveyed also generate income from the provision of **services to insurers**. Reinsurance broking accounted for the largest share of revenue of intermediaries in the sample, followed by claims administration, insurance underwriting and policy administration. However, it has to be taken into account that the way in which intermediaries have organisationally structured their activities has a great impact on the results; for instance, in some cases reinsurance broking was reported as part of the respondent's activities, whereas in other cases this activity was pursued by another company in the group and the corresponding data were not provided.

### 2.3.3 Commissions

The available data on trends in commission levels in the EU is limited[50]. More information may be available at the level of some of the national markets. For instance, German brokers pointed out in their responses to the Commission's questionnaire that business clients are generally well informed about commission rates, referring to press articles and to an overview of average commissions for three main classes of insurance, produced by the national brokers' association. However, an aggregated overview of average commission rates by broad lines does not enable individual clients to assess how much commission they are actually paying. Within the broader lines of insurance, differences can be observed between individual products (e.g. individual motor insurance vs. fleet insurance, commercial fire insurance vs. industrial fire insurance etc.); differences in commission rates may also be based on the client segment concerned, specific insurer-intermediary relations and a number

[50] Some findings have been reported by Swiss Re concerning the US market, but it is uncertain to which extent these finding may also apply to the EU markets. Cf. Swiss Re sigma No. 2/2004.

of other factors[51]. Insurers may also endeavour to use commission rates to gain entry to a market or to hold on to business, raising the concern that rates may be bid up.

The intermediaries' questionnaire requested information on commission rates applicable in several different scenarios. Minimum and maximum commission rates payable based on the intermediary's contractual arrangements or customary practice were requested for the (top) ten insurers with whom the intermediary placed the highest volume of business and for the (bottom) five insurers accounting for the lowest volume of placements. Due to a number of factors, however, the results of the analysis were not statistically conclusive[52]. A number of intermediaries stated that commission rates agreed with individual insurers were largely homogeneous for comparable transactions. The relatively high transparency (from the insurers' and brokers' point of view) of commission rates, traditional practices or former regulation of the markets were indicated as reasons for the sometimes high uniformity of rates. At the same time some intermediaries stated that commission rates reflected the amount of services provided by the broker to the insurer in cases where such services are not separately charged.

Bearing in mind that commissions constitute the remuneration of the mediation service provided by the intermediary and that this service is bundled with the provision of insurance cover, the question arises as to which extent competition on the price of the mediation service itself is possible. This price is agreed between the insurer and the intermediary[53], even though it is paid by the client as part of the insurance premium.

Some intermediaries have argued that competition takes place in respect of the overall (i.e. bundled) package consisting of the insurance cover and the services provided by the intermediary, alleging that the (separate) price of the mediation service will not matter to the client. Moreover, it was claimed that the price of mediation could not easily be compared, as intermediaries may or may not offer their clients additional services without separate charges and the quality of the services provided could vary.

In contrast to this, some respondents stated that they may rebate some of the commission earned to their clients. This seems to be the case in particular in relation to LCCs[54], reflecting the higher dependence of intermediaries on their large accounts and the higher level of expertise of LCCs in relation to insurance matters and risk management. It is worth noting that in Germany commission rebating is still legally prohibited[55].

Transparency would appear to be an important pre-requisite of any possible competition on the price of the mediation services. The survey requested information from intermediaries on the disclosure of commission. The graph below depicts the percentage of clients to whom the intermediaries surveyed claimed to disclose spontaneously the

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[51] Including, for instance, an insurer's business policy where commission rates agreed with intermediaries may be used to promote the sale of certain products that may be more profitable than others.

[52] For instance, intermediaries pointed out that the examples given still allowed for discretion, thus widening the range of ways to commission the business. The example "fire insurance" was considered problematic by some because fire insurance is mostly sold as part of a package providing property cover also for other perils.

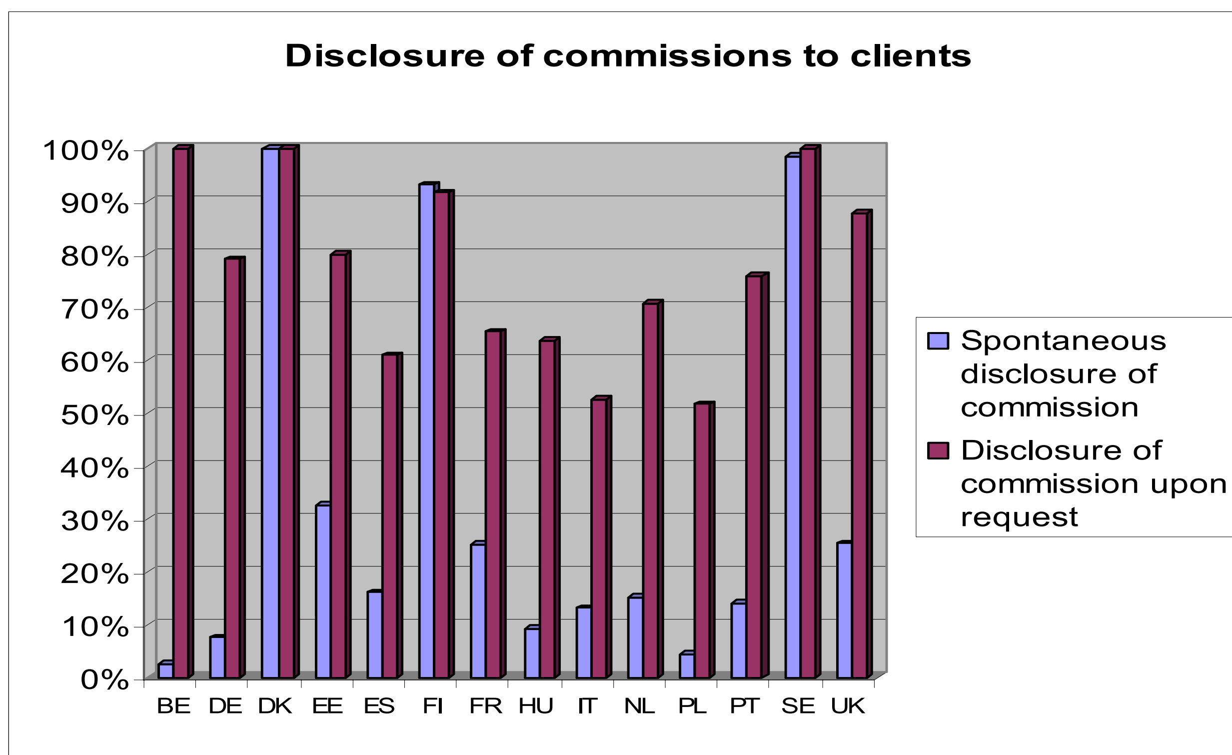
[53] Obviously, this does not refer to net-quoted business.

[54] The questionnaires did not specifically address the issue of commission rebating, however. See further part 3 below.

[55] Respondents from Germany have stated that for LCCs insurance may be quoted on a net basis, thus creating scope for negotiation of the level of remuneration with clients, while avoiding conflict with the legal prohibition. Other respondents have pointed to the high number of business insurance clients that have established their own in-house brokers, reflecting another strategy to provide for more flexibility to negotiate commission rebates in the face of legal restrictions.

commission earned on the insurance business arranged and those to which they claimed they would disclose it at the request of the client.

Graph IV.11




*Source: European Commission, Business Insurance Survey 2005-2006*

The graph shows a very low rate of spontaneous disclosure of commissions in all Member States except Denmark, Sweden and Finland, which is explained by the recent developments in these countries concerning the introduction of net quoting. The figures stated by brokers in relation to the disclosure of commission upon clients' request are higher in all Member States[56]. However, a considerable number of clients – up to nearly 50% in Italy and Poland – do not receive information about commissions, even when they specifically request this information[57].

It should be noted that besides straightforward commissions, intermediaries may earn additional remuneration on the insurance arranged for clients. For large customers, the lack of transparency in relation to contingent commissions including profit commissions appears to be the main problem[58]. This issue is highlighted below in section 2.3.4.

In part 3, some evidence on the (limited) extent to which competition on the price of mediation services takes place through commission rebating is presented.

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[56] Note that these figures stated by brokers may not be entirely reliable. A number of respondents stated that clients allegedly never request this information, but that they would – hypothetically – provide the information, if asked.

[57] It should be noted that there may be some doubts as to the reliability of these figures, since a number of respondents claimed that their clients never request this kind of information, but that they would – hypothetically – provide the information if asked.

[58] Cf., for instance, "Industrie droht Versicherern mit EU-Vorstoß", *Financial Times Deutschland*, 5 October 2005.

### 2.3.4 Contingent Commissions including Profit Commissions

#### 2.3.4.1 Background

Contingent commissions received public attention following investigations carried out in the United States of America by the office of Eliot Spitzer, at the time New York State Attorney General[59]. Contingent commission agreements and allegations of bid-rigging were at the centre of the investigations, which led to a number of complaints filed by Mr Spitzer's office in 2004 and 2005 against the world's largest insurance broking firms and against several insurance companies.

Mr Spitzer's complaints alleged, inter alia, infringements of antitrust law, fraudulent business practice, securities fraud and common law fraud. The complaint against Marsh concludes: *"Marsh's conduct had the purpose or effect, or the tendency or capacity, unreasonably to restrain trade and to injure competition and purchasers, by, among other things: (a) Limiting the number of insurers competing to sell insurance to persons seeking such insurance; (b) Allocating the market for the sale of insurance; and (c) Using inflated bids, prices and other terms of sale with respect to insurance to mask the absence of free and open competition by insurers for the sale of such insurance"*[60].

In his testimony to the US Senate Mr Spitzer noted: "*By looking closely at these contingent commissions, we uncovered another side of the insurance industry. Not only do brokers receive contingent commission to steer business, but many brokers, with the collusion and assistance of insurance companies, engage in systematic fraud and market manipulation in order to ensure that profitable and high volume business goes to a few selected insurance companies. In other words, we found that favoritism, secrecy and conflicts rule this market, and not open competition*"[61].

Settlements were agreed with the incriminated parties leading to the adoption of far-reaching business reforms. Among other things, incriminated brokers agreed to prohibitions of certain types of compensation including contingent commissions as well as of reinsurance brokerage "leveraging", while at the same time committing to full disclosure vis-à-vis clients in respect of compensation received and of all quotes and indications sought and received in connection with the clients' business placed or serviced[62]. The commitments made in these settlements in the United States are, however, subject to a limitation on extraterritorial effect[63].

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[59] Several other State Attorneys General as well as State Insurance Departments also commenced investigations and participated in settlements reached with incriminated parties.

[60] Complaint, The People of the State of New York by Eliot Spitzer, Attorney General of the State of New York, Plaintiff, -against- Marsh & McLennan Companies, Inc. and Marsh Inc, -Defendants. Page 27 et seqq.

[61] Testimony of State of New York Attorney General Eliot Spitzer to the United States Senate Committee on Governmental Affairs, Subcommittee on Financial Management, the Budget and International Security, Washington D.C. November 16, 2004.

[62] Cf. Agreement of the Attorney General of the State of New York, the Superintendent of Insurance of the State of New York, the Attorney General of the State of Connecticut, the Illinois Attorney General, the Director of the Division of Insurance, Illinois Department of Financial and Professional Regulation, and Aon Corporation and its subsidiaries and affiliates (collectively "Aon"), dated March 4, 2005, p. 6 et seqq. Agreement Between the Attorney General of the State of New York and the Superintendent of Insurance of the State of New York, and Marsh&McLennan Companies, Inc., Marsh Inc. and their subsidiaries and affiliates (collectively "Marsh") dated January 30, 2005, p. 5 et seqq.

[63] The according provisions apply to entities that service clients in the United States, place, renew, consult on or provide services for policies covering risks in the United States or are, themselves, domiciled in the United States.

#### 2.3.4.2 Scope of the analysis, data and limitations

Part of the sector inquiry aimed at establishing the nature and the prevalence of contingent commission agreements in the Member States of the European Union.

To this end, insurers were requested to provide details of contingent commission agreements that had been in effect at any point in time since 1 January 2003 or that had been negotiated since with effect in the future. The elements to be provided included details of (i) the intermediaries concerned, the dates of the agreement and their validity, (ii) the basis of remuneration, (iii) the scope of the agreements in terms of classes of business, geographic markets and types of clients concerned, and (iv) the amounts paid under the agreements in the last year of their validity for which data was available. Furthermore, copies were requested of the five agreements under which the insurers made the highest payments to intermediaries for each year since 2003, allowing for a more in-depth analysis of the nature of those agreements. Insurers were also asked to provide specific details of profit commissions paid in the year 2005 to different types of intermediaries, distinguishing between intermediaries with and intermediaries without underwriting authority[64]. Moreover, insurers had to indicate (in percent of policies written by intermediaries) which kind of commission arrangements applied to the various lines of insurance and to the different client segments, distinguishing between net quote, commission, contingent commission and other.

Similarly, intermediaries were requested to submit details of contingent commission agreements as well as copies of agreements concluded with insurers, providing the same elements and level of detail as requested from insurers. Intermediaries were also asked for a breakdown of the various sources of their revenue. Furthermore, they were required to indicate, separately, the total revenue generated by contingent commission agreements and profit commission agreements for each year since 2000, the number of insurers and insurance groups with whom such agreements had been in place and the amounts of revenue received from the top five insurers and the top five insurance groups.

In a certain number of cases responses submitted by insurers and intermediaries were not clear or did not appear correct or coherent. In some of these cases additional information was requested from the parties or, where this was possible, the parts of the responses concerned were completed or corrected by the sector inquiry team, using information supplied by the parties in cover letters, annexes or under different headings of the questionnaire. Missing responses or obviously incorrect data that could not be rectified were excluded from the computation of statistical measures.

#### 2.3.4.3 Empirical findings and interpretation of data

This section provides an indication as to how widespread and significant the practice of contingent commissions has been in the recent past in the EU.

It should be borne in mind that contingent commissions have been a contentious issue and that there has been a lot of negative publicity subsequent to the Spitzer investigation. The figures calculated on the basis of affirmative responses received are likely to understate the actual values, as some insurers and intermediaries have not provided the entire set of data requested. This was sometimes explained by reference to alleged limitations of the respondents' information technology or management accounting systems. In other cases, respondents attached copies of agreements and provided further explanations, but stated that

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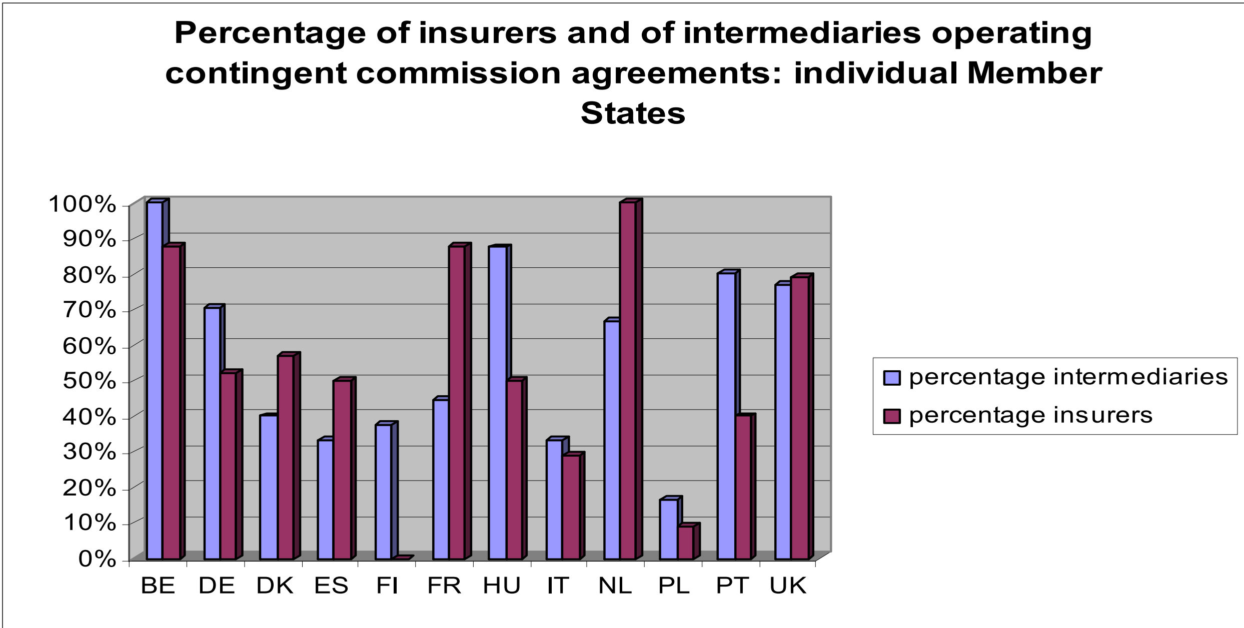
[64] Underwriting authority was defined as authority to grant cover for some or all clients on behalf of the insurance company, clarifying that intermediaries without underwriting authority may introduce clients but cannot grant cover on behalf of the company, cf. glossary in annex.

they did not consider the agreements to be contingent commission agreements (sometimes it was stated, in a more nuanced way, that the agreements presented were not comparable to the contingent commission agreements which were the subject of the Spitzer complaint). The analysis of the copies of agreements attached and of the further explanations showed, however, that in most cases the agreements in question were in fact captured by the definition of contingent commissions provided in the questionnaire and that the corresponding details should have been indicated in the response.

The percentage of respondents that admitted or gave evidence of having operated contingent commission agreements at any point in time between 2003 and 2006, irrespective of the number of agreements operated and of whether or not agreements have been abandoned subsequent to the investigation of Mr Spitzer, was over 50% of insurers in the EU25, reaching 60% for EU15; for the intermediary sample nearly 60% accepted or could be shown to have operated such arrangements[65]. Additional elements highlighting the significance of contingent commissions and the effect of the Spitzer investigation are provided further below.

The following graph shows the prevalence of contingent commission agreements in twelve of the MS in the intermediaries' sample, calculated in the same way, as reported by both insurers and brokers. Note that it is not surprising that these figures diverge, since brokers may report business from insurers not established in the MS concerned, or not part of the sample. This is particularly evident in the case of Finland where domestic insurers are not allowed to pay commissions of any sort.

Graph IV.12




*Source: European Commission, Business Insurance Survey 2005-2006*

It can be seen that the insurers' survey pointed to a high prevalence of contingent commission agreements in Belgium, Germany, Denmark, Spain, France, Hungary, the Netherlands and the UK, where at least 50%, and in some cases up to 100%, of respondents indicated that they operated at least one such agreement during the period under

65 More details on the findings and methodology are in section IX.3.4.3 of the Interim Report.

consideration. To a lesser, but still considerable, extent, insurers in Portugal and in Italy also reported contingent commission agreements. The corresponding figure for Poland is much lower. Subject to the comments above, the intermediaries' responses largely confirmed a similar picture.

For those Member States where only insurers were surveyed, it would appear that contingent commissions may have played a fairly limited role in most of the EU10. In Austria, the majority of responses confirmed that contingent commissions were paid. Most respondents did not, however, submit the full set of data requested, arguing that such agreements were a traditional form of remuneration and claiming that their agreements were different from the ones that were the focus of the Spitzer investigation.

As explained earlier, the payment of contingent commissions depends on the achievement of agreed targets related to the business placed by the intermediary with the insurer concerned. Respondents were requested to indicate the basis of remuneration for each of the agreements in effect at any point in time during the period from 2003-2006. Full results are presented in the Interim Report; in summary, volume, growth and profitability targets were stated as the most important criteria taken into consideration, whilst, on balance and with a few exceptions, policy renewals of clients and claims made by clients played a less significant role. The analysis of intermediaries' responses confirmed this observation.

The Commission services also inquired about the effect of the Spitzer investigation and the increased public attention on respondents' policy concerning contingent commissions. In Belgium, Germany, Spain and Ireland between 20% and 50% of insurers stated that the Spitzer investigation had indeed led to changes in their policy. However, in none of these cases had all contingent commissions been abandoned. Similarly, in the UK and France 70% and 80% of insurers said that changes had been made to their policy, but the number of insurers that abandoned all contingent commissions was much lower. Analysis of individual answers reveals that in some cases contingent commissions that were based on volume had been given up partly or entirely. Profitability-based contingent commissions appeared to be perceived as less contentious by some insurers. In several cases respondents stated that they considered profitability-based remuneration a necessary means to control their risk exposure, in particular where intermediaries are granted underwriting authority. By linking intermediaries' remuneration to the profitability of the business underwritten, insurers aim at creating incentives for prudent underwriting and to disincentivise potential opportunistic behaviour[66].

As far as intermediaries are concerned, in Belgium, Hungary and Portugal roughly 40% of respondents confirmed that their policy concerning contingent commissions had changed subsequent to the Spitzer investigation. The corresponding figure for Germany is 50%, for France 60%, and for the UK more than 80%. However, in the UK and in Germany less than half of the respondents who reported changes of their policy had abandoned all contingent commissions (including profit commissions).

The inquiry also looked at the average number of insurers with whom intermediaries had contingent commission agreements (other than profit commission agreements), and, separately profit commission agreements in the years 2004 and 2005. It should be noted that some respondents stated that they were not able to distinguish between profit and other contingent commissions, in which case the responses were included in contingent

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[66] In the past there have also been attempts to avoid such conflicts of interest by creating hybrid underwriting facilities that include insurer's staff embedded in the facility operated by the intermediary.

commissions. This may correspond to our finding that in a large number of cases agreements appear to have been based on the achievement of multiple targets.

In relation to contingent commissions that are not profit commissions, in particular, the results showed a noticeable decrease from 2004 to 2005 in the average number of insurers with whom the intermediaries surveyed had agreements, highlighting the effect that the Spitzer investigation had. This tendency was clearest in the UK, where the average number went from around 18 to around 2.5. To a large extent, the drop in the average number reflected the fact that some major brokers that had agreements with a large number of insurers abandoned all or most of their contingent commission agreements. By way of contrast, there was not a major change in the incidence of commissions based on profitability of business, where the average number of insurers involved by such agreements even rose in the case of Belgium.

Our study showed that, in the Member States considered, the top five insurers accounted for the vast majority of intermediaries' revenue from contingent commissions, ranging on average from 72% to 100%. The relatively small number of insurers with whom intermediaries have concluded contingent commission agreements and the concentration of revenue generated highlight that there can be a strong incentive for intermediaries to steer business to a few selected insurers.

#### 2.3.4.4 Other forms of remuneration of intermediaries

Some insurers make payments to intermediaries that are related to the business placed by an intermediary with the insurer, but claim that such payments are not directly related to the achievement of agreed targets (and thus would not constitute contingent commissions in the sense used in the questionnaires).

One example of this are so-called *advertising cost allowances* granted by an insurer to some brokers or multiple agents. Other respondents have mentioned complementary remuneration for the broker's *support in raising the commercial image of the insurance carrier with clients* or *support in carrying out market analysis.* In another case, *special commissions on the growth of premiums collected* by brokers were not indicated as contingent commissions, but as other commissions.

It cannot be excluded that in some instances agreements that materially constitute contingent commission agreements may have been described somewhat euphemistically by respondents and have not been included in responses, thus leading to an understatement of the figures reported. In this context, reference may be made to the findings of the Spitzer investigation according to which agreements to pay contingent commissions were "*... styled as payments for nebulous services*"[67] and "*... that brokers routinely mislead their clients about the true nature of contingent commissions*"[68].

Irrespective of the formal categorization of agreements, it would appear that, depending on the amounts at stake and on the technicalities of agreements under which additional sums are paid by insurers to intermediaries, such payments could also cause a conflict of interest for the intermediary and create incentives to steer business to a particular insurer, even where not formally contingent on the achievement of any agreed targets.

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[67] Cf. Complaint, The People of the State of New York by Eliot Spitzer, Attorney General of the State of New York, Plaintiff, -against- Marsh & McLennan Companies, Inc. and Marsh Inc, -Defendants, p. 2.

[68] Testimony of State of New York Attorney General Eliot Spitzer to the United States Senate Committee on Governmental Affairs, Subcommittee on Financial Management, the Budget and International Security, Washington D.C. November 16, 2004, p. 6.

However, the data obtained in the framework of the sector inquiry did not allow for any concrete conclusions as to how widely spread and financially significant payments of this sort were in reality.

## 2.4 Observations received during the public consultation

The issue of conflicts of interest received a lot of attention in the public consultation. Below, an overview of the observations received is provided and the most relevant aspects are commented upon.

### 2.4.1 The prevalence of conflicts of interest in the market

Most respondents that commented on this issue, including brokerage firms and other representatives of insurance intermediaries, acknowledged the existence of conflicts of interests in the insurance mediation market.

For instance, the European Federation of Insurance Intermediaries (BIPAR), whose response to the public consultation was endorsed by a number of national associations of insurance intermediaries, noted: "Conflicts of interest, and potential conflicts, are ubiquitous in the financial services industry and are not unique to the insurance industry. Therefore, the fundamental issue is how to manage such conflicts or potential conflicts in the best interest of the client. BIPAR believes that it is essential that companies put in place robust systems to identify, manage and mitigate conflicts of interest."

A few respondents felt that potential conflicts of interest were mitigated by the degree of competition in the market that allegedly forced brokers to provide their clients with the best possible offers, as they could otherwise lose business to their competitors and/or suffer reputational damages. Also the professional standards set by brokers' industry associations or brokers' fiduciary duties established by jurisprudence were considered to be mitigating factors.

A number of respondents – representing insurers, brokers and clients - expressed concern about the lack of transparency in the mediation market, which was said to reduce the efficiency of the market, prevent clients from making informed choices or allow conflicts of interest to materialise. Two insurance associations made reference to past allegations that brokers had placed insurance contracts with companies that paid them the highest remuneration, or more generally, that brokers had failed to act impartially and to provide independent advice to their clients. One market participant observed with great concern a recent trend for creating integrated brokerage and underwriting agencies in the UK, alleging that this trend resulted in even more conflicts of interest and that rules on disclosure of such conflicts were insufficient.

### 2.4.2 Managing conflicts of interest

While there was little controversy about the existence of potential conflicts of interest, the responses received showed differences of opinion in relation to the question of how such conflicts needed to be managed, and if further regulatory/supervisory measures were necessary or if existing measures were sufficient. These issues will be discussed below.

#### 2.4.2.1 The Insurance Mediation Directive

Section IX.2.8 of the Interim Report made reference to the information requirements for insurance intermediaries according to the Insurance Mediation Directive ("IMD")[69] and enumerated some of these requirements. According to Article 12 of the IMD, insurance intermediaries must inform their clients, inter alia, whether they give advice on the basis of a 'fair analysis' or whether they are under a contractual obligation to conduct insurance mediation business exclusively with one ore more insurance undertakings. If the insurance intermediary informs the customer that he gives his advice on the basis of a fair analysis, the intermediary is obliged to give that advice on the basis of a sufficiently large number of insurance contracts available on the market, to enable him to make a recommendation, in accordance with professional criteria, regarding which insurance contract would be adequate to meet the customer's needs. The IMD also requires intermediaries to inform customers about capital links between the intermediary and insurance undertakings exceeding a certain threshold. Furthermore, it stipulates an obligation for the intermediary to specify, prior to the conclusion of any specific contract, the demands and the needs of the customer and the underlying reasons for any advice given to the customer on a given insurance product. It should be noted, however, that these information requirements do not apply when the insurance intermediary mediates in the insurance of large risks.

Several respondents, mostly brokers or their representatives, argued that some of the findings presented in the Interim Report reflected the fact that at the time of the inquiry's market surveys the IMD had not yet been implemented in two Member States[70] or that the national laws, regulations and administrative provisions implementing the IMD in other Member States had not been in effect for a sufficient period of time to be fully reflected in the responses provided by market participants. One respondent considered that, as far as transparency was concerned, the requirements of the IMD were more than sufficient. A few other respondents were of the opinion that the risk of conflicts of interest had to be seen in the light of information obligations pursuant to the IMD or that the IMD rules providing for a clear understanding of the status of the intermediary and of the nature of the advice offered allowed solving possible conflicts of interest.

These responses fail to recognise certain issues set out in the Interim Report. While it is true that the information requirements for intermediaries stipulated in the IMD increase transparency in relation to the status of the intermediary and the basis of the advice offered, the IMD does not address the types of conflict of interest highlighted in the Interim Report. More specifically, it does not contain any transparency provisions in relation to intermediaries' remuneration or to intermediaries' provision of services to insurers, both of which can constitute sources of conflicts of interest. Moreover, as pointed out above, the information requirements for intermediaries according to the IMD do not apply in relation to the mediation of large risks.

A few respondents made reference to stricter provisions adopted in some Member States that impose additional information or disclosure requirements on intermediaries[71]. Aspects relating to disclosure, other than status disclosure under the relevant IMD provisions, will be discussed in the following section.

#### 2.4.2.2 Disclosure and transparency

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[69] Directive 2002/92/EC of the European Parliament and of the Council of 9 December 2002, please refer to the Directive for full details of information requirements.

[70] As explained in section IX.2.8 of the Interim Report, at the time of the survey France and Germany had not yet implemented the Directive.

[71] Cf. Article 11(5) of the IMD, providing for this possibility.

The majority of respondents in the public consultation considered that transparency was essential in managing conflicts of interest, and that insurance intermediaries had to provide clients with sufficient information to make informed choices. Differences of opinion emerged in relation to the question of how much transparency was necessary or desirable, how transparency should be achieved in the market and whether or not disclosure alone was sufficient to manage conflicts of interest.

The majority of responses received concerned the issue of brokers' **remuneration**. Respondents from France and from the UK pointed to national rules on disclosure. Intermediaries that provide advice on the basis of a fair analysis have to disclose the commission received for insurance placed on behalf of a commercial client upon request of that client (in the UK), or upon request where the insurance premium exceeds EUR 20000 (in France). In the Netherlands, according to the national insurance association, further transparency of costs and commissions is currently a subject of discussion between the government, the supervisory authorities and insurers[72].

One respondent was concerned about possible unintended consequences of enhanced transparency, considering that brokers might conclude that it was no longer cost-effective to provide current levels of advice to SME clients, which could reduce the number of available brokers and, in turn, the pool of insurers to which the SME sector had access. A number of other respondents stated that, in particular, large corporate clients were generally well informed in respect of brokers' remuneration and increasingly dealt with insurance intermediaries on a fee basis, alleging that this provided for complete transparency of intermediaries' remuneration.

Respondents representing the client side contradicted these assertions and, in the vast majority of cases, spoke out in favour of greater transparency. In a joint response, three German associations stated that most brokers did not spontaneously disclose their remuneration to clients and that, in general, insurers and brokers followed a restrictive information policy in relation to intermediaries' remuneration. The Federation of European Risk Management Associations (FERMA) acknowledged that the large international brokers had made a significant effort to make some kind of disclosure following the Spitzer investigation, but noted a strong opposition to the disclosure concept from a large majority of the rest of the market, raising concerns about a distortion of competition. The concept of commission disclosure at the request of the insured was criticised, as this required that the insured was mature enough to make a judgment of the level of remuneration of the intermediaries. Where only larger clients were entitled to benefit from disclosure, this was said to go against the principle of equity. FERMA also noted that the description of the content of the disclosure was often vague and unclear with regard to the nature of remuneration of the intermediaries, and that contingent commissions were usually not disclosed. The British risk management association AIRMIC demanded that full disclosure of intermediaries' remuneration should occur automatically and for all clients, regardless of the size of the insured, and in all circumstances.

Also, a considerable number of representatives of the insurance industry and some brokers supported the concept of full transparency, pointing, for instance, to the fact that in the absence of spontaneous disclosure and transparency of both source and levels of remuneration a client was not able to make a fully informed decision on the insurance cover recommended or on its price. It was noted that the current market environment did not go far

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[72] Note also that legislation and market practice in relation to net quoting in the Nordic countries is explained in detail in section IV.1 of this report.

enough in protecting the brokers' clients and in creating a fair and level playing field for insurers; lack of transparency of intermediaries' remuneration was said to inhibit true competition among insurers around product, service and financial strength and to promote inferior capacity within the market, whereby insurers could effectively "buy" distribution. Furthermore, it was stated that commission rates were very high (above 40% of the premium) in some classes of business, and that the highest level of commission seemed to gravitate toward low loss ratio classes of business rather than business that required the most servicing or the most specialist knowledge. Insurers that wanted to participate in the market were said to be forced to pay such high commissions as they would otherwise not receive any broker business.

It was also pointed out that, even where rules did exist granting clients the right to request information about remuneration received by the intermediary, clients were often not aware of their right to information. Furthermore, rules on disclosure were said to be insufficient as they typically did not include other forms of remuneration besides standard commissions and were generally too vague; full disclosure would have to concern all relevant information, including full broker earnings related to the business placed, but also for instance, details of facultative reinsurance. It was said that clear standards for disclosure were necessary to achieve transparency, as brokers otherwise might disclose information in such a way that clients would not be able to draw meaningful conclusions on the potential for conflicts of interest. One respondent argued that it was too easy to 'move' commission from one part of the group to another in order to, for example, artificially depress the 'broking' commission, which would be disclosed to customers. Some respondents would prefer the introduction of national rules on disclosure over EU rules, as the former could, allegedly, take better into account the local market environments.

Brokers would like to see disclosure requirements extended to agents and other distribution channels, as they felt that this was the only way to guarantee a level playing field between intermediaries. Insurance associations disagreed with this argument, stating that conflicts of interest resulting in a possible provider bias did not concern insurers' exclusive agents.

None of the respondents to the public consultation spoke out strongly in favour of contingent commissions; one association expressed the view, however, that the effect of contingent commissions should not be over-rated as they, in their view, only accounted for 1% of intermediaries' revenue. This observation does not correspond with the findings of the market survey, which established that in some Member States, and for some brokers, revenue from contingent commissions reached considerable amounts[73]. One insurer defended the payment of profit commissions to brokers, stating that they were commercially useful for the insurer as they incentivised the broker to pay attention to the quality of the business placed. This argument, meant to support the payment of profit commissions, also highlights, however, the potential for conflicts of interest they create. Another respondent pointed out that the definition of contingent commissions used in the sector inquiry was too narrow, as it did not include volume commission where there were no targets at all, but merely an agreement to pay a further fixed agreed percentage of total premium received by insurers, usually paid later on a deferred basis; the true amounts of contingent commissions were thus said to be understated in the Interim Report. Several respondents considered that contingent

[73] It should also be kept in mind that some respondents failed to provide fully comprehensive answers to the Commission's request for information and, as was explained in section IX.3.4 of the Interim Report; the figures presented thereby in all probability understated the actual revenue from contingent commissions.

commissions should be legally prohibited. The resulting conflicts of interest could be difficult to solve by disclosure alone.

A limited number of comments received were related to conflicts of interest that result from intermediaries' providing **services to insurers**. Some respondents from the brokerage industry argued that the provision of certain services listed in the Interim Report was pro-competitive, for instance, by benefitting clients, creating efficiencies in the market or facilitating market entry by foreign insurers. The same respondents did, however, acknowledge the potential for conflicts of interest arising from the brokers' dual role, in particular where brokers act on behalf of insurers under delegated authorities. To manage such conflicts, mandatory full disclosure was perceived to be an important element. Respondents further pointed to the necessity to have robust systems and policies in place, which would include, for instance, that underwriting functions for insurers would have to be performed in a separate department or unit within the broking house.

### 2.5 Managing conflicts of interest – brokers' responsibility alone?

Several respondents indicated that, in their opinion, conflicts of interest should be dealt with under civil law, not competition law, as they mainly touched upon the brokers' fiduciary duties. Similarly, some representatives of the insurance industry asserted that conflicts of interest concerned the relationship between brokers and their clients and that their management thus was the brokers' exclusive responsibility.

Such statements may appear simplistic, however. Where insurers consciously take measures that are prone to expose brokers to conflicts of interest, they cannot evade responsibility by pointing to the brokers' responsibility to manage the resulting conflicts. This is the case, for instance, where insurers devise or agree to remuneration schemes that may be aimed at unduly influencing brokers' advice to clients and inciting them to place business (or business that responds to certain criteria) with the insurer concerned, even where competing offers may be better suited for the client.

As any other agreement between undertakings, agreements between insurers and brokers can be subject to scrutiny under applicable competition rules.

In its decision of 21 December 2006, the Hungarian Competition Office (GVH) established that certain agreements between two insurers and three brokers restricted competition and levied total fines of Ft 6.8 billion (EUR 27 million). The decision was based on national competition law, namely the Hungarian Market Practices Act, which is based on criteria comparable to European competition rules. The agreements that were found to infringe competition law concerned the distribution of motor third-party liability and all risk insurance cover through brokerage firms represented at the point of sale, i.e. through car dealerships, with the brokerage firms belonging to the same group of companies as the car distributors. The agreements included, for instance, volume-based contingent commissions and undertakings on the part of the brokers concerned to place a specified minimum number of contracts with the insurers concerned in a given (future) period of time. The Hungarian Competition Office considered that the agreements had the restriction of competition as their object and effect; by influencing the behaviour of insurance brokers in favour of the insurers concerned, they also caused welfare losses for the consumers and limited access to an important distribution channel for other insurers on the market. The agreements were part of a network of agreements where, in exchange for higher repair fees, the car dealers' broking firms favoured the products of the insurance companies concerned.

### 2.6 Conclusions on conflicts of interest

Brokers act both as an advisor to their clients and as a distribution channel for the insurer, often with underwriting powers and binding authorities. This dual role can be a source of conflict of interest between the objectivity of the advice they provide to their clients and their own commercial considerations.

Conflicts of interest that could jeopardise the role of brokers and multiple agents in stimulating competition in the insurance marketplace can also arise from a number of sources, linked to their remuneration, including contingent commissions and fees from services rendered to insurers. Despite a certain impact of the Spitzer investigation, contingent commissions are still part of the business practice of some of these intermediaries.

The market surveys and the public consultation highlight the fact that current market practices and the lack of spontaneous disclosure of relevant information by insurance intermediaries create an environment in which business insurance clients, in many cases, are unable to make fully informed choices.

Practices aimed at inciting brokers to place business with particular insurers undermine fair competition in the insurance market around terms and conditions of cover, service and insurers' financial strength. Such practices might, instead, result in insurers' competing against each other on the level of remuneration afforded to brokers in an attempt to "buy" distribution, or at the very least influence the broker's choice.

Disclosure of relevant information by intermediaries, in relation to remuneration received from insurers and services provided to insurers, may help mitigate conflicts of interest. At present, even where disclosure takes place, it does not always appear to be complete, clear and understandable to the client.

It is questionable if disclosure alone is sufficient to mitigate conflicts of interest, in particular in relation to those types of remuneration that specifically aim at aligning the interest of brokers with that of insurers.

## 3. COMMISSIONS AND COMMISSION REBATING

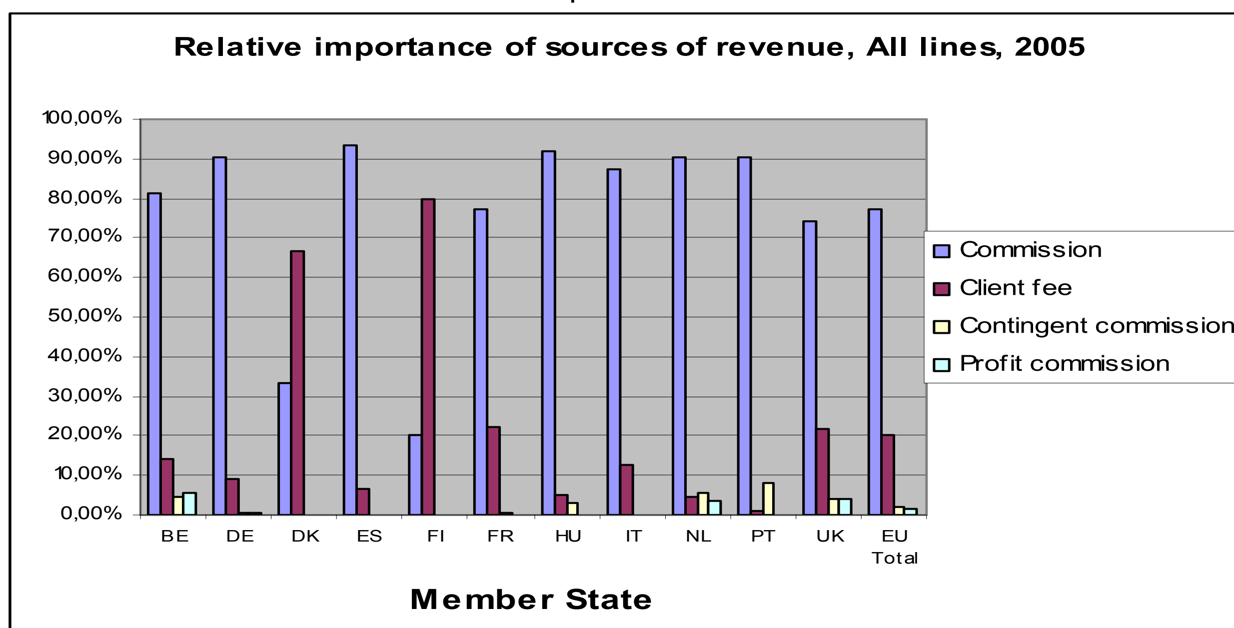
### 3.1 Background

The Interim Report examined the structure and the relative importance of the various components of brokers' revenue. In relation to insurance placement, brokers may receive remuneration in the form of client fees, commissions and, in certain cases, contingent commissions.

Client fees are paid either instead of, or in addition to, commissions paid by the insurer. Fee-based remuneration is far more common in relation to large corporate clients than to small and medium-sized enterprises. It is worth noting that the larger and international brokers, whose services tend to be used more frequently by the former client segment, generate a much higher share of their revenues from fee-agreements than small and medium sized brokers do. Our market survey showed, however, that, with the exception of the Nordic countries[74], commissions remain the most common form of brokers' remuneration in the EU in relation to insurance placement.

[74] Cf. the explanations in section IV.1 of this report on net quoting in the Nordic countries.

Graph IV.13




*Source: European Commission, Business Insurance Survey 2005-2006*

It is obvious that in the case of client fees, the terms of the intermediary's remuneration as well as the services to be provided by the intermediary are determined in negotiations between the client and the intermediary.

The Interim Report drew attention to the fact that in the case of commission-based remuneration the mediation service provided by the intermediary is bundled with the provision of the insurance cover. The price of the mediation service is agreed between the insurer and the intermediary, even though it is paid by the client as part of the insurance premium. The Interim Report raised the question, to which extent competition on the price of the mediation service itself was possible in the system of commission-based remuneration. It further highlighted that transparency of intermediaries' remuneration - a pre-requisite for any meaningful negotiation of the price of mediation services – was generally low across the EU[75].

The Interim Report also noted that the sector inquiry had not collected specific information on the prevalence of commission rebating by brokers, but that the issue could be further explored in the follow-up of the report, i.e. in additional fact-finding carried out by the Commission services and in the framework of the public consultation.

[75] For details on this, please refer to the Interim Report. It should be noted that subsequent to the Spitzer investigation in the United States a few brokers have adopted business reforms that provide for full disclosure of compensation received and the prohibition of certain types of compensation, in particular contingent commissions. In the Nordic countries, transparency of intermediaries' remuneration has been enhanced by the system of mandatory net quoting, which, however, has been controversially discussed in the public for other reasons, cf. section IV.1.

## 3.2 Additional fact finding

The Commission services requested specific information on the subject of commission rebating from a sample of insurers and brokers in France, Italy and the UK[76]. The results of this fact-finding exercise are detailed below.

### 3.2.1 France

Respondents from France explained that, as in Germany, French legislation did not allow intermediaries to actually share commissions received from insurers with the clients on whose behalf insurance is placed. By law, the payment or retrocession of commissions is only permitted to insurance intermediaries. Consequently, only clients that place their insurance through a captive ("in-house") broker may benefit from actual commission retrocession. Respondents agreed, however, that other clients could also negotiate a lower (than customary) commission rate with their broker; in such a case the broker would ask the insurer to decrease the gross premium invoiced to the client by the corresponding amount. Respondents further pointed out that whilst French tax legislation required that the insurance premium had to include a commission element corresponding to the intermediary's remuneration for placement of the policy; the intermediary's remuneration for other services provided to the client[77] could be subject to a separate fee agreement and did not need to be included in the insurance premium.

Brokers' responses as to the prevalence of commission rebating in the French market do not provide a homogeneous picture. While some respondents felt that this was not a customary practice, others stated that commissions were frequently reduced, but mostly in relation to large accounts. Several brokers stated that with large corporate clients a more common approach was to negotiate a fee that was paid by the client in lieu of commissions (to the extent allowed by French tax legislation, cf. above), but that in some cases reduced commission rates were negotiated taking into account the work to be done by the broker. At the same time, respondents agreed that small and medium sized enterprises benefited to a much lesser extent, if at all, from commission rebating. Insurers' responses were worded cautiously, indicating that the question of commission rebating concerned the relationship between intermediaries and their clients. Some respondents stated that commission rebating did not appear to be a general practice in the French market, but that it appeared to occur sporadically and mostly in respect of larger clients. Other insurers stated that the reduction of commissions (in the gross premium invoiced) was a regular practice in relation to large accounts - in particular where clients agreed a fee with the broker - but seemed more exceptional in relation to SMEs. Several brokers and one insurer also reported that insurers sometimes encouraged intermediaries to lower their commission rates, where a "joint effort" of insurer and broker was considered necessary to offer a lower gross premium to the client in order to retain that client.

[76] The questions on commission rebating were not included in the questionnaires sent to addressees in Germany due to the legal prohibition on commission rebating in Germany. The Interim Report had, however, highlighted strategies adopted by market participants in Germany that provided for more flexibility to negotiate commission rebates in the face of these legal restrictions. Brokers in Germany may conclude fee agreements with large corporate clients and ask insurers to quote on a net premium basis for such clients. The creation of captive brokers or captive insurance companies by large clients are other ways to evade the legal prohibition on commission rebating. It appears that SMEs are less likely to be able to resort to such strategies.

[77] For an overview, please refer to the definition of "client services" in the glossary.

All French respondents said that they were not aware of any agreements or practices of undertakings that would prevent or discourage independent intermediaries from rebating their commissions to clients or from advertising the fact that they may rebate commissions to clients.

The vast majority of the French respondents did not claim any possible efficiencies that could be created through agreements or practices aimed at preventing or discouraging commission rebating. Two brokers stated that, in their opinion, the quality of advice and client service as well as brokers' level of professional know-how[78] could deteriorate if the commission levels were too low, or that only large brokers would be able to undercut the market, and that consequently small and medium sized brokers could be squeezed out of the market.

### 3.2.2 Italy

Italian **insurers** stated that they had no knowledge of any agreements or practices preventing or discouraging independent intermediaries from commission rebating.

Some confusion appeared to exist among Italian **brokers**, however. One broker believed that the retrocession of commissions was not allowed or "disincentivized" by the brokers' industry association. Another broker stated that in the professional code of this industry association, there was a recommendation not to retrocede commissions, but that this clause was removed three years ago. Other brokers said they had no knowledge of any restrictions. Several of the brokers confirmed that they do rebate commissions, but typically only to the largest customers or in particular lines of insurance. One respondent stated that this occurred in particular when the client had a captive broker or managed a large group portfolio.

One broker indicated that they would be favourable to a ban on commission retrocession, on the claimed grounds that insurers would then quote lower premiums.

### 3.2.3 United Kingdom

UK insurers and brokers stated that commission rebating did occur in the UK market, but views varied as to how common this practice was. The prevailing view was that intermediaries rebated commissions (other than in the context of fee agreements) in some instances in order to win or retain business. Respondents felt that rebating was far more common with large corporate clients than with small and medium sized enterprises. On the other hand, respondents pointed out that policies for large corporate clients were frequently issued on a net basis, in which case the intermediary was remunerated by the client through a separately negotiated fee.

Insurers widely considered that commission rebating was part of normal competitive behaviour between intermediaries and that intermediaries had to compete with each other with respect to the level of service offered to clients as well as on the amount of their fees. Some insurers spoke out in favour of greater transparency of intermediary remuneration, which would increase competition among intermediaries in respect of both the levels of commission and the quality of service.

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[78] Based on the necessity to research relevant actuarial, legal and fiscal matters and to invest in professional training.

Some respondents made reference to the property investor/property owner market, in which it was "widely known" that commission rebates formed part of the negotiation process between the insured and the intermediary. It was stated that for insurance placed on behalf of property management companies some insurers "built" in much higher commissions than the market norm for similar classes in order to allow for the intermediary to "share" their commission with the property management company, which collected regular monthly insurance premiums along with rents for landlords on the buildings that they rent out. The practice was justified as a compensation for the administrative costs that otherwise the insurer or broker would have had to incur.

Neither brokers nor insurers were aware of any practices in the market that would prevent or discourage independent insurance intermediaries from rebating commissions to clients or from advertising the fact that they may do so.

None of the respondents identified any efficiencies that could result from practices that would prevent or discourage commission rebating.

### 3.3 Observations received in public consultation

A number of observations were received in respect of various aspects relating to the commission system as such and to possible competition on the price of the insurance mediation service including commission rebating.

Regarding the commission system as such - which the Interim Report had not, however, directly questioned - representatives of the brokerage industry considered that commissions constituted a simple and cost-efficient way of remunerating intermediaries, in particular as far as placement and servicing of smaller accounts was concerned. It was stated that commission-based remuneration made it possible to save on transaction costs, as no individual negotiation of fees and services to be provided in relation to the client's business was needed and no separate invoices concerning the intermediary's fees needed to be produced. Brokers also argued that the commission system could be advantageous for (in particular small) clients, since clients did not have to worry about additional costs, as the broker would normally provide a full package of services to the client that in the case of fee-agreements could be invoiced separately (e.g. claims handling services in the event of a loss occurrence). Furthermore, the fact that intermediaries provided clients with free quotes, and that clients only paid commission where the intermediaries' efforts actually led to the placement of a policy, was said to be in the interest, particularly, of small clients.

Some intermediaries confirmed their view, previously described in the Interim Report, that competition took place in respect of the overall (i.e. bundled) package consisting of the insurance cover and the services provided by the intermediary, alleging that the (separate) price of the mediation service was not a prime concern for the client. In relation to smaller commercial clients this position appeared to find a certain degree of support at the public Hearing on the Interim Report, held in Brussels on 9 February 2007, through the statements made by a representative of a European association representing the interests of SMEs. At the same time one association of intermediaries stated that they were firmly opposed to disclosure of independent intermediaries' remuneration as this would probably cause loss of business for independent intermediaries. One insurer argued that higher transparency of remuneration could result in a lower level of advice provided to SME clients, which could in turn reduce the pool of insurers to which the SME sector had access.

In contrast to this, a number of respondents considered that not only the level and quality of the service provided, but also the price of the insurance mediation services should

be subject to competition in the market or that the ability to rebate commission was part of the competitive dynamics. The assertion made by some intermediaries that SME clients were allegedly not interested in the cost of the mediation service was questioned by some respondents. One market participant, specialised in SME business, highlighted that the percentage of the insurance premium needed to cover the costs of commissions and insurer expenses was particularly high for SME-clients. Other market participants pointed out that, even for some smaller or medium sized risks, the terms and conditions of cover offered in the market could vary; consequently, it would be necessary to know the separate prices of the insurance cover and of the mediation service in order to assess and compare the merit of different offers. One of the large international brokers stated that if there was no spontaneous disclosure and transparency of both source and levels of remuneration a client was not able to make a fully informed decision on the insurance cover recommended or its price. Brokers would, however, like to see transparency of remuneration, if imposed, extended to include agents, in order, in their view, to create a truly competitive distribution market and level playing field.

Several respondents suggested that clients underestimated the percentage of their insurance premium paid as a commission to the intermediary. In this context, one respondent provided a detailed market study highlighting that basic commissions received by UK brokers on commercial business (excluding motor insurance) were nearly twice the average of what their commission-paying clients had estimated them to be in a survey.

As far as competition on the price of the mediation service itself is concerned, the public consultation confirmed the findings of our market survey in the three Member States described above. It appears that, typically, price competition only takes place in relation to larger clients (mostly through fee agreements, but sometimes through the negotiation of lower commission rates), reflecting the higher dependence of intermediaries on their large accounts and the higher level of expertise and buyer power of LCCs in relation to insurance matters and risk management.

### 3.4 Conclusions on commission rebating

The Interim Report explained that the prohibition of commission rebating by insurers could amount to resale price maintenance and, as such, would not benefit from the block exemption granted by the Regulation on vertical agreements and concerted practices. Horizontal agreements or concerted practices of intermediaries or decisions of their industry associations not to rebate commissions to clients would likely constitute restrictions of competition in the sense of Article 81 of the Treaty.

Market surveys conducted in three Member States and the public consultation have not produced evidence as to the possible existence of private agreements or practices acting to prevent or discourage independent insurance intermediaries from rebating commissions to their clients. However, responses submitted by Italian brokers indicate certain confusion as to the broker association's policy in relation to commission rebating and suggest a need for further clarification.

At present, the competitive market dynamics in relation to the price of mediation services appear limited, at best, as far as SME clients are concerned. The seemingly low concern of SME clients with the price of insurance mediation services may perhaps be due to a common misconception as to the amount of commission (and possibly other types of remuneration) actually paid to the intermediary included in their insurance premium.

# V. HORIZONTAL COOPERATION AMONGST INSURERS

Some forms of cooperation between insurers are at present block exempted by Regulation 358/2003[79], which succeeded to Regulation 3932/92[80]. The current Regulation block-exempts the following types of agreements in the insurance sector:

- the joint establishment and distribution of calculations and studies;
- the joint establishment and distribution of standard policy conditions;
- the joint coverage of risks;
- the establishment, recognition and distribution of technical specifications, rules and codes of practice on security devices[81].

The current Block Exemption Regulation (BER) was adopted with a validity of seven years and will thus expire on 31 March 2010.

In the Interim Report, it was observed that the actual use of the Block Exemption Regulation – meaning by this the degree to which the practices exempted by the Regulation are actually observed in the market – varies significantly across Member States and also by line.

In their responses, industry stakeholders usually observed that the forms of agreements and concerted practices exempted by the Block Exemption Regulation are in fact pro-competitive, implying that their absence in certain markets was more a matter of concern than their presence in others. Several respondents suggested that the absence of market-wide historical risk information or the unavailability of standard conditions (with an associated case law interpreting their scope) were barriers to entry in certain markets.

During the consultation, although few specific concerns with respect to the forms of cooperation covered by the BER were raised, some comments suggested that the BER might inadvertently have led to a diminishing of competition in some downstream related markets such as markets for security devices.

The vast majority of respondents, at least from the insurance community, were very much in favour of extending the current Block Exemption Regulation when it expires in 2010. Several respondents argued that the Commission should, in any case, not draw any firm conclusions as regards the future of the BER from the results of the Sector Inquiry, given that the latter only covered business insurance whereas the BER is wider in scope.

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[79] Commission Regulation (EC) No 358/2003 of 27 February 2003 on the application of Article 81(3) of the Treaty to certain categories of agreements, decisions and concerted practices in the insurance sector (OJ L 53, 28.2.2003, p. 8).

[80] Commission Regulation (EEC) No 3932/92 of 21 December 1992 on the application of Article 81(3) of the Treaty to certain categories of agreements, decisions and concerted practices in the insurance sector (OJ L 398, 31.12.1992, p. 7).

[81] Council Regulation (EEC) No 1534/91 empowering the Commission to apply Article 81(3) of the Treaty to the insurance sector covered not only the four types of agreements which are covered by the Commission's first and second Block Exemption Regulations but also agreements on claims settlement and on registers of aggravated risks. The Commission considered, however, that it did not have enough experience in relation to these two types of agreements as to include them in its first Block Exemption Regulation. It followed the same approach for the second Regulation.

The Commission services recognize the attachment of many in the industry, especially insurers, to the BER. However, they believe that it is necessary to set this debate in a wider context.

Firstly, almost all replies failed to make a distinction between the desirability of the forms of cooperation covered by the BER, and the desirability of the BER itself. In this context, it is necessary to recall that the objective of the BER before the entry into force in May 2004 of Regulation 1/2003, was to exclude certain generic types of agreement from the ambit of Article 81(1), thereby obviating the need for separate and time-consuming individual exemptions. However, since the entry into force of Regulation 1/2003 there is no longer any requirement on undertakings to notify forms of cooperation to the Commission which may fall within the scope of Article 81(1) in order to obtain a decision exempting those forms of cooperation under Article 81(3). Rather, undertakings may, and should, satisfy themselves through a process of self-assessment, aided as necessary by external counsel and other advisors, of the compatibility of their behaviour with the competition rules. The Commission no longer holds a monopoly in the public enforcement of Article 81(3) either, but shares this power with national authorities. This new enforcement regime is entirely dissimilar to the situation which prevailed at the time that the BER was initially adopted and subsequently renewed, when insurers were reluctant to engage in certain forms of cooperation because of the bottleneck of pending notifications at the level of the Commission and the consequent lack of certainty as to how the Commission would view the practice in question. The BER also served the purpose of allowing the Commission to clear some of this backlog of notifications and focus on issues of greater concern.

It is worth, in this context, recalling the Commission's policy stance on the air transport Block Exemption Regulation under the new enforcement regime created by Regulation 1/2003, as set out in *Commission Regulation (EC) No 1459/2006 of 28 September 2006 on the application of Article 81(3) of the Treaty to certain categories of agreements and concerted practices concerning consultations on passenger tariffs on scheduled air services and slot allocation at airports*. This Regulation replaced *Commission Regulation (EEC) No 1617/93 of 25 June 1993*, which expired on 30 June 2005.

In recitals 1 and 2 of Regulation 1459, the Commission notes that: "Since 1 May 2004, the air transport sector has been subject to the generally applicable provisions of Council Regulation (EC) No 1/2003 of 16 December 2002 on the implementation of the rules on competition laid down in Articles 81 and 82 of the Treaty. Regulation (EC) No 1/2003 provides that agreements which fall under Article 81(1) of the Treaty which satisfy the conditions of Article 81(3) are not prohibited, no prior decision to that effect being required. In principle, undertakings and associations must now assess for themselves whether their agreements, concerted practices and decisions are compatible with Article 81 of the Treaty."

The Commission noted, in that context, that there were not sufficient grounds to continue to declare by Regulation Article 81(1) inapplicable to agreements of the type concerned, but that "the airline industry should be allowed sufficient time to adapt to the new situation and to assess for themselves whether their agreements and practices are compatible with Article 81 of the Treaty and, if necessary, to amend them" (Recital 7). Accordingly, the new Block Exemption Regulation was adopted for a limited transitional period, until 31 December 2006, and it has now expired.

To the extent that this decision may constitute a precedent, and while recognizing that sectoral specificities should be considered, it is unlikely, in the case of insurance, that the Commission would consider a further transitional period necessary, given that the existing insurance BER already runs until 2010.

The main arguments advanced in support of an extension of the BER relate to legal certainty as to the antitrust status of a given practice, as well as enforcement consistency within the European Competition Network. It was also argued that the existence of the BER reduces legal compliance costs for the industry, and that public authorities rather than the industry itself might need to intervene in order to craft certain market solutions, such as standard clauses.

A certain number of respondents have argued that the BER itself lacks clarity and should be modified in some respects. This suggests that there may be a certain amount of confusion between the scope of what is unambiguously exempted under the BER and the larger set of agreements which is exempt under Article 81(3) and Regulation 1/2003 due to the efficiencies created. Claims settlement agreements are specifically cited as an area where insurers would like to cooperate more but, presumably, sometimes feel impeded from doing so (even if there is quite a lot of cooperation in this area in some Member States). The reasons put forward for any reluctance to cooperate in this area were not set out, however. In any event, the fact that claims settlement agreements are not mentioned amongst the forms of cooperation exempted by the BER certainly does not mean that these agreements are forbidden. On the contrary, an assessment under Article 81 (3) might lead to the conclusion that the efficiencies brought about outweigh the restriction of competition. The fact that many agreements of this type do exist also suggests that this assessment has been made by the industry without the need for the inclusion of this class of agreements in the BER. This suggests that the level of cooperation in pro-competitive arrangements might not be substantially lower in the absence of the BER, whilst there is always a risk that it inadvertently exempts certain anti-competitive arrangements.

Some respondents disputed that the insurance industry needs a special treatment under the antitrust rules.

In this regard, it is worth recalling that, even if the insurance BER were to lapse, this would not necessarily generate significant additional uncertainty as to the exemptability under Article 81(3) of the practices covered by it, and the Guidelines on horizontal cooperation agreements would apply[82]. This needs to be considered in any decision regarding renewal of the BER, but tended not to be taken into account in the replies received from the industry during the public consultation on the Interim Report.

Although the range of concerns related to allowing the BER to lapse is broad, it is fair to say that respondents have not provided very specific empirical evidence about problems that would arise if this were to happen.

This is a discussion that will continue, as under the terms of the enabling legislation the Commission is required to submit, by 31 March 2009, a report on the functioning and future of the BER[83]. Industry participants and other interested stakeholder are therefore very much encouraged to continue their reflection in the interim, focusing on the role of the BER in the legal order rather than the specific forms of cooperation which it covers.

[82] Commission Notice - Guidelines on the applicability of Article 81 to horizontal co-operation agreements (OJ C 3, 6.1.2001, p. 2).

[83] Article 8 of Council Regulation (EEC) No 1534/91 of 31 May 1991 on the application of Article 85(3) of the Treaty to certain categories of agreements, decisions and concerted practices in the insurance sector.

# VI. DURATION OF CONTRACTS IN THE BUSINESS INSURANCE SECTOR

## 1. INTRODUCTION

Amongst the various data concerning business insurance products and product design collected from insurance companies during the Sector Inquiry, the Commission services decided to focus their analysis on the duration of contracts and on the clauses concerning their renewal and extension, because of the competition concerns that the duration of contracts might potentially raise. Such concerns were also raised during the Sector Inquiry by some market participants.

In its Interim Report on the Business Insurance Sector Inquiry[84], it was noted that agreements of long duration (so-called long-term agreements) between an insurer and various business customers could raise competition concerns related to the risk of foreclosure of the relevant insurance markets to new entrants. In other terms, if customers are committed with the same insurer for a long period, this could affect competitors who are trying to gain access to the market or to increase their market share.

The Commission services note, however, that the definition of an agreement as a long-term agreement depends not only on the explicit contractual provision concerning the contractual period but also on the existence of automatic renewal/extension provisions and on the conditions for termination of such agreements by the business customer. The impact of such agreements on the market and accordingly their status under competition law also depends on a variety of other considerations which will be alluded to below.

In order to avoid any misunderstandings, the Commission would like to emphasize that it is concerned with the exclusionary effects of long term contracts under competition law when either (a) their cumulative effect causes market foreclosure, or (b) in the event that such contracts were used by a dominant undertaking to prevent or limit competition in violation of Article 82.

## 2. THE FINDINGS OF THE SECTOR INQUIRY

### 2.1. Duration of contracts

The findings of the Interim Report show that, as far as contracts for SMEs are concerned, in a majority of Member States, the average duration of contracts is approximately or a little over 12 months. However, in a few Member States (Austria, Slovenia, Italy and the Netherlands), the average duration was found to be much higher: in Austria it was calculated as approximately eight years (101 months), in Slovenia almost seven years (81 months), in Italy approximately six years (73 months), and in the Netherlands, approximately six years (79 months). In all four countries, the average duration exceeded six years for contracts relating to General Liability and Property insurance.

[84] See Chapter 7 – Duration of contracts in the Business Insurance Sector.

Data in the Interim Report showed that tacit renewal or extension of contracts was frequent in three of the Member States where the average duration of contracts was found to be high (Austria, Italy and the Netherlands).

In this context, further investigation was undertaken focusing on the factual circumstances specific to these Member States.

None of the respondents surveyed was in a position to provide information to establish a contrary picture in relation to the statistical findings of the interim report, although in certain instances respondents did express surprise in relation to the findings which they felt were not borne out by their subjective experience. Whereas respondents from Austria and Slovenia declared that they did not possess any information confirming the data on the average duration of insurance contracts presented in the Interim Report, the Italian undertakings generally confirmed these data and certain sources in the Netherlands acknowledged that in the case of property insurance the duration of contracts is on average still long (3 to 10 years).

The Commission's further fact finding has not, however, enabled it to add to the information contained in the interim report in relation to this theme, but only to dismiss or narrow potential concerns as indicated below. It is therefore underlined that in relation to those countries where concerns have not been eliminated, the Commission does not presently have sufficient information to conclude as to the existence of an infringement or, more generally, of a market structure which impedes entry. These matters therefore remain open.

### 2.1.1 Austria

The results of the further phase of fact-finding have been insufficient to allow the Commission services to eliminate their concerns related to long term contracts on the Austrian market.

Certain insurers active in the Austrian market suggested that long term agreements were simply a manifestation of customer loyalty. It was also suggested, but not explained, that ongoing liberalization in the Austrian insurance market might be expected to bring down average contract duration.

These interlocutors have also claimed that market entry is frequent and unimpeded and that one third of the insurers currently active in Austria are EEA insurers operating via branch offices. The Austrian industry and regulator are of the view that actual market entry has shown that the market is contestable. In addition, it is argued that there is a growing market potential in the business insurance market, e.g. through the development of rather new insurance lines such as director's and officer's liability insurance.

The Commission services are of the view that these explanations are, however, insufficient to dispel the concerns which it raised in the Interim Report and that it would be advisable to subject the situation in Austria to greater scrutiny.

Indeed, it has been suggested by some market participants that not only are average contract durations in Austria very long, but renewal practices also act to dissuade switching, since insurers and/or brokers attempt to renew ten-year contracts well before their actual expiry with allegedly favourable terms. At this moment, it may be impossible to obtain a competing quote given that coverage would not enter into force for a considerable period.

### 2.1.2 Slovenia

In the case of Slovenia, several considerations lead to the conclusion that the concerns expressed in the Interim Report related to the long duration of contracts have substantially diminished. The principal reasons for this are as follows:

Under the Slovenian Civil Code, it appears that insurance contracts concluded for more than 3 years can be terminated by any contracting party after the expiry of a period of three years from the date of signature of the contract. It is stated by the insurers' association that standard practice is to foresee termination clauses in business insurance which further foresee the possibility for the customer to terminate insurance contracts earlier on specific grounds. There is no fee for termination.

Slovenian respondents point to the effect on the Slovenian business insurance market of new entry subsequent to EU accession in May 2004.

It further appears that the market is not yet saturated. At the beginning of 2005 there were over 120 names on the list of companies which have obtained licences form the Slovenian Insurance Supervision Agency and wished to do business on the Slovenian market.

Finally, the Interim Report showed that whereas the percentage of insurers in the EU as a whole having made an affirmative reply to the question concerning the automatic extension or renewal of contracts is in general extremely high, this practice appears to be considerably less frequent in Slovenia, thereby diminishing potential foreclosure concerns.

### 2.1.3 The Netherlands

In the case of the Netherlands, there are some elements which allow the Commission services to eliminate the major part of their concerns.

The Dutch Civil Code provides for a legal right to terminate long-term insurance contracts after 5 years, giving 2 months' notice. Business insurance customers also have the possibility to agree terms which derogate from this provision and make it possible to terminate the contract before the expiry of this period.

Dutch industry respondents consider that the Dutch insurance industry is moving towards shorter terms (1-3 year terms) in the SME segment. It seems that annual contracts have long been standard practice in the Netherlands within the LCC segment (since 1990).

The Commission services do not have evidence that long term agreements have presented a barrier to entry for insurers wishing to enter the Dutch market.

In principle, there is no fee for terminating a contract on the terms foreseen for termination in either the contract itself or the law.

### 2.1.4 Italy

Whilst respondents in Italy acknowledge the past practice of long contract duration, it is anticipated that the situation will change with the entry into force of Law n°40 of 2 April 2007[85], enacting the Decree Law n°7 of 31 January 2007, which provides inter alia for the possibility for the insured to cancel a long-term insurance contract without penalty upon providing 60 days' notice to the insurer. The law has stipulated that those clauses in conflict with the provisions established by the law itself are to be considered null and void. The new provisions apply to contracts concluded as from 3 April 2007. For contracts concluded before

[85] Enacting the Decree Law No 7 of 31 January 2007.

that date, the right of withdrawal from the contract can be exercised only after 3 years as from the date of signature of the contract.

The Italian law came as a response to several concerns in the business insurance market, one of them being that insurance agents allegedly succeeded in tying their customers down through long-term contracts. Some market players have declared that this was no longer a real problem because the intermediaries do not propose long-term agreements any more. On the other hand, there are still a lot of residual long-term agreements underwritten in the past. It has also been argued that actual effective market entry in Italy has been low outside of niche segments.

It is too early to assess the real impact on competition caused by the new provisions on long-term contracts and actual customer behaviour. However, the new Italian legislation would appear to have the potential to remove part of the concerns in respect of excessive contract duration. It should be noted, however, that business customers (not only in Italy) also express the concern that they are often unable to obtain contracts of the duration they would wish[86] and by being forced to concede a unilateral option to cancel, there may be a risk that Italian insurers may raise the price of insurance or no longer offer contracts with the duration that the market demands. Therefore, it remains to be seen whether the solution to the problem found in Italy in fact improves the situation for customers.

## 2.2. Cumulative market coverage of the contracts

The longer the duration of contracts, the greater the possible foreclosure effect. In addition, it appears that tacit renewal or extension of contracts contribute to the chilling effect on customer's switching behaviour, particularly for smaller companies or risks.

In certain cases, the length of the insurance coverage offered by a contract is an essential characteristic of the product that is defined and offered by the insurance company because of the duration of the risk being covered and the desire of customers to obtain certainty as to terms and conditions of coverage from the outset. When contract duration is motivated by such objective factors, it seems doubtful that it could be seen as a restriction of competition[87].

However, if this is not the case, long-term agreements[88] between an insurer and various business customers could raise competition concerns related to the risk of foreclosure of the relevant insurance markets to new entrants[89]. In other words, if customers are

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[86] It is believed that this may be related in part to the prevailing annuality of reinsurance contracts.

[87] See, on this point, Wulf-Henning Roth, *European competition policy for the insurance market*, [2000] E.C.L.R., Issue 2, p. 107.

[88] The long duration of an agreement depends not only on the explicit contractual provision concerning the contractual period but also on the existence of automatic renewal/extension provisions, which, as mentioned above, are extremely frequent in the business insurance industry, and on the conditions for termination of such agreements by the business customer.

[89] Concerns relating to the impact of long-term agreement on the insurance markets have also been taken into account by the Commission when defining the conditions for the block exemption granted to agreements in the insurance sector (Commission Regulation (EC) No 358/2003 of 27 February 2003 on the application of Article 81(3) of the Treaty to certain categories of agreements, decisions and concerted practices in the insurance sector - OJ L 53, 28.2.2003, p. 8). The block exemption does not apply to cooperation concerning the drafting of standard policy conditions when such conditions contain clauses that: (a) impose on the policyholder in the non-life assurance sector a contract period of more than three years; (b) impose a renewal of more than one year where the policy is automatically renewed unless notice is given upon the expiry of a given period (See article 6.1 f) and g) of Commission Regulation (EC) No 358/2003).

committed with the same insurer for a long period, this could affect competitors who are trying to gain access to the market or to increase their market share.

This might happen when long-term agreements "combine with other factors to have a cumulative effect on competition"[90]. As stated by the Court, however, the assessment of the foreclosure effects of long-term agreements will also depend on the assessment of other factors pertaining to the economic and legal context of the agreement. These factors are related, on one side, to the "real concrete possibilities for a new competitor to penetrate the bundle of contracts"[91] and, on the other, to the conditions under which competitive forces operate on the relevant market[92]. Notably, the analysis should focus on issues such as the number of similar contracts, their duration, the share of the market that this type of agreements covers, the degree of market saturation and customer loyalty.

The Commission Notice on agreements of minor importance[93] provides that "A cumulative foreclosure effect is unlikely to exist if less than 30% of the relevant market is covered by parallel agreements having similar effects".

In case there is a cumulative effect on the market, then it is necessary to assess the extent to which the agreements entered into by the specific insurer contribute to the cumulative effect produced by the totality of similar contracts found on that market[94].

If this assessment confirmed the existence of an appreciable restriction of competition within the meaning of Article 81(1) EC, it would then be necessary to establish whether the agreement at stake fulfils the conditions for exception set out by Article 81(3) EC.

As a contract between an insurer and a business customer is a vertical agreement (i.e. an agreement between two undertakings operating at a different level of the production or distribution chain), it could benefit from the block exemption granted by the Commission through the Regulation on vertical agreements and concerted practices (Vertical Block Exemption Regulation)[95].

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[90] See case 23/67, *Brasserie De Haecht v Wilkin*, [1967] ECR 407, at 415.

[91] See case C-234/89, *Stergio Delimitis v Henninger Bräu AG*, [1991] ECR I-935, paras 21.

[92] See case C-234/89, *Stergio Delimitis v Henninger Bräu AG*, [1991] ECR I-935, paras 22.

[93] Commission Notice on agreements of minor importance which do not appreciably restrict competition under Article 81(1) of the Treaty establishing the European Community (de minimis) (OJ C 368, 22.12.2001, p. 13).

[94] See case C-234/89, *Stergio Delimitis v Henninger Bräu AG*, [1991] ECR I-935, paras 24-27. It must be noted that the jurisprudence at stake concerns the foreclosure effect at distribution level. Restrictions on access at distribution level could however be overcome by strategies of vertical integration or by developing or using alternative distribution channels. When foreclosure is at the level of the final consumer, as in the case of long-term insurance contracts, competing insurers trying to enter the market cannot develop these types of strategies. (See, on this issue, Wulf-Henning Roth, *European competition policy for the insurance market*, [2000] E.C.L.R., Issue 2, p. 115).

[95] Commission Regulation (EC) No 2790/1999 of 22 December 1999 on the application of Article 81(3) of the Treaty to categories of vertical agreements and concerted practices (OJ L 336, 29.12.1999, p. 21). The Vertical Block Exemption Regulation grants a block exemption to long-term agreements entered into by insurers whose market share does not exceed 30 %. The benefit of the block exemption could however be withdrawn in case a specific agreement "nevertheless has effects which are incompatible with the conditions laid down in Article 81(3) of the Treaty, and in particular where access to the relevant market or competition therein is significantly restricted by the cumulative effect of parallel networks of similar vertical restraints implemented by competing suppliers or buyers" (emphasis added - See Article 6 of the Vertical Regulation). Moreover, in case of parallel networks of similar vertical restraints covering more than 50 % of a relevant market, the Commission may declare by Regulation that the block exemption does not apply to agreements containing that specific restraint in that market (See Article 8 of the Vertical Regulation). These Articles

The existence of the cumulative effect should also be assessed from the perspective of the source of new clients on the market. If the bulk of new clients can only be recruited among the already existing customers, then the cumulative effect is more likely to have a foreclosure effect.

Some of the respondents to the Public consultation consider that the termination rights may significantly enhance the clients' ability to switch their insurance company and that the mere existence of termination rights acts as a competitive constraint on the client's insurance company.

Anyway, it should be noted that there are often additional incentives for a buyer not to make use of termination rights, like rebates on premiums, which could amount to en effect that is similar to de facto long term agreements.

Also, a notice period is another element which has to be considered when assessing the duration of a contract, as a lengthy notice period lowers the likelihood of successful switching.

The actual length of the contractual relationship on a specific market has to be taken into consideration and emphasis should be put on the assessment of the real opportunities for access by new entrants.

### 2.3. Efficiencies

A number of respondents to the public consultation drew attention to efficiencies brought about by the conclusion of long term agreements.

It appears that sometimes long term agreement are requested by clients as they save time and costs involved in developing a new relationship or because clients may not be willing to divulge sensitive information on a regular basis.

Customers might want to benefit from rebates on premium or from the stability of premium level, which would allow the customers to better manage the risks related to adverse price movements. Insurance contracts covering the entire life of an asset may have several advantages, including when that asset is pledged as collateral.

This benefit is mitigated, however, to the extent that it appears to be universal practice that insurers have the unilateral right to terminate contracts in the event of a claim.

Also, it was mentioned that the automatic renewal clauses protect customers in ensuring that they are covered in any circumstance, even if they forget to explicitly renew. In addition, since the customer is able to terminate the contract, other insurers are not prevented from entering the market.

All the efficiencies possible invoked within a specific market investigation would need to be considered on a case by case basis. However, it is necessary that the benefits which for certain customers may represent real value are not outweighed by the negative foreclosure effects of long-term contracts on competition and consumer welfare.

## 3. CONCLUSIONS

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show that concerns relating to the cumulative effect of parallel networks have received a specific attention when defining the conditions for the Vertical Block Exemption Regulation.

The analysis developed above gives some indications as to the issues that should be taken into account when assessing potential competition concerns raised by long-term agreements in the business insurance sector.

As a basic principle, freedom of contract should underlie the organization of markets unless such freedom leads to anti-competitive market foreclosure, in which case it should be curtailed only to the extent necessary to protect consumers' interest.

Whilst in certain circumstances the Commission is able to intervene under competition rules, this is not always the preferred route. In the present instance, the Commission services believe that it would be appropriate to consider the situation in Austria further, without prejudice to the route that this might take. As indicated in the Italian case, regulatory intervention could alleviate concerns under the competition rules.

# VII. CONCLUSIONS

## 1. FINDINGS OF THE SECTOR INQUIRY

The Final Report of the Sector Inquiry focused on five aspects of the provision of insurance to businesses in the EU: the financial performance of the insurance industry (though not intermediaries); the issue of alignment of terms and conditions in ad hoc coinsurance and reinsurance; the structure, function and mode of remuneration of distribution channels; horizontal cooperation among insurers including the Block Exemption Regulation; and duration of contracts.

As far as the **financial aspects of the industry** are concerned, although it is impossible to be conclusive, it appears from the analysis conducted that profitability is quite high in business insurance at the EU-25 level, but also very variable by line or geography. The profitability of the brokerage channel was not assessed. The extent of variation in profitability indicates an important degree of market fragmentation and the potential scale for more efficient markets leading to lower prices in several Member States and perhaps also the EU as a whole.

On **reinsurance and coinsurance**, the inquiry looked at arrangements whereby ad hoc (re)insurance syndicates are formed, particularly with the assistance of brokers. It found that, while use of a formal "best terms" clause appears currently to be in decline, it is nonetheless widespread practice in the market to conclude such agreements on identical terms for all participants, including, most worryingly, premiums. To the extent that this involves agreements or concerted practices between undertakings, these may well fall within the scope of Article 81(1) and there are indications that they might then fail to meet all the conditions of Article 81(3). However, this would need to be determined on a case-by-case basis.

On **distribution channels** for business insurance products, it is noted that certain distribution structures (e.g. networks of exclusive agents) can, under specific circumstances, act as entry barriers. Conversely, the existence of a broker channel can facilitate market entry for foreign insurers. However, the predominant mode of remuneration of brokers, namely commissions paid by insurers, is characterised by a lack of transparency in respect of the (separate) prices of the insurance cover and of the mediation service, which reduces the scope for competition in the market and is susceptible to creating conflicts of interest that risk to be damaging to the interests of customers and leading to higher prices. This is all the more so when additional remuneration is paid by the insurer to the broker that is contingent on the achievement of agreed targets relating to the business placed by the broker with that insurer. Any form of remuneration that has the capacity to unduly influence brokers' advice to clients might harm competition in the insurance market for the provision of the most suitable insurance products and services to clients and might, instead, result in insurers' competing against each other on the level of remuneration afforded to brokers. Full and automatic disclosure of relevant information by intermediaries to their clients about remuneration received from insurers and services provided to insurers could help mitigate conflicts of interest, but may not be sufficient to mitigate such conflicts in relation to those types of remuneration that specifically aim at aligning the interest of brokers with that of insurers.

Commission rebating can be a way for brokers to compete on the price of the mediation service provided to clients. Market surveys conducted in three Member States (UK, France and Italy) and the public consultation have not produced evidence as to the possible existence of private agreements or practices acting to prevent or discourage independent insurance intermediaries from rebating commissions to their clients. However, responses

submitted by Italian brokers indicate certain confusion as to the broker association's policy in relation to commission rebating and suggest a need for further clarification. At present, competition on the price of the mediation service takes place primarily through fee agreements that are almost exclusively concluded with large corporate clients. The actual rebating of commissions, even if permitted, appears to be uncommon in general and very rare in relation to small and medium sized clients. The unequal scope for competition on the price of mediation in respect of large and small and medium sized business insurance clients is solidified in Germany due to a legal prohibition on commission rebating (similar restrictions exist in France), which can be circumvented by large clients through the creation of in-house brokers or the conclusion of fee agreements with brokers, in which case business is placed on a net quote basis with the insurer. At the same time, resulting from the general lack of transparency in the market, it appears that SME clients grossly underestimate the cost of mediation and may therefore be less inclined to engage in negotiations with their broker.

The Sector Inquiry showed that **horizontal cooperation among insurers** varied substantially between insurance lines and from one Member State to another. Although the evidence suggests that the practices covered by the BER are in most cases unproblematic or even desirable in the market, this is not by itself a compelling reasons to renew the BER, which may also cover some practices which distort competition. However, a final decision on this matter has not yet been taken and is outside the scope of the Report.

On the **duration of business insurance contracts**, the inquiry has concluded that there may be problems in Austria leading to higher barriers to entry and this needs to be further examined. In the case of Italy, it is believed that there were problems in the past but that the situation is likely now to change. The Commission services will keep the situation in Italy under review.

## 2. NEXT STEPS

The Commission services plan to engage in dialogue with the parties concerned by the various issues identified above, with a view either to clarifying the situation, modifying behaviour, or, if necessary, proposing enforcement proceedings. This process will be carried out in accordance with normal competition advocacy and enforcement procedures.

The Commission services welcome comments on the report, which should be sent to the email address: Comp-Sector-Insurance@ec.europa.eu.

# ANNEX 1 – NOTES ON METHODOLOGY

Certain notes on limitations in the methodology and reliability of data gathered and underpinning some parts of the analysis in the Final Report were noted in the Interim Report and it is useful to summarize them again here.

Firstly, there was often some difficulty in obtaining data relating exclusively to business insurance or isolating such data from that which related to a broader field of insurance. Data on insurance usually distinguishes between life and non-life insurance, but within the later category there is rarely, if ever, a division between business insurance and 'personal lines' of insurance. So, in some cases, non-life insurance had to be taken as a rough proxy for business insurance.

Secondly, just as published data rarely distinguishes between business insurance and personal lines of insurance it rarely, if ever, distinguishes between different customer segments within business insurance, and notably between small and medium-sized enterprises (SME) and large corporate clients. If insurance companies have information systems which make such a distinction, they are unlikely to be aligned on the definitions used by the Commission services in their survey. This introduced an inevitable element of estimate into the data furnished by companies.

Thirdly, insurance contracts can be complex, and there is a huge range of different products. As a consequence, there are many ways of classifying the various lines of insurance. Reporting entities, whether public or private, rarely adopt precisely the same classification. Further difficulties arise as a consequence of the use of different boundaries for classes of insurance which appear to be common; for example, the inclusion of accident and health insurance sold by non-life insurance companies in some figures relating to non-life insurance and its exclusion from others.

There are a number of areas where the data generally are very thin in either some or all EU Member States. A key example concerns insurance distribution. While information on premium volumes is available from at least one reliable source in every Member State, detailed and accurate information on distribution channels is rarely available. In the case of some Member States there appears to be an almost complete absence of such data at national level.

While the academic literature consulted on insurance was often found to be useful and of high quality, the volume of such literature (especially in Europe) appears to be quite small when compared with the scholarly work that is available in other areas of finance, such as banking and securities markets.

# ANNEX 2 – DEFINITIONS

Please note that the definitions provided below are exclusively for the purpose of the report and do not necessarily correspond to the definitions contained in EU insurance legislation.

## Acronyms for Member States

AT – Austria
BE – Belgium
CY – Cyprus
CZ – Czech Republic
DE – Germany
DK – Denmark
EE – Estonia
EL – Greece
ES – Spain
FI – Finland
FR – France
HU – Hungary
IE – Ireland
IT - Italy
LT - Lithuania
LU - Luxemburg
LV - Latvia
MT - Malta
NL – The Netherlands
PL - Poland
PT - Portugal
SE - Sweden
SK - Slovakia
SL - Slovenia
UK – United Kingdom

## Affinity groups/buying group/retailers

Groups with common needs which arrange insurance for their members (e.g. Federation of Small Businesses, industry groups and associations)

## Agency

The relationship with an insurer with whom an intermediary is able/authorised to place commercial insurance, taking into account the intermediary company's/group's rules on cooperation with insurers (for instance, a list of “approved insurers”), as well as the insurers' readiness to accept the business.

## Active agency

The relationship with an insurer with whom an intermediary did actually place some business during the reference period (i.e. year 2005), excluding any revenue/activity in respect of prior years/adjustment of prior year placements.

## Business insurance

The provision of insurance products and services to any type of business, irrespective of its size, form of organisation or legal structure.

## Classes of insurance

### *Property/Business Interruption*

Physical damage to property or loss of revenue arising from damage to property of any kind and by any risk not specifically mentioned below. This includes technical and machinery insurance related to property as well as machinery interruption.

### *MAT*

Class of insurance that includes the following:

**Marine**

Blue water and brown water hull and liability risks, including Protection & Indemnity risks and other associated risks.

**Aviation & Space**

Aviation and space hull and liabilities risks, including Aviation and Space Product Liabilities and associated risks.

**Transportation**

Cargo and goods-in-transit coverage.

### *Motor*

Legal liability for (A) death, bodily injury or damage to property arising from the ownership, operation or use of a motor vehicle and (B) physical damage to owned or hired vehicles.

### *Liability*

Class of insurance that includes the following:

**General Liabilities**

Includes public liability, product liability and employers' liability, including residual employers' liability where there is state provision of primary employee cover. Legal liability for death, bodily injury or damage to property arising from the business or the manufacture or sale of products.

**Professional Indemnity/E&O (errors & omissions)**

Legal liability for the provision of negligent advice or services (not related to the sale of a product) that results in financial loss or death, bodily injury or damage to property.

**Environmental Liabilities**

Legal liability for bodily injury, death or damage to property as a result of gradual pollution or of other sudden pollutions excluded from general liability insurance. Includes clean-up costs and remediation costs and bonds associated with environmental risks.

**Directors' & Officers' Liability**

Indemnifying companies and (where allowed by law) individual directors & officers from personal liability and financial loss arising out of wrongful acts committed or allegedly committed in their capacity as corporate officers and/or directors.

### *Personal Accident/Medical Expenses*

Injury to individuals or employees, or private medical expenses, where insurable, where benefit is paid to the individual or used to reimburse the company for benefits provided, including Key Man insurance protecting the business from the impact of injury of specific key employees.

### *Credit and suretyship*

Insurance against non-payment by debtor/s where goods or services have been supplied. Includes export credit coverage, surety and bonds.

## Cross-border insurance mediation activity

Cross-border insurance mediation is to be understood as business placed on behalf of a client established in a Member State different from that in which the intermediary is domiciled.

## Foreclosure

Strategic behaviour by a firm or groups of firms to restrict market access possibilities of potential competitors either upstream or downstream.

## Group

The group to which a company belongs includes:

**(a)** the company itself;

**(b)** the companies in which the company referred to in (a), directly or indirectly:

- (i) owns more than half the capital or business assets, or
- (ii) has the power to exercise more than half the voting rights, or
- (iii) has the power to appoint more than half the members of the supervisory board, the administrative board or bodies legally representing the undertakings, or

(iv) has the right to manage the company's affairs;

**(c)** the companies which have in the company referred to in (a) the rights or powers listed in (b);

**(d)** the companies in which a company as referred to in (c) has the rights or powers listed in (b);

**(e)** the companies in which two or more companies as referred to in (a) to (d) jointly have the rights or powers listed in (b).

## Insurance distribution channels

**1. Direct** – insurance arranged between insurer and insured with no intermediary involvement (including through insurer's company staff and call centres, but except 2).

**2. Internet** – insurance arranged by the insured where contact and underwriting is processed directly through the insurer's website.

**3. Exclusive Agent** – an intermediary who is acting as an agent of the insurer and who is under exclusive agreements to refer business to one insurer or otherwise constrained by agreement to refer business to one insurer (except 5 below).

**4. Other Agent** – an intermediary who is acting as an agent of the insurer and who has multiple insurer agency agreements (except 5 below).

**5. Bank** – a bank or other lending institution acting as an insurance agent or insurance broker.

**6. Insurance broker** – an intermediary acting as agent of the insured, who is not tied or constrained by agreement to refer business to an insurer (except 5 above).

## Insurance Mediation Directive (IMD)

Directive 2002/92/EC of the European Parliament and of the Council of 9 December 2002 on Insurance Mediation, OJ L 9, 15.1.2003

## Large Corporate Clients (LCC)

Businesses exceeding one of the thresholds provided in the definition of small and medium-sized enterprises (cf. definition below) are considered large corporate clients (LCC).

## Net quote

Premium quoted net of all commission.

## Renewal notice

Notice sent to the policyholder and/or the intermediary reminding them that an insurance policy is due for renewal and/or stating the renewal premium due.

## Services provided by intermediaries

### *a) Client Services:*

**Insurance placement**

Arranging insurance on behalf of a client, including advice before and after the placement related to that insurance.

**Claims management services to clients**

Advice or administrative services, separately charged, which relate to the management of claims to the insurance placement clients.

**Loss Assessment**

Representing claimants, for whom the broker did not place the insurance being claimed upon, in formulating claims and securing payment on their behalf.

**Legal services**

Giving legal advice, whether related to insurance matters or other issues, in exchange for a separate fee.

**Captive management**

The establishment and management of insurance companies on behalf of insurance placement clients, including such services to the clients of other insurance intermediaries.

**Risk management**

Advice to clients on the management and/or financing of:

(1) risks other than insurable risk or

(2) risks that may be managed or financed by techniques other than insurance, including the use of self-insurance and of captive insurance companies.

**Risk control**

Advice to clients on risk identification, assessment and control including workplace health & safety, hazard management, environmental management and risk related training services.

**Installment premiums/premium credit**

Provision of installment premiums/premium credit, including commissions paid by third party providers and specific revenues paid by insurers for the sale of their premium credit services.

**Financial planning**

The provision of financial advice, including investment, pensions and mortgage/loan advice, for third parties, whether individuals or legal entities.

**Asset management**

The provision of transactional services related to investments and mortgages/loans for third parties, whether individuals or legal entities.

## *b) Services to Insurers:*

**Reinsurance broking**

Arranging reinsurance on behalf of an insurer, including advice before and after the placement related to that reinsurance.

**Insurance underwriting**

Underwriting risks on behalf of an insurer or a panel of insurers, which includes all or any of the setting of terms and premiums, binding of cover and agreement of claims, and also including profit commissions paid by insurers on client portfolios or segments thereof.

**Loss Adjusting**

The provision of independent advice to insurers and to their clients in the establishment of the cause of a loss, the validity of any claim and the quantum of that claim.

**Claims management**

Providing advice or administrative services relating to the management of claims to the intermediary's reinsurance clients, where the former are separately charged for that service.

**Claims administration**

Providing insurance companies with services related to the handling of claims made against them by their direct clients, whether mutual clients or not.

**Policy administration**

Providing insurance companies with services related to the issuing of policies, endorsements and other documentation, including cover notes and certificates, to their direct clients, whether mutual clients or not.

**Accounting services**

Providing insurance companies with services related to the collection of premiums and the settlement of claims to their direct clients, whether mutual clients or not.

**Risk modelling**

Assessing and reporting to insurers on probable risk outcomes for specific risks or risk portfolios.

### Risk surveying

Assessing and reporting to insurers on risks, including client and third party risks, where a fee is paid by insurers for the service.

## Small and Medium Sized enterprises ("SME")

Any company whose staff number is below 250 people and whose turnover is under 50 MEUR (million EUR). Micro-companies are thus also included in the SME category. Businesses exceeding these thresholds are considered large corporate clients (LCC).

## Sources of revenue (intermediaries)

### Commissions

Revenues paid by insurers or reinsurers where the amount payable is fixed as a percentage of the premium for the policy placed, also including any subsequent additional revenues from the adjustment of premiums subsequent to original placement.

### Client Fees

Revenues paid by clients either in addition to, or instead of, commissions paid by the insurer/reinsurer.

### Contingent Commissions

Any kind of payment (excluding client fees and commissions as defined above) paid by insurers to intermediaries that are not exclusive agents of the insurer, where the amount payable is based on the achievement of agreed targets relating to the business placed by the intermediary with that insurer.

### Profit Commissions

Commissions or fees paid by insurers for the achievement of profitability targets or otherwise related to the profitability of the insurer's book of business with the intermediary. To the extent that they are not paid to exclusive agents, profit commissions are a sub-category of contingent commissions, exclusively related to profitability.

# ANNEX 3 – INTERPRETATION OF COMBINED RATIOS

## 1. ACCOUNTING FOR EXPECTED FUTURE CLAIMS

The combined ratio is affected by rules currently applying to the EU insurance industry relating to the mode of reserving for future claims. The technical details of these rules are beyond the scope of this Report and complex. Their objective is to ensure that customers of insurance companies may be confident that, having paid their premium, the insurance company will be able to honor any future claims. The loss ratio as reported by insurers is based on provisions for future claims which are subject to rigid accounting rules as well as, inevitably, the insurer's own calculation of the risk involved. Thus, it is not perfectly accurate to view the loss ratio as representing the expected margin before expenses on the premiums booked.

Accounting rules appear to raise at least two issues in relation to the combined ratio as it is reported by insurers.

The first of these is related to a requirement to reserve claims at nominal value. Assume a premium of 100 is charged today, there are no expenses and the combined ratio is 100. This means that a claim of 100 is expected, but it says nothing about when. Let us suppose that it is expected to be paid in one year's time. The full 100 of premium will be set aside for this purpose today. However, this 100 will be invested by the insurer and thus, in one year's time, the insurer will have more than 100 available. For example, if it is invested at a risk free rate of 4%, the insurer will actually have 104 in one year's time, from which it will make a profit of 4. This profit is generated by today's business, but does not appear in the combined ratio but rather as an investment return. For this reason, the Commission services believe that the combined ratio underestimates profits by at least the risk-free rate.

A second issue concerns whether what is reserved is actually the expected (nominal) value of future claims, or a higher amount. In principle, if the expected value is reserved, then 50% of the time, actual losses will exceed this value. Regulators are unlikely to view a 50% probability of default as adequate, and so might require a reserve policy which overstates the expected value of future claims. To a certain and perhaps great extent, this concern will be offset by the law of large numbers when the insurer holds a large and diversified portfolio. However, certain risks are of such a nature that they cannot be offset fully through this mechanism and particularly not over a single-year period. Thus, it is to be expected that what is reserved is not the expected value of future claims, but a higher amount. This effect acts to further bias the combined ratio towards a value which is indicative of lower expected profits than in fact is the case.

Of course, this is later balanced by a reserve adjustment in the books, but this reserve adjustment apparently does not figure in the calculation of the combined ratio.

## 2. THE EFFECT ON THE COMBINED RATIO OF THE MODE OF DISTRIBUTION

The combined ratio is also a function of the mode of distribution and of how premiums are booked by insurers. Also for this reason, it tends to underestimate profitability. In this section, this point is illustrated by means of an example.

Let us imagine, for the sake of argument, that a given risk has a pure premium for the insurer (average expected payout in the event of a claim) of 40 and cover is available either through a tied agent or a broker. The insurer targets a profit of 20 over and above the pure premium and realizes this in all cases.

Case 1. Assume the broker channel costs the same as the tied agent – 30 – but realizes an economic profit by means of commission at 40% on the amount paid by the client. Thus, the cover costs the client 90 if bought through the tied agent and 100 if bought through the broker. In either case, the insurer obtains its profit of 20 and, in the second scenario, the broker obtains an additional profit of 10.

- Tied agent scenario: loss ratio 40/90, expense ratio 30/90, combined ratio 70/90 = 78%.
- Broker scenario: loss ratio 40/100, expense ratio 40/100, combined ratio = 80%.

However, both scenarios represent identical profits for the insurer.

This demonstrates that the combined ratio can be biased merely by the mode of distribution. It is biased upwards if the broker channel is more expensive. If it is further considered that this figure still does not capture the profit internalized by the broker so that the real "combined ratio" for the value chain in the latter scenario is in fact 70%, there is a further reason to be cautious in interpreting the results found.

Case 2. Let us suppose, as also may happen, that the broker in the previous case receives the client's payment and passes it on net of commission to the insurer. In this case, the latter will book 60 as premium and no corresponding expense. Its combined ratio is then 40/60 or 67%, which *overstates* even the profit in the whole chain. The insurer has still made precisely the same profit of 20.

Case 3. Let us now assume that the brokerage channel is less expense, both channels price at cost and the broker has lower costs – the tied agent channel still costs 30 but the broker only 20. For distribution through the tied agent channel, the insurer again charges 90 and achieves a combined ratio of 78%. Through the broker channel, the price is 80. If the insurer books this as a premium and the broker's fee – 20 – as an expense, the combined ratio is 40/80 + 20/80 = 60/80 = 75%. If the broker passes it on at net value, then the insurer again has a combined ratio of 40/60 = 67%.

This shows that the combined ratio may be a poor measure of profitability and also underlines that it may fail to capture costs and profit in the independent distribution part of the value chain. Nonetheless, for the reasons explained in the main body of the report, for practical reasons it has often been relied upon as an indication of insurers' profitability, and for relative comparisons its weaknesses are fewer than if considered an absolute measure.